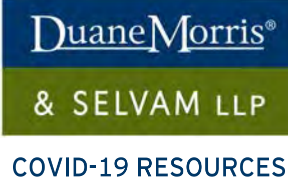
Navigating Crisis – Considerations for Private Equity and Venture Capital Funds

9 July 2020



Globally, private equity ("**PE**") and venture capital ("**VC**") funds ended April 2020 with a record $2.6 trillion in unspent capital at their disposal. With cash readily available, the ongoing coronavirus pandemic presents ample opportunities for well-managed PE and VC sponsors to capitalize on these trying economic circumstances. At the same time, the economic damage wrought by the pandemic presents significant challenges to sponsors and their portfolio companies. This article discusses some of the ongoing opportunities and challenges PE and VC sponsors face, with a focus on three broad categories: (i) considerations for existing portfolio companies, (ii) the impact on transaction execution and terms for new portfolio investments, and (iii) fund-level considerations.

Existing Portfolio Investments

We are seeing sponsors closely reviewing their portfolio investments to assess the breadth and depth of coronavirus' impact on each portfolio company. Sponsors are providing their portfolio companies with increased operational assistance, and where necessary financial support, especially across hard hit industries such as restaurants and hospitality, travel, entertainment, "brick and mortar" retail and energy.

Financing and Liquidity Management

Sponsors are actively reviewing the liquidity of their portfolio companies taking into account, among other factors: (i) business closure, (ii) headroom under, and possible withdrawal of, existing credit facilities, (iii) potential loss of customers or suppliers, (iv) the consequences of delayed payment or nonpayment under commercial contracts and debt facilities, (v) write-offs of accounts receivables, (vi) the costs and benefits of temporary or permanent reductions in workforce, and (vii) tax and stimulus benefits available under government programs.

Critically, companies are evaluating the likelihood of potential defaults under credit facilities and commercial contracts, along with allowable grace periods and cure rights. Companies facing liquidity shortfalls should consider renegotiating their contractual arrangements with suppliers and lenders and drawing down on credit lines in advance of liquidity shortfalls.

We have seen increased interest in restructuring the debt of portfolio companies, including potential payment deferrals, waivers or amendments of covenants, and extensions of maturity. With interest rates at historic lows, some sponsors are encouraging portfolio companies to pursue financing while they can. Some companies, particularly SMEs and companies in distressed sectors, may find it more difficult to obtain traditional bank or capital markets debt, providing an area of opportunity for PE and VC investors, such as credit funds.

In assessing compliance with financial ratios and other covenants, some companies are discussing the possibility of coronavirus-related EBITDA add-backs, such as for losses covered by insurance or "one-off" expenses or revenue losses (so-called "**EBITDAC**"). Companies considering such add-backs should carefully review the terms of their debt facilities to assess whether they are permitted. For new debt, some borrowers are negotiating for express coronavirus add-backs.

For companies with strong liquidity positions, it may be worthwhile to consider debt or equity buybacks. For debt, portfolio companies should review their debt agreements to ensure that the contemplated buybacks are permitted under all debt facilities, not just the facility to be bought back. For example, high yield bond indentures generally prohibit repurchases of subordinated debt without first repaying the bonds. Sponsors may also consider buying the debt of portfolio companies, though they need to consider their fund documentation and any shareholder agreements to ensure that such purchases are permitted. For equity, aside from voluntary repurchases by the company, drops in share prices may also trigger rights for PE investors to acquire further stake from founders or controlling shareholders.

Companies and sponsors should review the relevant investment documents and applicable corporate and securities laws to ensure buybacks comply with legal requirements. Critically, securities buybacks must comply with the prohibition on insider trading. As the coronavirus pandemic evolves, many public companies find themselves possessing potentially material non-public information, such as the timetable to resume operations, large scale employee layoff plans, or renegotiation of material contracts. A number of regulators globally, including the U.S. Securities and Exchange Commission, the UK's Financial Conduct Authority and India's Securities and Exchange Board, have published detailed guidance for public company disclosures, which companies and sponsors should consult before engaging in buybacks.

Regulations

From a regulatory perspective, portfolio companies should ensure that their compliance functions are well staffed and trained to stay promptly informed of regulatory developments, which are changing rapidly. Focus should be given to regulations that restrict or impact operations, such as

closures or safe distancing measures, as well as financial stimulus and tax deferment programs. Parties should be mindful to fully comply with the terms of any government stimulus measures, such as prohibitions on laying off or furloughing employees. For companies seeking IPOs in the future, we expect regulators to give enhanced scrutiny to these issues.

Insurance

Companies should assess their coverage under existing insurance policies, including business interruption insurance. The wording and governing law of the specific insurance policy in question are paramount. Post-SARS, many insurers have specifically excluded epidemics and pandemics in their business interruption policies. Even under policies without express exclusions for epidemics and pandemics, the governing law of the policy may prevent recovery. For example, New York law requires actual property damage to trigger business interruption coverage, and so would not cover business closures due to government shutdown orders.

We have already seen substantial litigation regarding business-interruption insurance coverage, with at least 150 lawsuits filed in U.S. federal courts through mid-June. Absent extremely clear language that entitles the insured to recovery, we expect this trend to continue. Sponsors and portfolio companies, therefore, should not rely on quick recovery under insurance policies, and should instead undertake their liquidity planning and stress testing on the assumption that insurance proceeds will not be readily available in the near term.

Cybersecurity

With continued work-from-home arrangements, companies should review the adequacy of their critical technology systems, including backup servers and infrastructure. The increased reliance on online and remote access technologies poses new and heightened security concerns, so companies should ensure strict administrative, physical, and technical security measures to prevent data loss, destruction, theft, unauthorized access, damage, modification or alteration. As part of this, companies should consider enhancing employee training on data security.

Accounting Policies and Audit procedures

Companies should consider whether coronavirus will require them to make any changes to their accounting policies or audit procedures. As to accounting policies, there may be significant changes in the judgments applied in determining fair value measurements, the treatment of impaired assets, loan loss allowances or restructuring charges. In terms of process, auditors often rely on physical verification of books and records in their audit, and therefore may not be able to issue audit opinions in the same timeframe as before. Moreover, the increased use of remote working technologies may have implications on auditors' internal controls review, as auditors may need to test the design and operating effectiveness of remote working arrangements that they have not previously review.

Companies should consult early with their auditors as to the timing and substance of the audit procedures, and how to overcome difficulties such as access restrictions. Where there is a risk that

audit processes may not be completed in time, companies and sponsors should consider the impact of their reporting obligations to shareholders, creditors, and limited partners.

In addition, for companies that have been particularly impacted by the virus and who may receive a "going concern" qualification in their upcoming audits, this may constitute a default under debt facilities and other contracts.

Senior Management

At an operational level, companies should ensure that they have in place updated succession plans and are able to address absences of key personnel. If portfolio companies in distress need to lay off key management, sponsors should ensure that they are familiar with the incentive schemes applicable to such key personnel (such as any golden parachutes or other benefits), as well as any additional benefits such people may be entitled to under law.

Board Duties

Sponsor-appointed directors owe fiduciary duties to all shareholders, not just the sponsor. Many critical decisions may get referred to the board during these times, and it is imperative that sponsor-appointed directors beware of conflicts of interest. For companies that are in or are nearing insolvency, directors may owe duties to creditors in addition to shareholders.

Deal Terms/Execution

As PE and VC funds have ample dry powder, we have seen strong continued investment activity in countercyclical industries and those less impacted by coronavirus, such as healthcare, technology (especially remote work technologies, data centers and data security services), infrastructure and pharmaceuticals. Investors looking at making new investments during these times should mitigate the risks presented by coronavirus through enhanced due diligence and downside protection, as well as careful consideration of the investment terms and representation and warranty insurance.

Due Diligence

Sponsors should undertake enhanced due diligence around a company's business continuity planning, liquidity position, supply chain certainty, insurance, and compliance with the terms of government stimulus programs. As part of this, sponsors should carefully review the force majeure and material adverse effect ("**MAE**") provisions in commercial contracts and debt facilities to assess the ability of counterparties to terminate or challenge contractual obligations. Whether a party can call a force majeure or MAE due to coronavirus is a highly specific analysis that depends on (i) the language of the contract in question, (ii) the contract's governing law and (iii) the impact of coronavirus on the company.

With travel restrictions and work-from-home arrangements limiting the ability to undertake physical due diligence, such as site visits, sponsors should look to use creative workarounds. Options include

using technology to broadcast site visits electronically or hiring third-party experts, such as local law firms, auditors, or compliance specialists, to undertake the site visits on behalf of the investor (preferably combined with an electronic broadcast).

Downside Protection

We are seeing PE and VC investors focus heavily on downside protection. Examples include: (i) exit rights that allow investors to dispose of their interests in downside scenarios, (ii) value adjustment mechanisms, including earn-outs and a move away from locked-box structures and back towards completion accounts, (iii) enhanced governance rights that take effect on the occurrence of downside scenarios, (iv) investments through convertible instruments instead of equity, and (v) founder guarantees.

Investment Terms

PE and VC investors are looking closely at information rights, decision-making rights, and key person provisions. On the information side, investors should make sure that they have rights to receive information in a timely fashion from potential portfolio companies so that they can help navigate the continuing crisis. They should also focus on veto rights and reserved matters so that they can assert control over critical business and strategic decisions arising from coronavirus.

For businesses with key persons, investors should ensure that their investment documents are clear as to what happens if a key person cannot continue work, either temporarily or permanently. Investors and their portfolio companies should also consider key person insurance.

Representation and Warranty Insurance

For investors who use representation and warranty ("**R&W**") insurance, R&W insurers are expecting to see proactive consideration of the issues caused by coronavirus. This includes specific disclosure from sellers on the impact that coronavirus has had on their business, covering matters such as liquidity and compliance with debt facilities, financial losses, potential or actual disputes with contractual counterparties, employees or other stakeholders, and the ability of counterparties to trigger force majeure provisions. Buyers and sellers should expect the underwriting diligence to include detailed questions on the impact of coronavirus.

Fund-Level Considerations

Investment Mandate

PE and VC funds looking to capitalize on new investment opportunities should review their investment mandates to assess whether they have sufficient flexibility to do so. Many sponsors are looking at changes to their underlying investment limitations to take advantage of new opportunities, such as distressed investing (including debtor-in-possession financing), direct lending, investing in

portfolio company debt, making open market repurchases of debt or equity, or investing in private investment in public equity ("**PIPEs**"). Sponsors should review and, as necessary, update their fund risk disclosures to reflect any changes to their investment mandate. They should also consider the process specified in the fund documentation to make changes to the investment mandate, including any consent thresholds.

Fund sponsors looking to make open market repurchases or invest in PIPEs must take into account the applicable prohibitions on insider trading.

Portfolio Diversification Requirements

Substantial market volatility can skew the proportion of different asset classes in a fund's portfolio. We are aware of sponsors that expect this volatility to knock them out of compliance with their portfolio diversification requirements. Moreover, funds seeking to change their investment mix to capitalize on new investment opportunities also need to be mindful of their portfolio diversification requirements. Fund sponsors should evaluate their portfolios to assess compliance with diversification requirements and assess their governing documents for the procedures to follow in case of breach.

Exit Planning

As the global IPO market has largely ground to a halt save for select sectors that are less affected by coronavirus, it may not be possible to exit through IPOs in this environment. If a delay in an IPO by a portfolio company triggers a redemption right or other transfer or exit right under the relevant investment agreements, investors should take note of any timelines within which they need to exercise those rights and assess the impact of exercising those rights on their investment.

Where IPOs are no longer possible, PE and VC funds should consider alternative exit opportunities such as secondary transactions and fund-to-fund sales.

Investment Period

Given the ongoing market disruptions, it may be difficult to exit investments at the desired rates of return or in the desired timeframe. Accordingly, sponsors may want to consider extending the life of their funds. Such sponsors should review their fund documents to assess the requirements to do so, such as any consents required from the limited partner advisory committee ("**LPAC**").

Reporting

As with portfolio companies, funds may be hindered in their ability to timely prepare their financial statements. However, most fund documentation does not allow relief from timely reporting to investors. Proactive communication of such challenges with investors may be advisable.

With the substantial volatility in financial markets, investors are even more keen than usual to receive frequent updates as to the status of their investments. Sponsors with investments in public

companies should be mindful of their obligations under applicable securities laws, especially fair disclosure requirements such as those under Regulation FD in the United States. These requirements broadly prohibit parties from disclosing material non-public information regarding a company to a limited group of investors. Before communicating information to fund investors or LPACs, sponsors should ensure that their portfolio companies have also publicly announced the information to the extent material.

NAV

With the potentially large change in asset values, sponsors are looking closely at their valuation and reporting processes. While some changes in valuation methodology may be justified in the circumstances, sponsors should be careful of making changes, should seek consent from investors or LPACs before making changes, and should ensure that they determine valuations in accordance with the disclosed methodologies. We expect this to be a focus area for the SEC in future reviews.

Consents and Meetings

Fund documentation should set forth the method and manner required for seeking consents and holding meetings of investors and committees. Sponsors should be mindful to comply with these formalities and seek any changes necessary to allow them to conduct business by virtual conference and written consent.

LP Capital Calls and Defaults

To quickly secure capital, PE and VC fund sponsors may want to accelerate capital calls from investors. The fund documentation will set forth the ability to make capital calls in advance of closing, as well as the impact of accelerated calls on the accrual of preferred returns. To avoid accruing preferred returns earlier than necessary, it may be cheaper for a fund to draw on credit lines and other liquidity sources before calling investor capital.

Due to cash flow constraints, sponsors may be faced with defaults by LPs. As a first stop, sponsors should review the default provisions in the fund documents to assess their rights and obligations, including any notice requirements and the ability to call on non-defaulting investors to fund the shortfall. Depending on the fund documents in question, sponsors may have a right to waive defaults or release investors from commitments, but in other cases may be prohibited from doing so without consent of investors or lenders. Sponsors should also review their investor diversification requirements, such as "widely held" requirements.

Finally, fund sponsors should consult their governing documents' bridging provisions to assess their ability to fund the equity shortfall through other sources, such as through the fund's credit facilities.

New Funds

Sponsors who are raising new funds should proactively address the fund-level considerations above in their governing documents, particularly as to the investment mandate, diversification

requirements, investment period, reporting processes, valuation methodologies and consent and meetings processes. This will provide sponsors with the flexibility necessary to capitalize on current circumstances. Fund documents should also consider including greater flexibility to recycle proceeds, broader definitions of follow-on investments, the ability to lend to portfolio companies in distress, and the ability to cross-collateralize across multiple vehicles to improve credit profile. Given current low interest rates, the market may also move towards lower preferred return rates.

Fund offering documents should adequately disclose coronavirus-related risk factors. Sponsors who disclose their track record in offering documents should be mindful to ensure that current market conditions do not fundamentally render the historic track record unreliable, and to the extent they continue to disclose track records statements ensure that the accompanying disclaimers are robust. Specific reference to coronavirus in the disclaimers is generally warranted in the circumstances.

At a practical level, some investors may face delays in receiving internal approvals or finishing due diligence, given work-from-home arrangements and lockdowns. Fund sponsors should consider being flexible in the number and size of closings, conducting necessary meetings via video conference, and using e-signatures.

For More Information

If you have any questions about this *Alert*, please contact Jonathan E. Crandall, Leon Yee, Ramiro Rodriguez, any of the attorneys in Duane Morris & Selvam's Private Equity Group or the attorney in the firm with whom you are regularly in contact.

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