



K&L GATES

Investor Landmines in a Work-Out World

July 29, 2020 11:00 AM - 12:00 PM PST / 2:00 PM - 3:00 PM EST

**Webinar Series Part II:
What Fiduciaries Need to Know**

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STRUCTURE OF THE PRESENTATION

- Recap of Part I and Current Observations
- Fraud at the Manager
- When a Manager or Fund Goes Bankrupt
- How Should LPs React to Bad News?
- Fiduciary Considerations

The image features a central dark blue horizontal band containing white text. Above and below this band are two identical horizontal strips showing a microscopic view of several virus particles. Each particle is roughly spherical with a textured surface and numerous thin, hair-like projections extending from it. The background of these strips is a fine, light-colored grid pattern. The overall color palette is dominated by shades of orange, red, and blue.

Recap of Part I and Current Observations

RECAP OF PART I OF THE WEBINAR

- Compared to the 2008 financial crisis, we are in a health crisis with a related economic fallout
 - Indications of economic impacts on funds
 - Be mindful of manager communications, particularly LPA amendment requests
- Increased awareness among LPs of the importance of coordination
 - Fund documents provide a starting point: “road map”
 - Communication with co-LPs is key to action

CURRENT OBSERVATIONS

- Investors are reevaluating what terms matter most
- No large frauds or bankruptcies at managers (yet)
- Fund-level debt may cause issues
 - Changes the risk profile
 - Potential unexpected and large capital calls to repay
- Bankruptcies at the portfolio company level
 - Stress on portfolio companies from monitoring and other offsettable fees



Fraud at the Manager

FINANCIAL STRAIN EXPOSES FRAUD

- Lack of liquidity and market concern – December 12, 2008
- Different kinds of fraud
 - Ponzi schemes—using new investors' monies to pay existing investors
 - Simple theft or conversion— simply taking money from the fund
 - Promotor/manager misconduct—could be independent of investments
 - Promotor or manager malfeasance—for example, failure to follow investment guidelines
- When it hits, it can do so in a wave

UNIQUE ASPECTS OF FUND FRAUD

- What can you recover?
 - Fraudster likely judgment proof
 - Limited, if any, fund assets to recover
 - Insurance is almost always insufficient, voided, or both
 - Potential claims against the professionals
 - Potential for government assistance—restitution, government insurance
- Bottom line: options may be limited
 - Suing a fund can be somewhat like suing yourself



When a Manager or Fund Goes Bankrupt

FINANCIAL STRAIN CAN LEAD TO BANKRUPTCY

- Fund bankruptcy filing will revise the capital structure of the fund
 - Generally, results in significant impairment or elimination of equity interests
 - Bankruptcy plans will often discharge claims of investors against management, the fund, and potentially other parties
- Order of distribution of liquidation proceeds is often the same in the LPA and insolvency proceedings
 - Secured creditors are first
 - Administrative and tax claims next
 - Then unsecured creditors
 - Equity holders—the LPs—are last

FINANCIAL STRAIN CAN LEAD TO BANKRUPTCY (CONT.)

- Process can be very fast paced, so important to react quickly to filings
 - Engage with bankruptcy constituents (management of the debtor and creditors) to evaluate risks and opportunities
 - Engage bankruptcy counsel to assess consequences of filing and navigate the bankruptcy process
 - Keep investor's Board apprised of filings and consequences

FINANCIAL STRAIN CAN LEAD TO BANKRUPTCY (CONT.)

- Bankruptcy plan negotiation process provides opportunities
 - May be possible to salvage value
 - At least may be possible to eliminate risks of claims against investors
 - Investors may face potential claims for avoidance and recovery of prior distributions, e.g., Ponzi case

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How Should LPs React to Bad News?

WHAT IS THE BAD NEWS AND WHAT DO YOU DO?

- Pure investment risk?
- Investment risk plus overreaction by fund manager?
 - Deviation from fund documents?
 - Did you approve the deviations?
 - Does this involve fraud or other bad acts?
- Bad acts, such as fraud?
- No assets left and bankrupt?
 - Investment loss
 - Fraud
 - Combination

IMPORTANT ACTIONS TO TAKE

- Quick assessment and actions
 - Collect facts
 - Evaluate potential claims and sources of recovery—what are your options?
 - Protect existing assets with the manager
 - Determine an interim strategy that may be adjusted
- Retain counsel
 - Protection of communications
 - Collection of information
 - Preliminary assessment of litigation strategy

TOOLS LPS HAVE FOR WORK-OUT ISSUES

- Seek advice from experienced third-party advisers—consultants and lawyers—who have weathered these storms before
 - Ask about practical outcomes:
 - Fact-check rosy claims from struggling managers
 - Ask advisers what is realistic
 - Do not delay: an investment firm under financial pressure is likely to quickly deteriorate, further limiting your options
 - Take advantage of privilege: loop in your outside attorney in internal sensitive conversations if confidentiality is a concern

TOOLS LPS HAVE FOR WORK-OUT ISSUES (CONT.)

- Check the fine print—documents as a “road map”
 - Contractual rights may protect LP interests, either in fund agreements or side letters
 - Information rights
 - Right to notice of insolvency and litigation?
 - Right to additional information upon request
 - Inspection rights
 - Are any key person events triggered?
 - Special redemption rights in open-end funds

TOOLS LPS HAVE FOR WORK-OUT ISSUES (CONT.)

- Use your leverage
 - Rights in documents may be useful to provide leverage in negotiations
 - Bankruptcy ipso facto limitations and automatic stay may affect enforceability of contract rights
 - Reputation
- Collaborate with other investors to leverage bargaining power
 - Seek out other LPs
 - Utilize the LPAC
- Take collective action
 - Reduce expenses and time commitment

TOOLS LPS HAVE FOR WORK-OUT ISSUES (CONT.)

- In the event of a bankruptcy filing
 - Make use of broad discovery rights
 - Consider appointment of equity-holders committee
- Federal or state government (potential cost savings and non-civil litigation options)
 - Securities and Exchange Commission (civil)
 - Department of Justice (criminal)
 - State Attorney General offices (civil and criminal)
 - U.S. Marshals Service (asset seizure and restitution)



Fiduciary Considerations

FIDUCIARY OVERSIGHT AND THE BOARD

- Most LPs have fiduciary duties to members/investors
- Key fiduciary responsibility resides with the Board
- Raise critical issues with the Board
 - Provide appropriate documentation for Board action
 - Is a Board memo necessary?
 - Review facts
 - Provide options
 - Use expert advice
 - Keep the Board updated

FIDUCIARY OVERSIGHT AND THE BOARD (CONT.)

- Public relations issues
- Privilege issues
- Litigation issues
 - Against the institutional investor
 - By the institutional investor

MAINTAIN OPEN COMMUNICATION

- Regularly communicate with managers
- Over communicate internally
 - Investment staff
 - Internal counsel and key officers
 - Keep the Board informed
- Evaluate due diligence process and revise as necessary

The image features a central dark blue horizontal band with the word "Questions?" in white, bold, sans-serif font. Above and below this band are two horizontal strips showing a microscopic view of virus particles. The particles are spherical with a textured surface and numerous thin, hair-like projections (spikes) extending from them. They are set against a background of a fine, light-colored grid pattern, which is overlaid on a darker, reddish-orange background. The overall color palette is dominated by warm tones of red, orange, and yellow, with the central blue band providing a sharp contrast.

Questions?

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