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COVID-19: Fund-Related Considerations for Private Equity Managers

The cascading impacts of the coronavirus outbreak (COVID-19) on markets and businesses are creating a variety of challenges and opportunities for private equity funds. General partners ("GPs") may want to consider a variety of proactive steps, including reviewing investment objectives; altering fund documents; being more proactive in information sharing, valuations and reporting; reviewing borrowing limitations and derivative contracts; and other protective measures.

Broaden the Investment Mandate

The recent market turmoil arising from COVID-19 will result in some GPs considering distressed and other non-traditional investment opportunities, including open market purchases of public equities. For existing private equity funds, the investment objectives set forth in the fund documents should be reviewed to explore whether or not they provide the flexibility to make these types of investments. For new private equity fund offerings, GPs may want to consider broadening the fund's strategy beyond traditional buyouts to include distressed investing for control, flexibility to invest in the debt of portfolio companies and possibly open market purchases of public equities. GPs will also need to understand the compliance and regulatory considerations (including filing requirements) pertaining to any such investments.

Alter the Fund Documents

- *Offering Period*: For ongoing fund offerings, GPs should expect delays in the offering process and may want to consider extending the offering periods of private equity funds beyond the customary 12 months. GPs may also wish to build in the flexibility for the consent of the advisory board or the GP to extend the offering period.

- *Capital Commitment Rollover*: GPs may want to consider asking LPs in existing private equity funds that are in liquidation or wind down to "reallocate" unfunded commitments into new distressed or other non-traditional strategies as a more efficient way of LPs' underwriting "new" commitments.

- *Commitment Period*: For ongoing fund offerings, GPs may want to consider building in commitment period extension mechanics (*e.g.*, the ability to extend by one or two years with the consent of the advisory board). For existing private equity funds that have the ability to extend commitment periods, GPs may want to consider seeking an extension now to get ahead of opportunities and ensure flexibility to draw on unfunded commitments.

- *Term*: For existing private equity funds nearing the end of their terms, GPs may want to consider seeking a term extension to provide additional time to weather a potential long-term financial downturn.

- *Follow-On Investments*: The expected need to provide additional capital to portfolio companies may put pressure on the follow-on provisions in fund documents (which typically cap the amount of follow-on investments at 15-20% of commitments after the end of the commitment period). GPs may want to consider whether, and to what extent, a follow-on investment is subject to these limitations if the follow-on investment is being funded without calling additional capital contributions (or through the use of leverage). If there is no follow-on investment capacity, or if follow-on capacity may be constrained down the road, GPs may want to consider if other means of credit support are available, such as portfolio company guarantees.

- *Recycling*: For ongoing private equity fund offerings, GPs may want to consider creating broader flexibility to recycle proceeds without regard to a specific timeframe (typically 12-24 months) or other than solely during the commitment period. GPs may want to consider the ability to treat special purpose vehicles as portfolio companies for purposes of enhancing recycling flexibility.

- *LP Meetings*: GPs may want to consider providing for alternative means of holding LP meetings, including by way of webcasts or other electronic means.

- *Warehousing*: GPs may want to consider the inclusion of warehousing provisions in fund documents to allow it or its affiliates to warehouse investments while private equity funds are in the offering period or are unable to obtain financing for an acquisition. Similarly, GPs may want to consider preserving flexibility to lend to funds or portfolio companies if traditional financing sources are not available.

Be Proactive in Information Sharing, Valuations and Reporting

- *Information Sharing/Selective Disclosure*: GPs are encouraged to be proactive as LP requests for information regarding the manner in which funds and portfolio companies are dealing with issues arising out of COVID-19's impact on operations. GPs should be consistent with the types of information and responses that are provided to LPs to mitigate selective disclosure issues. If LPs are inquiring about impacts on product demand, supply chain, working capital, valuation or deal flow, GPs may want to consider creating standard responses (consistent with how responses would be presented in DDQs) or holding an investor call to disseminate the information consistently to all LPs. GPs may want to seek feedback from portfolio companies in order to respond effectively and to ensure a consistent message is delivered to LPs, counterparties and customers.

- *Valuations*: The changing valuations of portfolio companies may impact the calculation of management fees, distribution waterfalls and clawbacks. GPs may want to give particular attention to the valuation provisions in their fund documents to ensure compliance therewith. GPs are also encouraged to consider the potential impact on any subsequent closings in process.

- *Financial Statements*: Many fund-level financial statements rely on the delivery of information from portfolio companies (which will likely be delayed given the current situation). GPs may want to review whether the fund documents have flexibility to go beyond the customary 90 or 120 day delivery timeframe or if the offering documents have disclosure relating to delayed reporting or force majeure risk. Potential delays beyond 120 days may have an impact on custody rule compliance as well.

A Time for Borrowings

- *Increased Use of Leverage*: Falling valuations and distressed or other non-traditional opportunities may drive increased use of leverage by private equity funds through the use of existing subscription line facilities (if capacity is available), total return swaps, margin loans or other alternative forms of financing. GPs may want to pay careful attention to borrowing limitations in fund documents and any requirement to reserve unfunded capital commitments for purposes of satisfying borrowings and other contingent liabilities.

- *ISDAs/Derivative Contracts*. GPs are encouraged to review their funds'/portfolio companies' derivative contracts to get ahead of any NAV triggers, margin calls or other contingent obligations that may arise in connection with outstanding derivatives transactions.

Consider Protective Measures

- *Insurance*: GPs may want to consider reviewing the expansion of insurance coverage applicable at the manager, fund and portfolio company level or consider what, if any, claims are available under existing coverage (*e.g.*, costs of cancelling business travel for investor or portfolio company board meetings).

- *Secondaries*: The market dislocation could lead to unique opportunities for GP-led secondaries, particularly in respect of individual portfolio companies that now need more time than otherwise expected to maximize value and distribute proceeds (instead, they now need an influx of new capital). In addition, investors may be looking for liquidity with respect to illiquid LP interests. Accordingly, GPs should be prepared for an uptick in secondary activity, including as a result of investors' defaults.

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