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COVID-19: What Private Fund Managers Need to Know Now

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The COVID-19 pandemic will affect managers of private funds in several ways. The nature and extent to which any particular fund manager is affected by COVID-19 will depend on many factors, including the type of fund, the investor base of the fund and whether the fund is currently being marketed to investors.

In this bulletin, we cover the following topics:

Considerations for Existing Closed-End Funds

We have set out below certain considerations for managers of closed-end funds to take into account as they navigate the COVID-19 pandemic. While some of the guidance set out below applies specifically to private equity funds, much of it also applies more generally to closed-end funds in other asset classes.

Portfolio Company Management and Risk Mitigation

Portfolio Company Management

- **Communication and Contingency Planning.** Private equity fund managers should ensure that they are in frequent and regular contact with members of management of their portfolio companies and that they implement new processes and procedures to permit the employees of their portfolio companies to work remotely. As the pandemic evolves, it will be important to understand the impact on the business of each portfolio company and ensure that all key members of management understand and implement contingency plans designed to address the absence of key individuals, travel restrictions, border closures and supply chain disruptions.
- **Incentive Compensation.** At the appropriate time, fund managers may consider evaluating existing compensation packages for key employees of their portfolio companies and adjusting performance targets to ensure a continued alignment of interest with those individuals. For example, stock-based compensation or phantom stock plans may be viewed as less attractive than cash bonuses and existing performance targets may be difficult or impossible to achieve in the current environment. The tax implications to the portfolio company and its employees should be considered in advance of any changes being made to existing plans or grants.
- **Cybersecurity.** Given the increased emphasis on remote workplaces and online transactions, fund managers should consider reviewing their portfolio companies' IT systems to ascertain vulnerabilities to cyberattacks, malicious software and phishing attempts,

etc. If any weaknesses are identified, enhanced processes and protections should be implemented to address them as soon as possible.

- **Potential Pivots.** If a portfolio company is exploring the possibility of a potential pivot of its business (e.g., to shift from manufacturing table linens to protective masks or hospital gowns, or to move from brick and mortar stores to an online platform), the portfolio company's credit agreement and other material agreements should be reviewed carefully to confirm whether the shift in business would require the approval of any third party. In addition, fund managers should work closely with members of management to ensure that they understand the potential costs of and barriers to making such changes, including additional regulatory burdens, potential liabilities and ongoing compliance costs.

Governance

- Funds that have nominees on the boards of their portfolio companies should bear in mind that their nominees owe a fiduciary duty to the portfolio company. Particularly in the context of a proposed bankruptcy or restructuring, the interests of the portfolio company may diverge from those of the fund. In addition, the general partner of the fund would also be subject to the standard of care and provisions that govern conflicts of interest set out in the fund's governing agreement.
  - Nominees of the fund should ensure that any possible conflicts of interest are disclosed at the earliest opportunity at board meetings and that they recuse themselves from voting with respect to such matters in their capacities as board members.
  - If all board members are conflicted, the board is permitted to approve the matter subject to shareholder ratification.
  - The shareholder agreement governing the portfolio company may contain mechanisms to deal with conflicts. If the shareholder agreement constitutes a "unanimous shareholder agreement" that restricts, in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the portfolio company, there is a risk that actions taken by the fund, in its capacity as shareholder under the unanimous shareholder agreement, may result in additional liabilities that the fund would not ordinarily have as shareholder. Although a shareholder of a Canadian company does not ordinarily owe a fiduciary duty to the company, a shareholder who is a party to a unanimous shareholder agreement has all the rights, powers, duties and liabilities of a director of a corporation.
- Under Ontario law, directors (but not board observers) are personally liable for, among other things, unpaid wages and unremitted employment withholdings.
  - Fund managers may wish to consider requesting weekly (or more frequently, depending on the portfolio company's cash position) reports from and meetings with the chief financial officers of their portfolio companies to ensure that these companies remain current with respect to all such payments.
  - Fund managers should also review (i) the investment restrictions in the fund's governing documents to confirm whether the fund has any latitude to make capital calls to fund follow-on investments in the event that capital is urgently required by the portfolio company to stay current on its obligations to pay wages and remittances, and (ii) the provisions of the portfolio company's credit agreement to determine whether any cash contributed by the fund to the portfolio company must be applied to repay the bank debt. See "Operational Matters – Managing Liquidity Needs of the Fund" below.

Employment and Labour Law Issues

- A significant number of companies across North America are laying off or terminating many of their employees as a result of the COVID-19 pandemic. Layoffs and terminations raise local law considerations, including whether the portfolio company would be entitled to lay off its employees temporarily without being subject to claims of constructive dismissal. See our bulletin on Canadian employment law for more information about these issues.

Compliance with Debt Covenants and Ratios

- Portfolio companies that are leveraged will be subject to financial covenants in their credit facilities (which in many instances must be maintained at all times) and generally will be obligated to certify compliance with such covenants on a quarterly basis as well as in certain other circumstances. In addition, credit agreements almost always require the borrower to notify the lender of any event of default or any event or circumstance that, with the passage of time or giving of notice, would become an event of default. It would be prudent for fund managers to review the credit agreements of their portfolio companies to determine the likelihood that the portfolio company will default on its financial or other covenants. If a default is likely, fund managers should develop a strategy for approaching the lender for a waiver of, or amendment to, the credit facility.

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Investor Relations

Communication with Investors

- It will be critical, as the COVID-19 pandemic evolves, for fund managers to engage with their investors in an open and transparent manner. Each fund manager should be prepared to respond to questions about the health of its portfolio companies; actions taken to mitigate the risks faced by its portfolio companies; the extent to which the fund modelled out any recession or market downturn scenarios when it acquired the portfolio company; and the expected capital needs of the fund's portfolio companies over the near to mid-term (including the extent to which the fund manager expects to call capital from the fund's investors to satisfy those capital requirements). Fund managers may wish to consider hosting an investor call in the near term in which investors can ask these types of questions. However, investor calls should not replace one-on-one engagement where necessary.

Annual Meetings

- Fund managers that have not held their annual investor meetings should consider postponing or cancelling the meetings (which may require a waiver of or amendment to the governing agreement of the fund) or holding virtual meetings. Fund managers should review the governing agreements of the fund to ensure that they permit virtual meetings and should coordinate the logistics of such meetings well in advance of the meetings. In addition, in light of the significantly increased demand for virtual meetings in the public company context (see our bulletin on virtual AGMs), fund managers should determine as soon as possible which platform would be most appropriate for their meetings. Although private funds are generally subject to fewer technical requirements than those applicable to public companies, it is important to test and address the capabilities and limitations of the platform, and to ensure that the fund's investors have access to it, sooner rather than later.

Reporting Requirements

- Many private funds are required to deliver their annual reports, including audited financial statements, to investors within 90 days of their fiscal year-end. Fund managers that need more time to prepare their annual reports should review the governing agreements of their funds to determine whether they have any flexibility in this regard. In addition, if an annual report has already been prepared but has not yet been delivered to investors, fund managers should consider updating the report to address the COVID-19 pandemic, the potential impacts of the pandemic on the fund and its portfolio companies, and the actions that the fund manager and its portfolio companies have taken and/or plan to take in light of the pandemic.

Side Letter Obligations

- Many funds are subject to side letters, whose provisions range from additional reporting obligations to covenants relating to environmental, social and governance issues, and to the obligation to notify the investor upon the occurrence of certain events. It would be prudent for fund managers to review their side letter obligations to determine whether they have any reporting or notification requirements as a result of the COVID-19 pandemic and its impact on the fund and its investments. Some side letter obligations, such as the obligation to provide regular, detailed reporting about a fund's portfolio companies, may simply be too onerous to comply with at this time. Ideally, fund managers will engage with investors about such provisions at the earliest opportunity to ensure a constructive ongoing dialogue and to agree on an alternative approach if warranted by the circumstances.

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Operational Matters

Managing Liquidity Needs of the Fund

- **Capital Call Facilities.** Funds with capital call or other credit facilities should consider reviewing the terms of those credit facilities to ensure that they understand the conditions and the timing for any drawdowns under those facilities in the event that capital is urgently required for any portfolio companies. In many instances, the terms of the loan documents provide that the funds are only being provided on an uncommitted demand basis, which means the lender has complete discretion over whether they will fund any advance (or demand repayment of existing advances).
- **Follow-On Investments.** If the fund anticipates making an additional investment in any of its portfolio companies, the provisions of the fund's governing agreement relating to follow-on investments should be reviewed to ensure that the investment will not violate the limitations on follow-on investments. In some cases, the restrictions on follow-on investments may be waived by the fund's limited partner advisory committee and in other cases, a formal amendment or waiver of the limited partnership agreement would be required. Fund managers should also review the portfolio company's credit agreement in connection with any proposed follow-on investment because credit agreements generally require any new equity that is contributed to a portfolio company to be used to repay existing bank debt.

Approach to Diligence and Deal-Making

- **Due Diligence.** Fund managers should revise their due diligence checklists to address the manner in which potential targets may be affected by COVID-19 and the potential for an economic recession. Fund managers should consider introducing additional stress-testing into the models used to evaluate potential investments.
- **Key Deal Terms.** If a fund is making or divesting an investment, the fund manager should consider key deal terms, including conditions to closing, the material adverse change (MAC) clause, representations and warranties and pre-closing covenants. "Tried and true" precedents and "market" deal terms may need to be adjusted and should be re-evaluated keeping in mind current market conditions and the particular circumstances of the company being bought or sold. For more information about MAC clauses, see our bulletin on MAC and MAE clauses.
- **Representation and Warranty Insurance.** While representation and warranty insurance has become increasingly popular with private funds as a way of mitigating the risk of post-closing claims, it remains to be seen whether and to what extent the COVID-19 pandemic will affect representation and warranty insurance policies. It is possible that any effects of COVID-19 will be excluded from those policies and that, as a result, sellers such as private equity funds will have relatively less certainty regarding their post-closing obligations and liabilities. Anecdotally, we have seen at least one insurer exclude the effects of COVID-19 in a quote for such insurance.
- **Distressed Investing.** Current market conditions may result in opportunities to invest in distressed assets. Fund managers should review the governing agreements and private placement memoranda of their funds to determine whether the funds have the capability to make those types of investments, given the investment mandate of the funds and the disclosure that was provided to investors at the time they made their investments.

Closing Risks for Existing Deals

- **Closing Conditions and Pre-closing Covenants.** The COVID-19 pandemic poses significant additional risks for transactions that have been signed but not yet closed. Fund managers should consider reviewing closing conditions, including the MAC provision (discussed above), with a view to determining whether all of those conditions can be satisfied. Similarly, fund managers may wish to review the pre-closing covenants applicable to any pending transactions to determine whether the portfolio company remains capable of complying with them. For example, it may not be appropriate or possible for the portfolio company to carry on business in the ordinary course.
- **Management of Capital Calls.** Fund managers should consider giving more notice than normal of capital calls to their investors so defaults by investors can be mitigated without adversely affecting the fund's transactions or portfolio companies. If the fund is unable to draw down on its credit facility to bridge defaults by its investors, the fund should consider its alternatives, including making a follow-on capital call to the non-defaulting limited partners. The fund's governing agreement may impose limitations on the fund manager's ability to make follow-on capital calls – an understanding of these limitations is essential to managing capital calls and the transactions undertaken by the fund.

Temporary Relief from Regulatory Filings

- **Relief from Certain Canadian Securities Filings.** Canadian registrants will benefit from blanket relief originally announced by the Canadian Securities Administrators on March 20, 2020. The Ontario order and similar orders issued in other Canadian jurisdictions on March 23 provide that the due dates for registered dealers, registered advisers and registered investment fund managers to deliver certain financial statements and excess working capital calculations are extended by up to 45 days when the delivery deadlines fall between March 23, 2020, and June 1, 2020. The Ontario order further provides that the due dates for registered firms and unregistered capital markets participants to satisfy certain fee-related requirements in connection with the payment of participation fees are also extended by up to 45 days when the delivery deadlines fall between March 23, 2020, and June 1, 2020.
- **Relief from the U.S. Investment Advisers Act Filing Obligations.** Private fund managers that are registered advisers or exempt reporting advisers with the U.S. Securities and Exchange Commission (SEC) may benefit from temporary relief from the obligation to file an amendment to their Form ADVs on the regularly scheduled filing date if they comply with an order that was granted by the SEC on March 13, 2020. Registered advisers and exempt reporting advisers that are unable to meet the filing deadline due to circumstances related to current or potential effects of COVID-19 will benefit from this relief if they promptly notify the SEC by email and disclose on their public websites (or if they do not have a public website, promptly notify their clients and/or private fund investors of) (i) the fact that they are relying on the SEC's order; (ii) a brief description of the reasons why they could not file or deliver the amendment on a timely basis; and (iii) the estimated date by which they expect to file the amendment. The SEC's order applies to amendments to Form ADVs that are due between (and including) March 13, 2020, and April 30, 2020. Registered advisers and exempt reporting advisers who rely on the SEC's order are required to file the amendment within 45 days of the original due date. For more information about the SEC's order, see our bulletin about the temporary relief announced by the SEC.

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Considerations for Fund Managers Launching or Marketing a Closed-End Fund

Disclosure

- Any fund managers that are actively marketing a fund should review the disclosure in their private placement memorandum to determine whether the risks associated with pandemics such as COVID-19 and the potential implications to the fund and its portfolio companies are adequately disclosed. In addition, if any performance information included in the private placement memorandum is expected to change in any material respect, the fund manager should consider including additional disclosure to that effect. Under Canadian securities laws, investors have statutory rights of rescission and statutory rights of action for damages if a private placement memorandum contains any misrepresentation, whose definition includes the omission to state a material fact that is necessary to make a statement not misleading in light of the circumstances in which it was made.

Key Fund Terms

- Given the uncertainty associated with the COVID-19 pandemic, managers that are currently launching or marketing a fund should consider whether to adjust key fund terms such as the following:
  - **Investment Restrictions.** Regardless of the approach that a particular fund manager may have taken in its prior funds, each fund manager should consider whether to propose changes to the investment restrictions in its governing agreement. Such changes may include extending the length of time in which the fund is permitted to treat a portion of an investment as a bridge financing, expressly permitting the general partner and its affiliates to make loans to the fund without the need for limited partner or limited partner advisory committee approval, removing restrictions on investments in particular geographical areas or industries, and lessening restrictions on investments in public companies.
  - **Fundraising Period.** Most closed-end funds have a period of 12 months from the date of the initial closing to complete the capital raise. A 12-month period may not be sufficient in today's environment and it would be prudent to provide for the ability to extend this period at the general partner's discretion or with the approval of the limited partner advisory committee. Many investors are not comfortable with making a commitment to a fund unless they have met the principals of the fund in person – the inability of fund managers to meet with their prospective investors could impede the speed at which fund managers can raise capital.
  - **Institutional Investors.** In addition, institutional investors may be in the process of re-evaluating the asset mix of their portfolios and may not be in a position to make a capital commitment in the immediate term. There is some historical precedent for this. Following the economic downturn of 2007/2008, some investors were impaired in their ability to make commitments to private equity funds because of the "denominator effect" that resulted from the delay in the revaluation of private fund assets compared to publicly traded assets and the resulting increase in their private equity investments as a proportion of their total investments. Institutional investors that are limited by private equity target allocations (or allocations in other asset classes such as real estate or infrastructure) may be unable to make investments in certain types of funds or unable to make commitments of the size that they would have otherwise chosen to make.
  - **Investment Period.** A five-year investment period is typical for private equity and venture capital funds. Real estate funds often have a shorter investment period (i.e., three years). Fund managers should consider providing for the ability to extend the investment period for a specified time (e.g., one year) at the general partner's discretion or with the approval of the limited partner advisory committee.
  - **Follow-On Investments; Recycling.** As noted above, portfolio companies may be experiencing greater capital needs over the short to medium term. Fund managers should consider proposing higher caps on the amount of follow-on investments that may be made by the fund after the investment period and greater latitude to recycle proceeds. This may include permitting the fund to recycle proceeds that are received after the end of the investment period to account for the fact that exits and realizations may take longer to achieve than they have in the past.
  - **Economics.** It is too early to tell how and to what extent the COVID-19 pandemic will affect fund economics, if at all. However, fund managers that have not yet launched their funds may wish to consider the key economic terms of their funds in view of the current environment. Fund managers, particularly those that are launching first-time funds, may find themselves in a challenging environment in which to raise capital.
  - **Fund Expenses.** Fund expenses should clearly include any expenses that are incurred to facilitate secondary sales of investors' interests in the fund, to arrange financings at the portfolio company level and to restructure portfolio companies. Fund managers that have not already done so should consider excluding amounts paid to operating partners (being employees of the fund who

are temporarily seconded to the portfolio company) from the fee offset provision so that the fund is not penalized for providing dedicated resources to its portfolio companies in critical times of need.

- **Reporting Obligations and Investor Meetings.** Fund managers should consider providing for flexible timelines for the fund's obligation to deliver quarterly and annual reports and ensure that investor meetings may be held remotely.

To see our insights on how COVID-19 may affect hedge fund managers, see our bulletin.

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