

K&L GATES

Investor Landmines in a Work-Out World

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Webinar Series Part II: What Fiduciaries Need to Know

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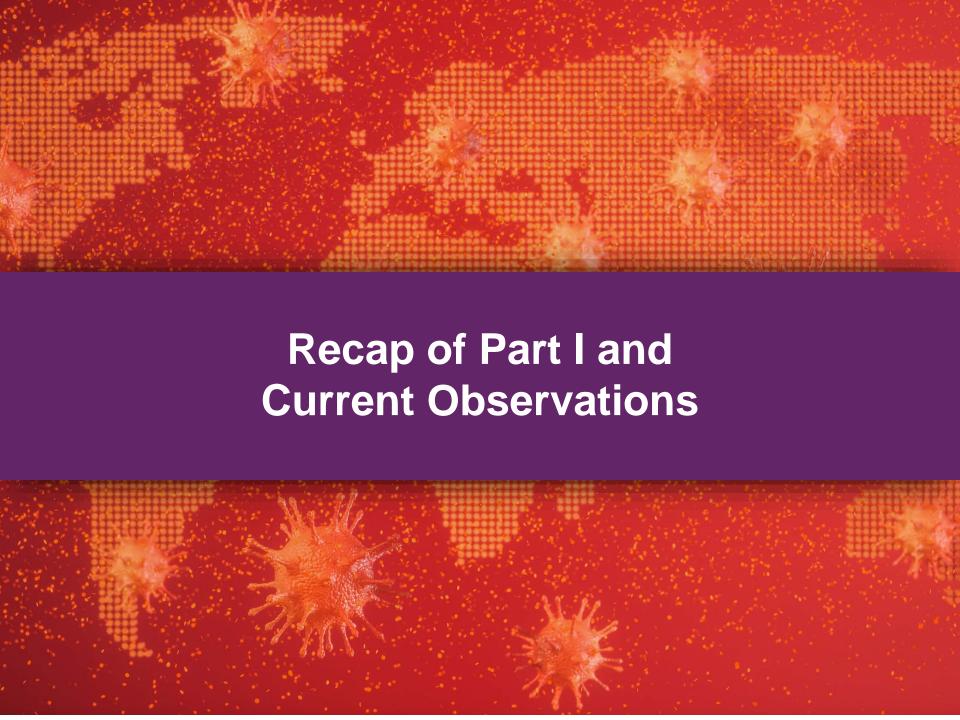
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3

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

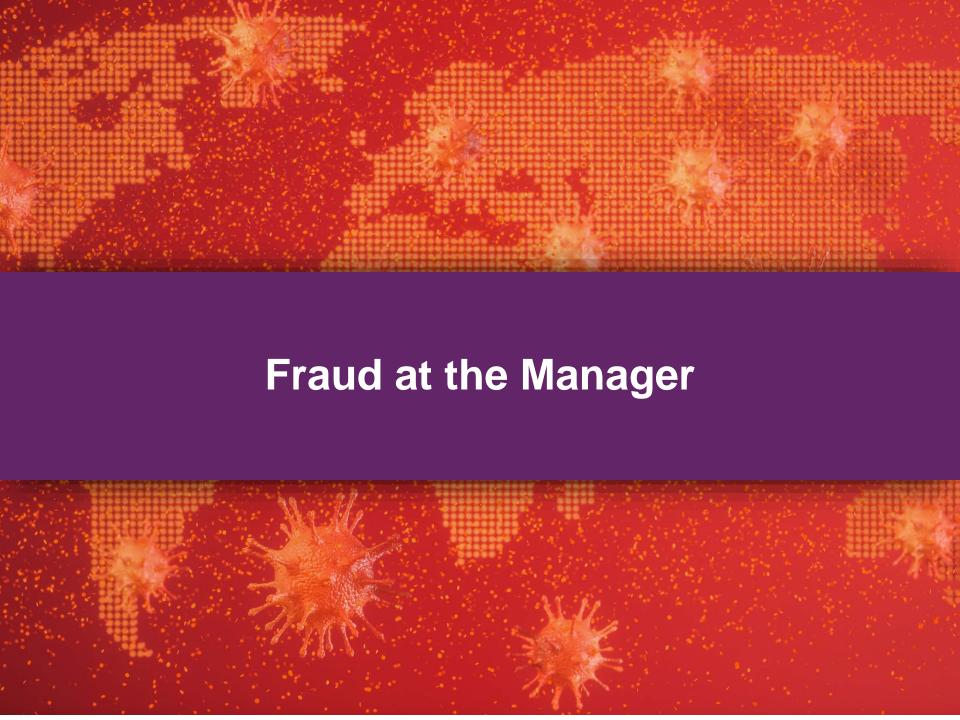


RECAP OF PART I OF THE WEBINAR

- 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

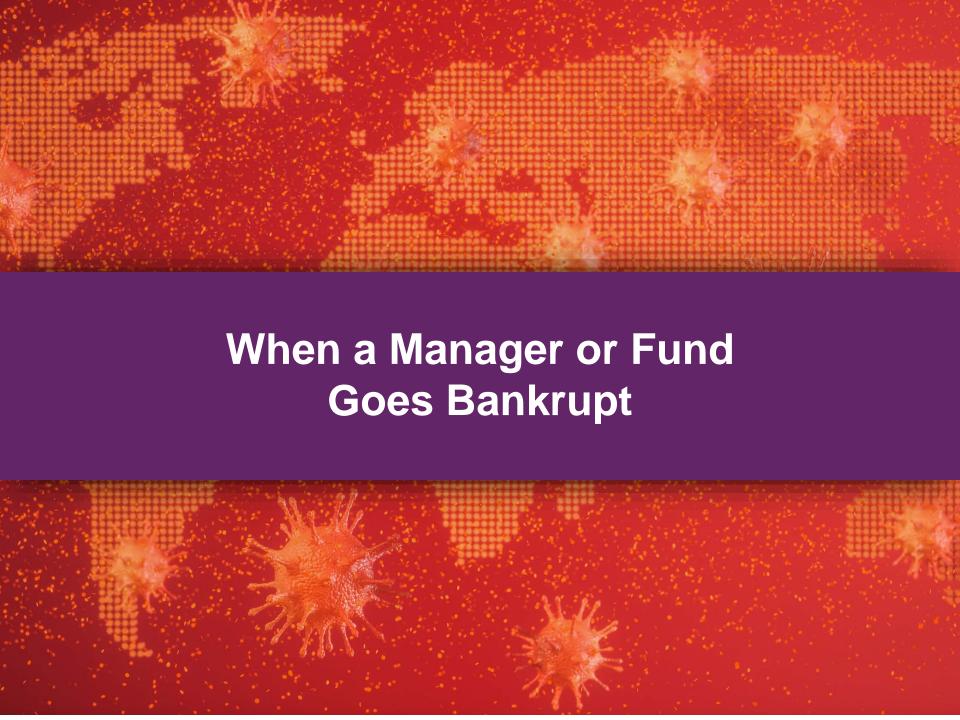


FINANCIAL STRAIN EXPOSES FRAUD

- 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



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.)

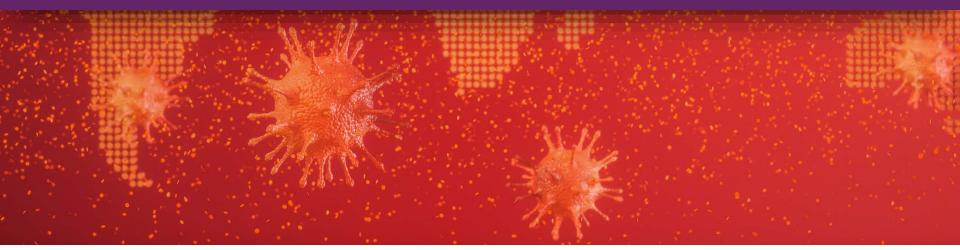
- Process can be very fast paced, so important to react quickly to filings
 - Engage with bankruptcy constituents (management of the debtor and creditors) to evaluate risks and opportunities
 - Engage bankruptcy counsel to assess consequences of filing and navigate the bankruptcy process
 - Keep investor's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



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.)

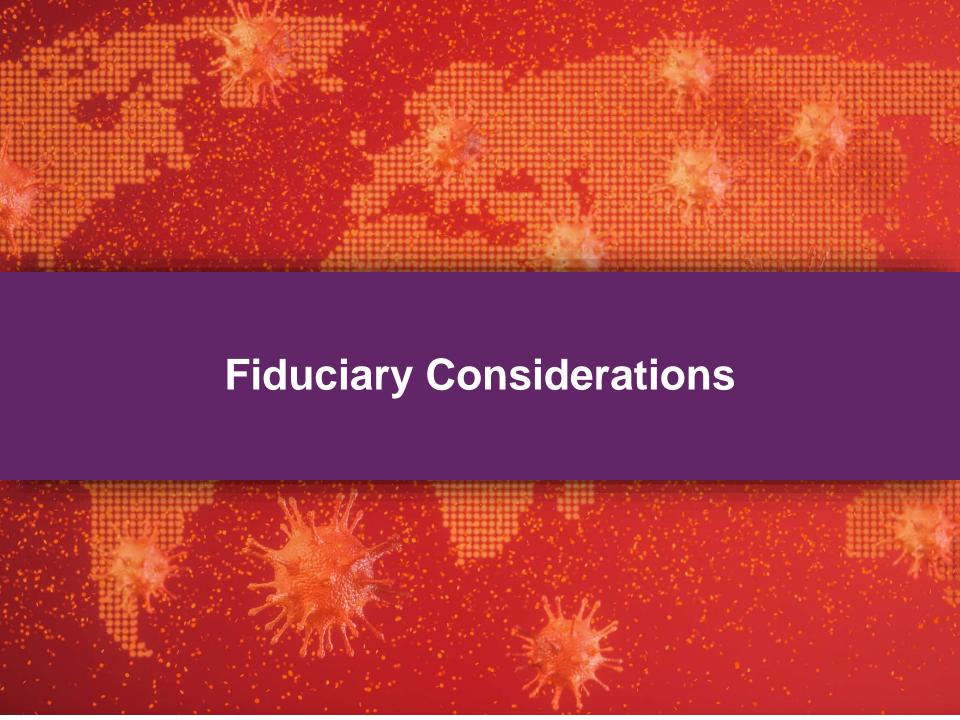
- Check the fine print—documents as a "road map"
 - Contractual rights may protect LP interests, either in fund agreements or side letters
 - Information rights
 - Right to notice of insolvency and litigation?
 - Right to additional information upon request
 - Inspection rights
 - Are any key person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



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