COVID-19: POTENTIAL LEGAL IMPACT ON PRIVATE EQUITY FUND TERMS

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1 INTRODUCTION

We are facing an extremely challenging investment environment as markets around the globe feel the effects of the economic slowdown occasioned by the COVID-19 pandemic. Whilst the private equity industry will survive these pressures, it will no doubt be challenging.

Generally, long term fund managers won't be under the same pressure as managers in the listed market to make immediate trading decisions. However, private equity funds will be dramatically affected both by the immediate impact of COVID-19 and by the ripple effects on industries and markets.

For instance, in the short term, managers of private equity funds will be preoccupied with determining the impact that COVID-19 has on current investments. At the level of the funds themselves, there will be a major impact on those currently raising capital and those which are at, or nearing, the end of their life-cycles. Managers will be less willing to part with choice assets in an uncertain and unfavourable market. As such we expect to see more special purpose continuation vehicles and secondary funds to allow for managers to retain these assets until there is more stability in the market.

As a general rule, private equity funds do not allow redemptions by investors and can therefore avoid mass-investor exit issues that affect other fund classes. Investors will however require that managers inform them of all actions they are taking to mitigate the effects of the COVID-19 outbreak. In dealing with issues related to the COVID-19 outbreak, managers should be careful not to lose sight of basic investment company issues, such as commitment call deadlines, financial statement filings and investor updates. This cannot be underestimated as investors, more than ever, are going to want to know what managers are doing and how they are mitigating any potential losses. Transparency is critical.

It may be timely for fund managers to review the terms of the fund's documentation (or proposed terms for those funds which have not yet launched) to check whether they can maximise their flexibility during this period of market disruption and beyond. As such, for the purposes of this note, we outline the key considerations that managers should bear in mind to try to mitigate the effects of the COVID-19 outbreak on fund terms. We will look at funds at different stages in the fund life, from funds in their capital raising stage to those at the end of life, and thereafter we will outline some general and regulatory considerations that managers should take into account in the current environment. While not covered in this note, managers are nevertheless also advised to carefully scrutinise their funding agreements with banks and third-party lenders.

2 FUNDS CURRENTLY RAISING CAPITAL

Funds that are currently raising capital in the market are more likely to receive commitments from investors who are already familiar with the manager than new prospective investors, unless such new prospective investors are already well advanced with their due diligence investigations. Investors will likely be considering the impact of the current economic environment on their own balance sheets, which could potentially result in delays and possibly reductions in commitments from investors.

Managers of funds which are currently raising capital should consider –

2.1 using alternative marketing and business development mechanisms to engage with potential investors given that physical meetings and roadshows won't be possible in the immediate future due to lockdowns and travel restrictions;

2.2 extending the period during which they seek investor commitments before holding their first close, and, to the extent that the fund has already completed its first close, requiring investor consent for an extension of the final closing date (it should however be noted that this may bring complicated equalisation issues into play);

2.3 reviewing and ensuring that "risk factor" and "risk disclosure" statements in private placement memoranda or offer documents are accurate in the context of the current situation and updating such statements to the extent necessary. Such amendments may also flow through to the fund documents. If a fund has already reached its first close and admitted investors, their consent to amending the fund documents will likely be required.

3 FUNDS IN THE INVESTMENT PERIOD

Managers of funds which are currently in the investment period should consider –

3.1 extending the time-period during which investor commitments can be drawn down, and the potential effect of any such extension of the fund investment period on management fees (this may need to be agreed with investors upfront). This will allow time for the manager to source suitable investments and flexibility for investors to spread the period over which their funds are being deployed;

3.2 reviewing their fund documents to ensure that it allows them to complete deals that are in process after the end of their investment periods, and that it contains follow-on investment provisions which permits the manager to make capital calls after the end of the investment period to preserve and enhance the value of existing portfolio investments;

3.3 reviewing their investment guidelines and strategies to assess how well they can accommodate opportunistic investments which may arise as a result of the current financial market displacement and equity valuations (e.g. debt and rescue financing for companies which are distressed as a result of the COVID-19 outbreak) and whether the fund documents allow for deals to be pursued outside of the existing funds managed (e.g. using deal-by-deal structures or co-investment structures which may be more appropriate and can often be established more quickly than a traditional private equity fund vehicle);

3.4 ensuring that any potential conflicts of interest are properly managed to the extent that investment opportunities arise in a different part of the capital structure of a portfolio company that the manager itself already may have exposure to. The terms of the fund documents should be reviewed, and the manager should always be transparent with the advisory boards of their funds if they wish to participate in such opportunities;

3.5 reviewing and updating the current risk strategies of the funds they manage to the extent necessary to ensure they are sufficiently robust to address any new or increased risks (e.g. increased liquidity risks, or unanticipated challenges with making interest payments and avoiding defaults (in cases where there is debt in the fund structure), or cash flow risks at portfolio company level due to a decline in consumers);

3.6 revising the funds business plan to reflect the current and probable future market disruption, as well as considering any revisions to the business plans of its portfolio companies. This also prompts managers to check their reporting and disclosures made to fund investors to make sure there is adequate flexibility for any practical commercial changes taking place, particularly in cases where the business plan may have been 'sold' to investors at the fundraising stage;

3.7 extending the funding timeframe or increasing notice of drawdowns to give investors additional time to address their own liquidity issues and to hopefully avoid defaults. Managers can also engage with existing investors to consider additional commitments to pick up any potential defaulting investor allocation, but in doing so should be ever mindful to not treat certain investors more favourably than others;

3.8 reviewing the fund documents to ensure that it allows for board meetings, investment committee meetings, advisory board meetings, investor meetings, annual partnership meetings, and any other relevant meetings to take place virtually or by telephone. Where relevant, managers will also need to consider whether there are a sufficient number of directors or key persons remaining in the jurisdictions where funds or fund managers are established to maintain tax residency, as well as the legal effectiveness of electronic execution of documents in respect of the relevant jurisdiction;

3.9 reviewing key person provisions in fund documents, in particular key person event triggers, which are usually drafted such that only an extended period of absence would trigger a key person event (and thus short term illness should not be an issue in the event that key persons contract COVID-19);

4 FUNDS IN HOLDING PERIOD

Managers of funds which are currently in their holding period should consider –

4.1 taking pro-active steps to develop and implement contingency plans to ensure business continuity and financial stability of its portfolio companies, and to determine the priority and allocation of its limited time and resources as between its portfolio companies. This will include staying abreast of, and ensuring that portfolio companies take advantage of, government bailout policies and initiatives;

4.2 increasing flexibility around recycling of commitments, creating larger reserves (and correspondingly, reducing, delaying or deferring distributions to investors until further notice and the situation becomes clearer). Whether there may be any clawback liabilities and whether reserves should be taken against distributions to the manager and/or investment professionals should also be considered;

4.3 whether any changes are required to reporting processes of the portfolio companies to the funds and reporting processes of the fund to investors. It may well be that in certain instances reporting deadlines cannot be met in practice and managers will need to be proactive about seeking extensions where this is necessary and explaining why it is necessary to investors;

5 FUNDS NEARING THE END OF LIFE

A manager of a fund nearing the end of its term has choice to either realise their investments at a sub-optimal time and sub-optimal price or find a way to buy time by extending the life of the fund, or raising new capital by way of co-investments and secondary transactions. Managers will need to ensure they follow the correct procedures regarding extensions, co-investments and secondary transactions, as set out in the fund documents, including seeking investor consents to the extent required.

5.1 Fund extension

Managers may wish to consider extending the life of the fund in order to allow for more time for the markets to recover before realisation of the portfolio. Usually fund documentation allow for 1 or 2 one year extensions to the fund life but anything beyond that will almost certainly require unanimous investor consent.

5.2 Co-investments

Managers may wish to offer investors co-investment opportunities where portfolio companies require follow-on capital, to the extent that this is allowed in terms of the fund documents, and reviewing its co-investment policy to ensure that it provides a clear framework in respect of participation by investors in co-investment opportunities as regards for example priority of investors, fees, carry, expenses, and timeframes.

5.3 **Secondary transactions**

Managers may wish to establish a continuation fund into which the portfolio companies of the existing fund will be transferred. The manager will typically continue to manage the continuation fund and investors will be given the option to elect to cash-out at prevailing NAV (or even a discount to NAV) or roll over into the new continuation fund. Investors who roll-over stand the chance of realising a return as and when the markets improve.

5.4 **Cross-trades**

Managers may wish to transfer portfolio assets from a prior fund to a successor fund, or between a fund nearing the end of its life and a newly launched fund. Cross-trades are distinct from secondary transactions in that it does not necessarily require the establishment of new fund specifically for the purpose of acquiring the portfolio companies, it may involve an existing fund managed by the manager, and it does not necessarily require the that the existing investors be given the option to roll-over into the acquiring fund. Managers should be particularly careful to consider any conflicts of interest provisions and related party rules applicable and should rely on independent valuation of the fair value of the assets being sold and purchased.

5.5 **Strip sales**

Managers may wish to transfer a fixed percentage of the fund's portfolio to a new acquisition vehicle to which commitments for follow-on funding is made by an entirely new investor (secondary buyer). As a strip sale is treated as a disposal by the fund. The fund's remaining interest in existing portfolio companies which have been stripped will be progressively diluted to the extent that the new acquisition vehicle is further funded by the secondary buyer.

5.6 **Annex funds**

Managers may wish to consider establishing a new fund vehicle specifically designed to provide follow-on funding to portfolio companies. These annex funds do not necessarily provide any additional time for realisation of investments, however they do provide additional drawdown capacity for follow-on investments in portfolio companies. Interests in the annex fund are offered initially to existing investors on a pro-rata basis, and thereafter any spare capacity is offered to those investors who accepted the initial offer and thereafter any remaining capacity is offered to third party investors. All investors buy in at a negotiated value (usually based on an independent valuation report) of the existing portfolio with no preference. These types of funds were seen to be formed by several international managers in the wake of the Global Financial Crisis of 2008.

6 GENERAL

6.1 Investor Relations

Investors crave insights from their investment managers during crises, and managers should therefore consider increased and proactive investor outreach, particularly around performance (and sensitivity of the portfolio to COVID-19 impacts), risk management, valuations and operational matters.

6.2 Business Continuity

Managers should ensure they have robust business continuity plans in place to ensure continuity of their own critical processes and the services they provide, and should also review service provider and counterparty operating conditions and business continuity arrangements to assess any impacts this may have on their own processes (e.g. administrators).

6.3 Employees

It is important for managers to ensure that employees are able to prioritize their own and their families' health in line with the guidelines from the relevant public health organizations. Managers can invest in bolstering their remote working technology (e.g. virtual private networks) and back-office infrastructure and provide appropriate training for employees to assist them in getting comfortable with this new operating model and to make sure they are appropriately trained and equipped to do their jobs remotely.

6.4 Data Privacy

Managers should take steps to ensure that data security is not compromised as they may face additional threats and vulnerabilities now with the increased levels of remote access to core systems, as well as employees and management being more susceptible to social engineering efforts in the midst of a crisis.

6.5 General contractual rights – *force majeure*

Managers should review fund documentation and other key agreements and consider the impact of *force majeure* clauses on their rights and obligations and the rights and obligations of their counterparties under these agreements. Managers should also consider, when negotiating new agreements, to include *force majeure* clauses with language to cover epidemics/pandemics and diseases, and particularly the actions of governments or states in response to those epidemics/pandemics and diseases.

7 REGULATORY CONSIDERATIONS

Save where regulators have stated otherwise, managers will not be excused from compliance with their regulatory obligations as a result of the COVID-19 outbreak and the disruptions it has caused. Therefore, managers need to ensure that appropriate business continuity plans are in place to ensure regulatory monitoring and reporting obligations are able to be met and should be alert to changes in regulatory requirements. If managers experience or anticipate difficulties in complying with obligations, they should communicate with the regulator timeously.

It is also worth noting the recent FSCA FAIS Notice 17 of 2020, issued on 31 March 2020, which provides an exemption from and extension of the period to comply with certain fit and proper requirements – in particular, (a) it reduces the number of continuous professional development (CPD) hours required to be completed by financial services providers, key individuals and representatives, (b) extends the period by which they need to comply in respect of the 2020 CPD Cycle to 31 August 2020, and (c) in respect of certain qualifying supervised representatives, extends the date for compliance with certain regulatory examination requirements to 15 December 2020.

8 CONCLUSION

In conclusion, and above all, the key to maintaining both investor relationships and investor confidence during this period of market disruption and uncertainty is communication and transparency.

Although the COVID-19 outbreak has caused a massive disruption in the public markets and is doing the same to private markets, there are options available to managers which seek to mitigate the negative effects of this crisis.

Depending on the terms of the fund documents, these options may require some form of investor consent or consent from an investor advisory board. Nevertheless, even where investor consent is not expressly required, it would be prudent to consult with the advisory board or seek advisory board consent to address any actual or potential conflicts of interest.

In the context of this unfolding humanitarian crisis, public expectations of business's role in society is shifting rapidly, and now is the time for managers to consider doubling down on their commitments to environmental, social, and governance related investing and to evaluate their actions through a lens of social citizenship, taking a long and indeed moral view as they plot their course.

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