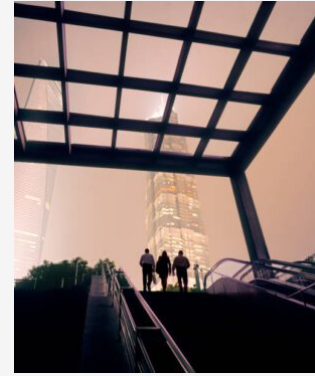


Secondary transactions in private equity: planning, governance and exit readiness

JANUARY 22, 2026 6 MIN READ



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Key Takeaways

- Sponsor-to-sponsor secondary transactions are an interesting alternative for sponsors looking to sell their stake in portfolio companies when other exit opportunities are unavailable or suboptimal.
- On the sell-side, careful planning and negotiation is required to ensure that the portfolio company is on board and cooperates with the sale process.
- On the buy-side, the incoming investor needs to structure its investment and the portfolio company's governance documents such that a streamlined exit route is available for the future and can be executed in a timely manner, with minimal hurdles and in line with its investment horizon.

Introduction

Private equity investors are increasingly turning to sponsor-to-sponsor secondary sale transactions, both to achieve timely exits and to deploy capital efficiently when other pathways for an exit are unavailable or suboptimal. In a secondary transaction, an existing sponsor sells all or a portion of its stake in a portfolio company to another sponsor. For sellers, secondary transactions can unlock liquidity when a portfolio company is not ready for an IPO or a strategic sale, or lacks the resources to fund a redemption at the preferred price. For buyers, it offers access to seasoned assets with established operating models and clearer value.

Secondary transactions benefit from early planning, thoughtful structuring, calibrated risk allocation, and alignment among the sponsors, the company, and management. In most cases, planning for a successful secondary transaction exit starts even before the selling sponsor acquires its initial stake in the portfolio company.

In this article, we explore key dynamics and considerations for sponsor-to-sponsor secondary transactions. It is relevant to both sponsors seeking an efficient exit and sponsors looking to buy into a portfolio company in a manner that provides them with a streamlined exit transaction down the line.

Overview of secondary transactions

Secondary transactions typically balance three objectives. First, the selling sponsor seeks a clean walk-away with minimal post-closing exposure. Second, the incoming sponsor wants to preserve and enhance its ability to exit efficiently in the future. Third, both parties need relative comfort with the valuation and pricing.

These secondary transactions may be structured as either:

- a secondary share purchase between the sponsors
- an investment by the incoming sponsor in the company coupled with a redemption or a purchase by the company of the shares held by the exiting sponsor or
- a hybrid secondary transfer transaction between the sponsors coupled with an investment and treasury issuance transaction between the incoming sponsor and the company

The selection of the optimal structure for a secondary transaction is often driven by Canadian and foreign cross-border tax considerations. It is always recommended to involve tax advisors early on in the structuring process.

Seller priorities: efficient exit with minimal tail risk

Selling sponsors seek to narrow their representations and warranties. Their representations and warranties are typically limited to fundamental corporate matters relating to their own status and title to the equity that they hold in the portfolio company. The company's cooperation with the process is required so that it can provide the business-level representations and warranties in favor of the incoming sponsor.

The selling sponsor's indemnity obligations are typically capped at the cash actually received (or a smaller amount) and are subject to relatively short survival periods, if any. Where multiple sponsor sellers are involved, joint and several liability is commonly resisted (i.e., several post-closing liability is generally the norm). In this context, incoming sponsors may consider buying buyer-side representation and warranty insurance to meet the requirements of the selling sponsors and to avoid the risk of breaches of company representations straining their relationship with the portfolio company or its management post-closing.

Selling sponsors should also protect the directors and officers that they nominated to the board or management positions at the portfolio company. Notably, selling sponsors should ensure that the transaction documents include direct indemnification obligations whereby the portfolio company undertakes to indemnify the selling sponsor's nominees in case of any liability related to such functions prior to the closing. The parties may also explore tail D&O insurance with an appropriate runoff period.

Buyer priorities: build for the next exit

Incoming sponsors seek to structure the portfolio company's governance documents in a manner that allows them to monetize their investment in the future in a streamlined manner. This typically involves negotiating to minimize equity transfer restrictions and impediments, such as by including carve-outs for secondary transaction exits from the application of the rights of first refusal and tag-along rights that may exist in the company's governance documents. Procedural certainty also matters, and incoming investors typically require that the governance documents set out clear provisions outlining processes and conditions for a streamlined exit in the future, such as shorter holding periods, transparent

pricing and valuation conditions, undertakings to cooperate and defined timelines and guardrails.

For incoming sponsors, it is important to structure their investments in a manner that preserves optionality and freedom to initiate and complete exit transactions in the future. For instance, the terms of the equity instrument should contain triggers entitling the incoming investor to require the company and its other equity holders to cooperate with a secondary transaction exit, such as through a forced sale or springing right mechanisms. In addition, sponsors may ask for tailored power of attorney provisions to manage the risk that other minority investors and management may interfere with future exit transactions. As incoming investors plan for their future exit, they should also consider how to align their own economic interests with the interests of the other investors and management.

Bridging the valuation gap

Needless to say, both the selling sponsor and the incoming sponsor will focus on valuation and pricing. To get the best return, the selling sponsor may consider a formal auction process or a price discovery process to solicit several offers. The incoming sponsor will run due diligence to get comfortable with the valuation being proposed. All these processes will require cooperation from the management of the portfolio company.

There are several approaches to bridging informational asymmetries and gaps in valuation between the sponsors. In the purchase agreement, typical solutions include purchase price adjustment mechanisms, earnouts tied to measurable performance indicators, or staged payments of the purchase price over time. In the company's governance documents, the incoming sponsor will want to protect its investment, for example by including a minimum return on its investment and clear priority waterfall in its favour for future distributions by the company (whether of profits or on liquidation) and in case of a sale of the company or another change of control transaction. To share the risk and ensure alignment, the incoming sponsor may also ask the selling sponsor to continue holding a certain equity stake in the company for some period after closing, subject to bilateral arrangements that give the incoming investor comfort with the valuation requested by the selling sponsor.

Takeaway

Sponsor-to-sponsor secondary transactions are an interesting alternative for sponsors looking to sell their stake in portfolio companies when other exit opportunities are not readily accessible. On the sell-side, careful planning and negotiation is required to ensure that the portfolio company is on board and cooperates with the sale process. On the buy-side, the incoming investor needs to structure its investment and the portfolio company's governance documents such that a streamlined exit route is available for the future and can be executed in a timely manner, with minimal hurdles and in line with its investment horizon.

Osler regularly acts on mandates for similar transactions for Canadian and international private equity sponsors and their portfolio companies. For additional information, please contact the authors.