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Private Fund Management Issues Arising From COVID-19

Travers Smith LLP



Sam Kay

The global COVID-19 pandemic is an unprecedented situation that will have a long-term impact on the private fund management industry, stretching beyond the current period of lockdown and altering the way in which private funds are raised and operated. Whilst there will be some market participants who have navigated prior economic downturns, the current crisis is throwing up challenges that few people will have prepared for. There will also be some within the industry (whether investors, general partners (GPs), service providers or advisers) who have only known a period of relatively steady growth over the last 10 years. There is little doubt that the period of calm is being replaced by a period of turbulence.

The private funds market has not stood still over the last 10 years and there are a number of recent innovations and developments that will now be tested, from the prevalence of subscription line facilities, to the way that valuations and fund reporting are carried out to the increasing interest in GP-led transactions as a form of liquidity. But this crisis will also give opportunity for new products and approaches to be developed and put into practice.

Set out below is an overview of the key issues that private fund managers should be considering in the short and medium term to best adapt to the new environment and to prepare for the future. This covers operational issues, effective investor relations during the market dislocation, liquidity and risk management and some considerations for future planning.

Operational Issues

1. Valuations

As the COVID-19 pandemic took hold during March 2020 and countries went into lockdown, there were obvious economic effects: productivity dropped quickly; developed economies, reliant on consumer spending, began to feel a sharp chill; and travel companies went into freefall. Given the reporting cycle, it was also a time when a large number of fund managers were about to issue 31 December year-end financial information for their funds. CFOs were in a quandary about what to report: the valuations as they stood at the end of 31 December, or take into account the impact that the lockdown was having on portfolio companies?

The consensus settled on valuing based on what was known as at 31 December rather than adjusting for what happened later, but the difficulty of valuing portfolios remained. For a number of private funds, including private equity, mark-to-market accounting (i.e. 'fair value') is a relatively recent development, having been implemented in Europe following the introduction of IFRS 13 in 2011. So, it is the first time that a large number of private fund managers will have had to value assets during a time of severe market dislocation. For private

funds that use the International Private Equity and Venture Capital Valuation Guidelines, the issue was considered by the IPEV Board and special valuation guidance was provided. In particular, the following was highlighted in the guidance: strong valuation processes should continue to be followed; fair value is based on what is known and knowable at the relevant date; fair value does not equal a 'fire sale' price but rather represents the amount that would be received in an orderly transaction; and firms should take care not to 'double-dip' downwards on their valuations if performance metrics have already been adjusted to take account of lower-than-expected performance; however, it may not be appropriate to use a recent transaction price as a way of determining fair value.

At the time of writing, it remains to be seen how this revised guidance will affect the valuation process. It is also worth noting that the focus with valuations has, so far, been on the downside risk. However, there will be some portfolio companies that are experiencing unusually high revenues due to the changing behaviours resulting from the lockdown. As well as the risk of underplaying drops in value to maintain performance levels, there is also a risk of banking growth which may simply be a result of the crisis rather than reflective of underlying fundamentals of the business.

2. Substance requirements

In recent years, the concept of 'substance' has been a key theme for the fund management industry. In a tax context, the focus on substance has increased since the OECD's initiative relating to 'base erosion and profit shifting', or BEPS, which looks at ending tax avoidance strategies that exploit gaps and mismatches in tax rules to avoid paying tax. Given the significant cross-border element to fund structuring, fund managers need to carefully analyse the taxable presence of the funds as well as the fund management businesses themselves. In addition, because the management of private funds has become increasingly regulated over the last 10 years, there is a separate (and, sometimes, conflicting) requirement to ensure that any regulated activity is being appropriately carried out by the correct authorised entity. In this context, the concept of substance means being able to demonstrate that individuals in the relevant jurisdiction are taking the required actions and making decisions for regulatory purposes.

The International Air Transport Association (IATA) has noted that, as of early April 2020, the travel restrictions imposed by governments had resulted in the number of flights globally being down 80% compared to 2019. The IATA also noted that the most severe impact was likely to be in the second quarter of 2020.

As fewer people have travelled, different approaches are needed to demonstrate substance in particular jurisdictions. A number of key fund jurisdictions have relaxed (or it is expected will relax) aspects of these rules and/or have published temporary guidance on how to comply with substance-based rules. For example, in the United Kingdom, although the rules themselves have not been changed, in relation to tax substance HMRC has emphasised that it will view company residency and permanent establishment issues in the round and not by reference to a one-off decision in the ‘wrong’ place. Other fund jurisdictions have introduced emergency measures in order to mitigate the immediate effects of COVID-19 for the whole business community but have not provided specific tax or regulatory guidance. For example, a Grand Ducal decree in Luxembourg made it clear that shareholder and board meetings may be held without any participant attending in person, but as of the time of writing the Luxembourg tax authorities have not provided any specific guidance. Given the likely ongoing challenges with travel for the foreseeable future, fund managers will need to carefully assess these requirements, particularly in jurisdictions where clear guidance has not been provided.

3. Signing and closing logistics

Because of the lockdown restrictions, there is potential for disruption when signatories are forced to work remotely. This may relate to signing or witnessing key documents or holding fund closings through to more mundane matters such as providing Know Your Customer documents (including certified copies) or filing documents with statutory or regulatory bodies. Whilst it is usually possible to find solutions, particularly through the use of platforms like DocuSign, the process inevitably takes longer and requires more planning.

4. Limited partner (LP) defaults

It is to be expected that, when any financial crisis is looming, commentators will begin to predict widespread LP defaults within the private funds market. The truth is that there have been very few significant or publicised defaults at all in the private funds market, whether in times of boom or bust. This may be due in part to the fact that private funds tend to be more relationship-driven between the GP and LPs than other markets; it may be in part due to the expected returns, even during times of crisis; or it may be due to the relatively harsh penalties and remedies available to GPs. On this latter point, it would be usual for the fund documentation to allow the GP to have a range of options if an LP defaults, including charging interest on the default amount, or withholding distributions until the default is remedied (or setting off a future distribution against the default amount), forcing the LP to transfer its interest or forfeiting the interest entirely.

Despite the historically low incidence of defaults, clearly both GPs and LPs should carefully consider their obligations and plan accordingly. GPs should speak to investors about the timing and frequency of future capital calls as this will reduce surprises for both the GP and the LPs. If there is a risk that an investor may default, there are various strategies that can be implemented, for example putting in place a subscription line facility, delaying or reducing some investment activity, introducing voluntary pacing restrictions to proactively manage the deal pipeline or permitting LP transfers (the increasing size of the secondaries market is helpful in this regard). During the Global Financial Crisis, there were very few significant defaults by investors in private

funds, partly because GPs and LPs worked together to get through the crisis. However, as the market has developed over the last 10 years, there are some additional points to consider. For some large institutional investors, it is more common to run an ‘over-allocation’ strategy with the expectation that distributions can be used to meet future capital calls. Given the current state of the market, this strategy may be put under strain. On the flipside, GPs have increasingly turned to subscription line facilities as part of their toolkit for effective cash management. But that also reduces to some extent the discretion that a GP will have with a potential default situation because the GP may need to involve the lender in any decision regarding action to be taken. If a GP has been using a subscription line facility, it should also consider whether the LPs have sufficient ‘skin-in-the-game’ to want to avoid a default, or whether a large part of the drawdowns have, to date, actually been funded by the lender.

Effective Investor Relations

1. Communications

The importance of letting LPs know how the investment portfolio is coping with the COVID-19 crisis should not be underestimated. Effective and timely communication between GPs and LPs will strengthen the relationship and allow for a more collaborative approach to dealing with the crisis. The push for transparency within the private funds market has resulted in more communication between GPs and LPs, but also more dialogue and coordination between institutional investors themselves. If GPs can demonstrate that they are communicating effectively, this is likely to enhance the brand and reputation of that GP not just within its own investor-base but also the wider investor community. It would also be prudent for a GP to discuss the likely cash requirements for the portfolio as this will help LPs with their own cash management. Whilst the direct and personal touch is always important, GPs should ensure they are being consistent with the types of information and responses that are being provided to investors to mitigate selective disclosure issues.

When considering effective communication, GPs also need to consider how to coordinate and hold investor meetings, for example meetings of the limited partner advisory committee, or LP meetings such as AGMs. These meetings are often viewed as a good opportunity for the GP and LPs to gather together and build the relationship by discussing issues and for LPs to obtain more information on the portfolio. Given the ongoing travel restrictions, meetings in person are very unlikely for the foreseeable future. Whilst it is clearly possible to hold meetings online or over the telephone and discuss all the same issues and topics that would have been covered at an in-person meeting, it is clearly more difficult to have a two-way debate over video or the telephone. Both GPs and LPs will need to adapt to this changing situation and find other ways of giving all parties the opportunity to maintain the dialogue.

2. Fundraising planning

Analysis shows that alternative assets have generated strong returns both during and after previous economic downturns. There remains a degree of optimism among institutional investors about the investment opportunities over the next 18–24 months. GPs should, therefore, be carefully planning their next fundraising, laying the groundwork with investors and making sure there is an allocation for the next fund. However, raising

first-time funds is expected to be more difficult as LPs are likely to focus on existing relationships. This will be partly the natural reaction to concentrate on incumbent relationships but also will be a practical response to the difficulty of holding face-to-face meetings with new GPs.

Even for established managers, the timing of going to the market will be important. Different fundraising strategies will be needed to ensure momentum within the fundraising process, for example, early-bird discounts on fees, giving LPs access to funds that operate different strategies and strengthening the investor-protection package for LPs. New strategies will be needed to meet with potential investors, such as digital fundraising roadshows and virtual due diligence visits.

Liquidity and Risk Management

1. Follow-on capacity and recycling

GPs should carefully consider what liquidity they are likely to need, both as the COVID-19 pandemic evolves and in its immediate aftermath. This is likely to include emergency funding for portfolio companies whose business has been hit by the pandemic as well as having sufficient firepower to make the most of investment opportunities over the coming months. GPs need to ask: is there sufficient liquidity in the fund as things stand?

Within a private fund context, it is common to have a fixed investment period followed by period of time (normally, a number of years) for the GP to work towards realising the portfolio. However, even within this ‘harvesting’ period, it would also be common for the GP to be permitted to make additional or ‘follow-on’ investments into the existing portfolio. It is likely that these powers will be restricted because LPs want the GP to focus on realisation rather than new investments: for example, the follow-on investments will need to be clearly linked to an existing portfolio company rather than a completely new investment; the GP may be limited to a making these investments during a period of two or three years after the end of the investment period; or the GP may only be permitted to draw-down a fixed percentage of total fund commitments (say, 20%) for follow-on purposes. Given the current COVID-19 situation, GPs and LPs should carefully consider these provisions and determine if they are relevant given the unprecedented situation and requirements on capital. Having an ability to inject extra cash into an investment may be better than allowing the business ‘go to the wall’ or the business being required to accept additional capital from another investor that has a dilutive effect on existing shareholders.

Most private equity funds will also permit some ‘recycling’ of distributions in order to make further investments. It has long been the case that if a private equity fund returns cash to investors within a short period from the original drawdown (for example, because the fund did not need to use the cash, or the investment was realised very quickly, or part of the investment was syndicated to a third party), it would be usual for the GP to be able to recall or reinvest those proceeds. In recent years, it has also become common for both GPs and certain institutional investors to want to reduce the cash drag created by the fees and expenses incurred by the fund by allowing the fund to recycle a larger proportion of distributions for investment purposes. These recycling powers can be usefully employed to increase the overall firepower of the fund, either for emergency situations, or follow-ons or additional investment opportunities. GPs should carefully look at what recycling is permitted under the fund documents. There may be some distributions that have been made historically which are, under the limited partnership

agreement, recyclable. Clearly, any GP needs to approach this in a responsible manner and be sensitive to the reaction of the LPs, but it may be possible to generate some additional liquidity without needing extra sources of capital.

2. Alternative liquidity options

As well as looking at follow-on and recycling options, GPs should consider the developing markets of NAV facilities and preferred equity products, which are tailor-made for this situation. In very broad terms, NAV facilities involve fund-level borrowing provided by a third-party lender against the value of the asset(s) of the portfolio whereas a preferred equity solution involves injecting prior ranking third-party equity within the fund structure in return for priority claims over future distributions. Both of these liquidity options have developed over the last couple of years as part of a wider ‘GP-led transactions’ toolkit available to GPs, i.e., bespoke structuring options to introduce a secondary purchaser or lender into the fund structure or into a new vehicle managed by the same GP. The emergence of this toolkit is taking fund managers beyond the traditional private fund investment and divestment cycles and into constant and active portfolio and investor-base management. But the toolkit is also evolving as GPs assess the potential additional funding requirements of their existing portfolios to ensure the GP has sufficient firepower to inject cash where needed. Older vintage funds, where there is significant NAV at risk and (perhaps) little remaining by way of uncalled investor commitments, are particularly exposed but also particularly well-suited to a NAV facility or a preferred equity solution. However, from a practical perspective, it is unclear whether there will be enough capital available to cover the demand for these products, so first-mover advantage could be crucial.

Future Planning

1. Understanding the requirements within the fund documents

For any future planning, the GP needs to understand what is and is not possible with the existing fund. This requires a careful and detailed analysis of the fund documents and any related side letters. The following areas should be considered:

- Follow-on provisions and recycling. As noted above, the terms of the fund may allow the GP to make follow-on investments or to maximise available capital by recycling distributions. It would be usual for these powers to be restricted, so the GP should carefully consider and understand what flexibility there is within these powers.
- Fund extensions. Because of the market dislocation, it may be difficult for a GP to complete its investment programme within the proposed investment period, or more time may be required to allow for an orderly realisation of the remaining assets. The GP should examine if there is an ability to extend either the investment period or the overall term of the fund. In either situation, both the GP and the LPs should consider what the management fee arrangements should be. On any investment period extension, if the management fee is constructed so that the amount paid to the GP reduces at the end of the investment period, the LPs may require that any extension of the investment period is only allowed if they are put in the same position with regard to the management fee as if the extension had not occurred. For any extension of the

overall term of the fund, should the management fee be reduced further to take account of the additional time that the GP will be charging fees?

- Diversification limits. The fund documents may contain restrictions on how much can be invested in different assets or geographies. As funds adjust to the crisis, it will be important to know what and where the fund can invest to comply with these requirements.
- Amendments and waivers. Some of the mid-term planning for the fund may involve changes to fund documents or waiving existing restrictions. As a result, GPs should consider the process they will need to follow, such as the thresholds for approvals and which groups of investors will need to be ‘on-board’ to approve changes. The GP may want to signpost its proposals to amend the fund documents, for example with any limited partner advisory committee. Further, there may be third parties that would also need to give consent, for example lenders under a subscription line facility.

2. Proactive fund management

A number of important considerations are set out above for the proactive management of any private fund, from effective communication between GPs and LPs, to liquidity solutions (including follow-on capacity and recycling), to fund extensions. The viability of a number of additional structuring options that should be reviewed are as follows:

- GPs should consider whether it would be appropriate to sell particular investments or hive-off specific assets into other vehicles. These are normally structured as a ‘GP-led transaction’ so that the acquiring vehicle is controlled by the GP. One option could be a sale of a ‘strip’ of the fund’s underlying portfolio, which means a fixed percentage of some or all of such assets. The acquisition vehicle is likely to be funded by a secondaries fund, which may also make additional follow-on capital available. Alternatively, the GP could ‘sell’ to another fund managed by the GP, for example a later vintage fund or a fund with a different strategy (such as selling assets from a venture fund to a growth fund).

- An alternative solution would be establishing an ‘annex fund’. This is normally structured as a new fund that is offered *pro rata* to existing investors, with new investors only being admitted if there are additional capital requirements. The annex fund is used to invest into and support the existing portfolio without any particular preference.
- The GP may also consider the creation of a continuation fund as part of a GP-led transaction. Some or all of the existing portfolio is transferred to the continuation fund, with existing investors being given the option to ‘exit’ (i.e. cash-out) or ‘rollover’ into the continuation fund. The transaction is underwritten by one or more additional investors (such as a secondaries fund) and the continuation vehicle will also allow for further capital to be invested into the portfolio.

3. Investment opportunities may change

Looking even further ahead, it is likely that certain sectors will become more attractive to investors, such as healthcare, life sciences and logistics. Companies that provide tech-enabled solutions for social distancing policies will be highly valued, whilst there is also likely to be an increased focus on distressed debt and special situations funds (given the anticipated economic downturn). Conversely, certain sectors such as retail, leisure, travel and energy may be less appealing to investors. It is also worth noting that COVID-19 is not just an economic crisis but a socio-economic one. This is different from, for example, the Global Financial Crisis in 2007–2009, so it is likely that there will be a wider societal response rather than one that is focused on the financial markets. Fund managers should consider areas like impact investing and sustainability to ensure they are properly aligned with the society in which they operate.



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His clients raise funds for private equity strategies (including venture, growth, buyout and PERE), private debt and credit strategies and in the infrastructure asset class. Sam also advises large asset management platforms on a range of funds-related matters. As well as fund formation work, Sam advises on secondaries transactions, carried interest arrangements and co-investment schemes, works with institutional investors on their participation in funds and has experience of internal restructurings, succession planning and management spin-outs. Sam regularly advises on cross-border fund structuring issues.

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