Proskauer

Considerations for Private Fund Managers to Weather the Storm of COVID-19

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I. Introduction

As COVID-19 continues to spread around the world, it has become apparent that it is having a significant impact on the global financial market, at least for the short- to medium-term. While the only constant is change, there are steps private fund managers can take that will help them weather the storm and best position themselves for the future.

II. Fundraising

A. ***Timing***. As of this writing, international travel restrictions are in place in numerous countries across the globe, already delaying in-person meetings between fund managers and investors, as well as slowing down the investment process for investors, generally. We currently expect established fund sponsors nearing fund closings to maintain or even accelerate scheduled closings with investors that have concluded their investment approval process. Sponsors that are less well-established and/or not as far along in the fundraising cycle may find challenges getting the attention of the limited partner community. To prepare for the uncertainties ahead, sponsors anticipating a new fund launch in the near term, or that are already in the process of fundraising, should consider whether extending the fundraising period beyond the conventional 12-month period is advisable.

B. ***Investor Allocations to the Asset Class***. There are as many possibilities as there are uncertainties. As we saw with the burst of the dot-com bubble and the financial crisis of 2008, we expect that investors will review, and ultimately adjust, their allocations to alternative investments to reflect changing market dynamics. Because internal benchmarks on allocations to alternatives are often tied to the overall value of an investor's portfolio, an overall decline in the value of an investor's public equity holdings could result in alternatives being over-weighted relative to the balance of such investor's portfolio. Interestingly, however, history has also shown that periods of crisis can present opportunities for success. Funds raised in the midst of challenging fundraising environments have often subsequently demonstrated strong overall returns. Investors with the flexibility to take these – or similar – patterns into consideration might choose to increase previously established allocations to alternative strategies.

C. ***Financing Flexibility***. In anticipation of potentially delayed fundraises, sponsors should review the documents for their current and new funds to determine whether GP affiliates or third parties are permitted to warehouse investments for the fund while fundraising is ongoing. If such warehousing activities are not permitted, sponsors should consider seeking amendments, or LPAC consents, if applicable, to permit those activities.

D. ***Risk Disclosure***. In light of the speed at which global conditions are evolving, sponsors should consider including additional disclosures in their marketing materials, offering documents, and Form ADV Part 2A regarding the potential (and uncertain) impacts of the global pandemic on funds and sponsor firms, including both the more generalized impact on financial markets worldwide, macroeconomic trends, and supply chains, as well as other matters such as the funds' investments, reporting, and operations.

E. ***Performance and Valuation Disclosures***. Recent market volatility may lead sponsors to conclude that a review of current valuation disclosures is warranted. Sponsors should be particularly vigilant in following their valuation policies and, when appropriate, updating valuations in pre-existing marketing materials. Finally, sponsors with funds in the midst of fundraising that have acquired assets during the fundraising period that have subsequently declined in value should expect subsequent closing investors to review existing investments carefully and potentially take issue with the standard "cost plus interest" true-up mechanism with respect to "catch-up" amounts owed to existing investors.

III. Existing Funds

A. ***Use of Capital***. Sponsors are advised to consider portfolio companies' near and mid-term capital requirements in light of changing market conditions. Although funds past their investment period would typically still have the ability to make follow-on investments in existing portfolio companies, sponsors should review their fund documents for any caps or other limitations on the deployment of capital in follow-ons or the ability to recycle capital. Funds still in their investment period should consider their flexibility to recycle distributions, or consider seeking amendments, or LPAC consents, as applicable, for increases to their recycling caps or extensions of their investment periods. For funds that are capital-constrained, in addition to GP-led secondary transactions discussed below, sponsors may consider alternatives such as raising an annex fund to invest in follow-on rounds of an existing fund's portfolio companies, re-opening a fund to accept additional or increased subscriptions, offering a new preferred class of interests to investors, utilizing single-asset co-investment SPVs, and, to the extent permitted in their fund documents, using debt financing alternatives such as fund-level NAV financing secured by a portion of the fund's investment portfolio.

B. ***Investment Strategy***. The current market presents a different landscape than when even very recent funds held closings just a few weeks ago, and may create attractive investment opportunities in areas not previously contemplated. For example, funds that have typically invested in private markets may now find public market valuations attractive. Sponsors are encouraged to review the investment objectives and limitations in existing fund documents to determine whether existing documents permit the fund to explore these new market opportunities, and to consider whether an amendment or discussion with the LPAC might be appropriate where they do not.

C. ***Financing***. Sponsors may be inclined to lean more heavily on capital call lines or other types of credit facilities currently in place. Thus, sponsors are advised to examine the borrowing limitations in fund documents and reserve requirements, and to review the funding conditions under the relevant loan documents, which typically require both the absence of any default and the bring-down of representations and warranties. Sponsors should be prepared to see additional inquiries from lenders relating to the fund's financial condition.

Some sponsors may choose to pay down or pay off outstanding capital call line borrowings earlier than usual or required in order to reduce the risk of a default if limited partners default on a later capital call if the current situation continues to deteriorate. Other sponsors, particularly those with uncommitted capital call credit facilities, may choose to proactively draw down capital in advance of a particular need, to the extent permitted by the applicable loan documents, to take advantage of the lowered cost of such capital. All sponsors should assess their funds' loan documents to re-familiarize themselves with the definition of "included investors" and the consequences under the loan documents and with respect to the borrowing base if one or more limited partners in a fund were deemed to no longer satisfy such definition.

With respect to existing asset-based credit facilities, sponsors should also plan for any potential decrease in the net asset value of the underlying portfolio, which may impact the borrowing base as well as compliance with any loan-to-value ratio requirements or other financial covenants under such facilities. Sponsors should also anticipate requests for funds to guarantee their portfolio companies' indebtedness and should review current documents to determine any limits to such guarantees.

D. ***Valuation***. Sponsors should ensure that valuations continue to be conducted in accordance with their valuation policies, notwithstanding the uncertainty in the markets. It may be prudent to seek input from independent valuation advisors on weighting of methodologies, for example, in cases in which precedent transaction analysis may not reflect the most current market information.

E. ***GP Clawback.*** In the event of a significant decline in valuations, sponsors are encouraged to review their fund documents to evaluate any clawback potential and the need for any additional reserves, as well as reserve policies at the GP entity level.

F. ***Information Sharing with LPs***. Sponsors may consider taking a proactive approach regarding information sharing with the limited partners, such as gathering feedback from portfolio companies on the anticipated impact of COVID-19 on their operations and performance, and preparing standard responses to limited partner inquiries. Further, sponsors should evaluate and confirm their ability to meet the reporting timeline provided under fund documents, including ensuring that, in turn, portfolio companies are able to provide the information necessary for the fund's reporting by the requisite deadlines.

G. ***LP Meetings***. Funds that had annual in-person limited partner meetings scheduled in the near term should be prepared to provide virtual alternatives, to postpone such meetings if fund documents require in-person meetings, or to seek appropriate consent to deviate from the manner required by the fund documents.

H. ***LP Defaults.*** Sponsors are encouraged to take a proactive approach in anticipating limited partner defaults as a result of the economic shock triggered by the pandemic, especially with respect to funds that rely heavily on commitments from high net worth individuals. Sponsors should analyze fund documents with respect to potential remedies for a default and are advised to give careful consideration to their fiduciary duties when determining if and when to apply default remedies. In addition, sponsors should also evaluate any consequences of defaults by limited partners under their credit facilities to ensure compliance with reporting and other obligations to lenders. Finally, sponsors might also canvass secondary market participants to determine who might be interested in purchasing fund interests from those limited partners wishing to sell.

I. ***Secondaries*.** Sponsors and secondary buyers and sellers are likely to witness a certain level of disruption with respect to existing secondary processes, resulting from fluctuating valuations and liquidity challenges. "Material adverse change" clauses, which permit buyers to walk away from deals under certain circumstances, have largely been absent in the private fund secondary market since the financial crisis of 2008, but may be re-introduced by buyers if significant market volatility continues. In the medium- to long-term, it is possible that the current market volatility will result in a rise in the level of secondary market activity as some investors seek liquidity solutions, although secondary buyers may initially be reluctant to engage until the markets stabilize. Similarly, market dislocations may also present opportunities in the medium- to long-term for GP-led secondaries, particularly with respect to individual portfolio companies in need of additional capital to maximize value in the long-term. Moreover, the use of leverage in secondary transactions may continue to rise in a low interest rate environment.

IV. Management Company Operations

A. ***Business continuity plans.*** Sponsors should review their business continuity plans ("BCPs"), if they have not already done so. Firms may consider establishing a task force to continuously monitor the development of COVID-19 and adjust firm policies accordingly, including ensuring the availability of key persons and planning for long-term flexible working time arrangements, remote-working capabilities, restrictions on business travel and alternative communication channels both internally and externally. Firms should also liaise with key service providers such as brokers, IT system providers, administrators and custodians to confirm they have robust business continuity procedures in place to avoid disruption caused by COVID-19. Registered investment advisers should document any revisions to their BCPs, any deviations, and reasons for deviations as business continuity plans may be a focus for the U.S. Securities and Exchange Commission (the "SEC") in future examinations. We note that as of this writing, the SEC has reached out to a number of investment management firms to inquire about their BCPs, including plans to address COVID-19 issues.

Should you wish to obtain a form of business continuity checklist for a fund manager or its portfolio companies or would like to know more about Proskauer's AI contract review tools that, compared to a manual review, can swiftly identify and evaluate key contractual terms such as force majeure clauses, material adverse change clauses and change in law provisions, please reach out to Proskauer's COVID-19 Taskforce.

B. ***Labor and Employment****.* In devising and implementing policies in response to COVID-19, sponsors should bear in mind requirements under labor and employment laws, such as the Occupational Safety and Health Act, the Americans with Disabilities Act and the Family and Medical Leave Act, as well as state and local laws and regulations, which are discussed in more detail here.

C. ***Insurance****.* Sponsors also should review insurance coverage for business disruption and other claims, paying close attention to any exclusions under the insurance policies and any notification requirements for claims. For what to look for in insurance policies, see Proskauer's recent client alert here.

D. ***Privacy and IT Infrastructure***. As covered in our recent blog post here, sponsors are encouraged to identify potential data privacy risks arising out of a possible restructuring of the workforce and remote-working arrangements. Stress testing of IT systems and close monitoring of cybersecurity threats, including a rise in COVID-19 phishing scams, are also advised in connection with any remote-working arrangements.

E. ***Working Capital***. Management companies, like their portfolio companies, should also review their own financing arrangements on an ongoing basis to ensure that they have sufficient working capital at the management company level.

F. ***U.S. Regulatory Developments****.* As covered in our recent client alert, the SEC announced the issuance of a pair of exemptive orders providing conditional relief for investment advisers. The relief, among other things, provides a 45-day extension to advisers that are unable to meet the deadlines for (1) amendments to Form ADV, (2) Form PF and (3) brochure delivery due to circumstances related to current or potential effects of COVID-19 provided that they notify the SEC and disclose on their websites certain information.

G. ***U.K. Regulatory Developments***. The U.K. Financial Conduct Authority ("FCA") recently published a statement confirming that the regulator remains focused on business continuity plans for financial institutions. The statement further confirms that it expects regulated institutions to take all reasonable steps to continue meeting their regulatory obligations and will expect firms to have contingency plans to deal with major events (and that those plans have been tested). While the FCA accepts that certain regulatory requirements may not always be met (for example, difficulties in submitting their regulatory data or telephone recording), firms are expected to maintain appropriate records during this period and, for regulatory data, should submit the data as soon as possible. Firms should be prepared to discuss with the FCA if there are concerns that certain regulatory obligations will not be met.

Proskauer will continue to monitor events and provide updates as needed. If you have any questions, please contact your attorney team at Proskauer.

Related Professionals

- **Mike Hackett**
  Partner
- **Howard J. Beber**
  Partner
- **Camille Higonnet**
  Partner
- **Stephen T. Mears**
  Partner
- **Robin A. Painter**
  Partner
- **Charles (Chip) Parsons**
  Partner
- **Michael R. Suppappola**
  Partner
- **David W. Tegeler**
  Partner
- **Nigel van Zyl**

Partner