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CORONAVIRUS PANDEMIC

Key Considerations for Private Fund Investors Navigating the Coronavirus Crisis

By Vincent Pitaro, *Hedge Fund Law Report*

The coronavirus pandemic has created vast social disruption and unprecedented volatility in the financial markets, raising risks for both hedge fund managers and their investors. A recent program presented by the Investment Management Due Diligence Association (IMDDA) offered a roadmap for private fund investors to navigate the crisis with their managers, including the tools that managers have at their disposal to manage the crisis; the steps that investors should take to monitor their investments; a comprehensive set of questions for investors to ask managers; and the remedies that may be available to aggrieved investors.

The program was hosted by IMDDA co-founder and managing director Daniel Strachman and featured Anne E. Beaumont and Scott M. Berman, partners at Friedman Kaplan Seiler & Adelman. This article explores the salient points from their presentation, which should also help fund managers prepare to answer potential questions from investors.

See "HFLR Webinar Covers Key Topics for Fund Manager GCs and CCOs in Light of Coronavirus" (Mar. 19, 2020).

Liquidity Management Tools

The current market volatility is absolutely unprecedented, making liquidity management a key concern for both fund managers and investors, Beaumont said. Fund managers may have certain fund- and vehicle-specific liquidity management tools at their disposal.

Gates

An investor- or fund-level gate can prevent a race to the exit and avoid a so-called "liquidation death spiral," in which a manager sells assets at a loss to meet redemptions, reducing the fund's net asset value (NAV) and leading to even more redemptions. The devil is in the details when gates are concerned, cautioned Beaumont.

See "Lock-Ups and Investor-Level Gates Prevalent in New Hedge Funds" (Mar. 23, 2017).

Side Pockets

Side pockets, which are somewhat less common since the 2008 global financial crisis, can be used to hold illiquid or hard-to-value investments. They can, however, be "kind of a mess" operationally, Beaumont observed.

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See "Six Important Lessons for Hedge Fund Managers, Investors, Administrators and Others in Structuring Side Pockets and Monitoring Their Use" (Mar. 4, 2011).

In-Kind Distributions

In-kind distributions can be used to satisfy redemptions, either by direct distribution of securities or distribution of shares in a special purpose vehicle created to hold certain assets.

See "How and When Should Hedge Fund Managers Value Securities Used to Satisfy Redemption Requests In Kind?" (Aug. 29, 2013).

Suspensions

A suspension of redemptions is an extreme remedy that may not be available in every case. Suspension or delay of the calculation of NAV is probably the most likely tool that managers will use in the current crisis.

See our two-part series "Schulte Partner Stephanie Breslow Addresses Gates, Side Pockets, Secondaries, Co-Investments, Redemption Suspensions, Funds of One and Fiduciary Duty": Part One (Dec. 4, 2014); and Part Two (Dec. 11, 2014).

Other Options

Managers may also consider asking investors to amend fund documents to provide for lockups in exchange for reduced fees, Beaumont continued. Some may even be considering bankruptcy or liquidation. Managers should have already reviewed their fund documents. "If you are just pulling them out and reading them today, you are already probably too late, but if you haven't, you should get on with it," she said.

See "Tools for Managing Hedge Fund Crises Caused by Liquidity Problems, Poor Performance or Regulatory Issues" (Jan. 9, 2014); and "Hedge Fund Liquidity Management Tools" (Nov. 15, 2012).

Five Defensive Measures for Investors

First, investors should review their fund documents, focusing on the manager's available liquidity management tools; key person and succession provisions; valuation provisions; available remedies; and any applicable side letters, Beaumont explained.

Second, investors should open lines of communication with managers and start asking questions. Managers have been concerned about potential leaks to the press and must "walk a fine line between working closely with investors and being even-handed with information," Beaumont noted. Consequently, they may ask investors to sign nondisclosure agreements that go beyond the confidentiality provisions in fund documents. Some managers have always been a "brick wall," but smart managers will want to keep open lines of communication with investors, she added.

See our three-part series "Key Legal and Business Considerations for Hedge Fund Managers in Drafting and Negotiating Confidentiality Agreements": Part One (Apr. 12, 2012); Part Two (Apr. 26, 2012); and Part Three (Jul. 19, 2012).

Third, investors should seek to understand the markets in which their managers operate, as each market is facing its own unique issues. Investors should thus try to find insightful

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coverage of each relevant market, Beaumont said.

Fourth, investors should consider identifying other similarly situated investors, continued Beaumont. Finally, investors should think about available remedies and how they may exercise those remedies.

Questions for Managers

Investors should be "asking good questions and asking them over and over and over" to see if there are any changes to the answers, Beaumont advised. They should prepare carefully framed questions in advance of their conversations with managers and document the answers in real time.

One way to do that is to include a colleague on the call to write down the manager's responses, Beaumont continued. Another is to record the call, taking into account the pros and cons of doing so, as well as the applicable law governing recording of conversations. An investor should also ask if the manager is recording the call.

"How Is It Going?"

An investor should ask open-ended questions to avoid missing important information, Beaumont recommended. Questions can be used to test if a manager is being candid with the investor and to understand what factors, in addition to the market, are affecting the manager's operations.

Investors should start conversations with questions such as:

- How is it going?
- How is the team doing?
- How is the portfolio doing?
- How have operations changed?

In addition to the substance of the responses, investors should consider the manager's tone of voice. "Anything that smacks of business as usual should make you nervous," Beaumont cautioned. "This is not business as usual in any form."

Business Continuity and Remote Operations

An investor should ask about the manager's remote operations and the implementation of its business continuity plan. For example:

- What went wrong or right?
- How did you address any issues that arose?
- Is it difficult not working together in one place?
- Have any key personnel (or their families or partners) been affected personally? The manager may provide a circumscribed answer to this question due to privacy laws.
- Have there been challenges with administrators, custodians, prime brokers, technology providers or other third parties?
- Have any cybersecurity issues arisen?

See "The Coronavirus Pandemic: Fund Managers Must Have Strong Business Continuity Plans" (Mar. 26, 2020); and "Key Considerations for Fund Managers Responding to the Coronavirus Outbreak" (Mar. 26, 2020).

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Third-Party Service Providers

In addition, investors should ask to speak with critical third parties and ask them the same types of questions, Beaumont suggested. Although independent directors may cooperate, a manager's third-party service providers are likely to be less cooperative than the manager. Those service providers will be most interested in avoiding liability, Berman added. Because their duty is only to the manager – not to fund investors directly – they will likely defer to the manager.

See "How Fund Managers Can Develop an Effective Third-Party Management Program" (Sep. 21, 2017); and "Legal, Operational and Risk Considerations for Institutional Investors When Performing Due Diligence on Hedge Fund Service Providers" (Jul. 8, 2010).

Portfolio and Risk Management

Investors should ask managers about trading, portfolio and risk-management issues. "Business as usual should be an alarm bell," Beaumont reiterated.

Investors should expect to hear about challenges involving liquidity, funding, changes in traditional correlations, pricing changes, volatility and widening spreads.

An investor's questions in this area could include:

- How has the portfolio changed?
- Are you mostly in cash?
- What challenges in the market have you identified?
- How are you addressing each challenge?
- Has there been any significant change in investment strategy or style?

See "Hedge Fund Managers Must Ensure Portfolios and Valuation Comport With Investor Disclosures or Risk SEC Fraud Action" (Jul. 28, 2016); and "Investors Sue Hedge Fund Manager Harbinger Capital and Philip A. Falcone for Alleged Style Drift" (May 31, 2012).

Leverage

"Leverage is a huge issue" that investors should focus on, Beaumont continued, suggesting that they ask:

- Are you subject to margin calls? If so, how have you met them?
- Have any NAV or other triggers in trading agreements occurred? If so, what action is the counterparty taking?
- Have any defaults been declared?
- Have prime brokers or other third parties changed funding terms?

See our two-part series "HFLR Program Provides Overview of Five Financing Options Available to Private Funds": Part One (Jun. 28, 2018); and Part Two (Jul. 12, 2018). See also our two-part series "Three Asset-Based Financing Options for Private Funds: Total Return Swaps, Structured Repos and SPV Financing": Part One (Apr. 5, 2018); and Part Two (Apr. 12, 2018).

Redemptions

Beaumont advised investors to look for signs of a liquidation death spiral. They should ask about levels of redemptions and whether the manager has invoked any gates.

See "How Private Fund Managers Can Prepare for a Potential Downturn" (Nov. 7, 2019); and our two-part series "Six Criteria for Hedge Fund Managers to Evaluate Before Granting an Investor's Request to Rescind Its Redemption":

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Part One (Oct. 3, 2019); and Part Two (Oct. 10, 2019).

Valuation

It is likely that a manager will have had to make some changes to its valuation policies and procedures, Beaumont said. All assets – even some publicly traded equities – are likely to be less liquid than they were just weeks ago and may have to be valued using different methods that reflect the new reality.

Changes to pricing data sources, however, while appropriate in many circumstances, should be an area of focus, and using cross-trades to establish value is "a quintessential red flag," Beaumont warned. She added that investors should have "auditor-like skepticism" of everything they see.

With those considerations in mind, investors may ask:

- Have there been any changes in valuation policies or procedures?
- What changes were made and why?
- Is the entire valuation committee available to meet?
- Does it have access to all requisite information?
- Are your data sources up to date?
- Are you using different valuation data sources or pricing services?
- Have there been changes to pricing models or inputs?
- Have you started using manager marks? If so, what process are you using?
- Have there been cross trades between vehicles?

Fund documents typically require managers to provide NAV and audited financial statements within a specified time frame, Beaumont added. Given that the end of March was a dealing day for many funds – as well as the due date for audited financials – the timing of the pandemic could not be worse. Many managers may have missed the deadline for audited financials. Nevertheless, most investors would rather wait for accurate NAV and financial statements than receive on-time, but inaccurate, financial information, she noted.

See "Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations" (May 11, 2017).

Side Letters

In addition to reviewing their own side letters, investors should ask managers what they are doing to fulfill their obligations under the side letters they have with other investors, Beaumont said. Any manager with many side letters is going to be facing a "gigantic mess." She cautioned, "In a perfect world, all investors get the best deal that is out there in the side letters, but as a practical matter, that is not always how that happens."

For more on side letters, see our two-part coverage of an HFLR and Seward & Kissel webinar: "Key Side Letter Terms" (Nov. 16, 2017); and "Side Letter Trends" (Nov. 30, 2017), as well as "Seward & Kissel Study Finds Reduced Fees and MFN Clauses Remain Most Prevalent Side Letter Terms" (Oct. 5, 2017).

Regulatory Action and Litigation

Here, too, investors should ask open-ended questions, the most important of which is whether the manager has heard from any regulators, Beaumont continued. For example, the SEC Office of Compliance Inspections

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and Examinations (OCIE) sent out a request letter to advisers at the beginning of March 2020 as part of a general sweep. Even though it appears that OCIE has clarified that it does not expect responses, managers that received such a request letter (or any other regulatory request) should mention it.

Regulators are continuing exams remotely, Beaumont noted. An investor should ask in the most open-ended way possible whether the manager is being examined or investigated or has received any requests for information from regulators.

Finally, an investor should question the manager on whether it is involved in any pending litigation or arbitration and whether it has threatened or been threatened with litigation or arbitration, Beaumont added. Confidentiality provisions, however, may limit the amount of information that the manager can provide.

See "Are Hedge Fund Managers Required to Disclose the Existence or Outcome of Regulatory Examinations to Current or Potential Investors?" (Sep. 16, 2011); and "Is a Hedge Fund Manager Required to Disclose the Existence or Substance of SEC Examination Deficiency Letters to Investors or Potential Investors?" (Jun. 1, 2011).

Fraud

Investors should consider whether a manager seems panicked or paralyzed, suggested Beaumont. Most hedge fund frauds do not start as frauds. Managers may begin to engage in fraudulent conduct when they are under severe stress. An honest manager may get to a point where it has a choice of doing the right thing or being "cute," she observed. For example, investors should be wary if a manager stops providing information that it used to provide, appears to be smoothing returns or is not being forthright about losses.

In Berman's experience, there is much more opportunity for fraud when managers have illiquid or hard to value assets. That is likely to be an issue during this financial crisis.

See "Manipulating Fund Valuations Can Bring Penalties From Multiple Regulators" (Sep. 5, 2019); and "Unreasonable Assumptions When Valuing Fund Assets May Lead to Charges of GAAP Non-Compliance, Fraud and Compliance Violations" (Aug. 24, 2017).

Investor Remedies

The first place to look for investor rights and remedies is the fund's governing documents, Berman said. Rights and remedies are also potentially available under federal, state or foreign law (depending on a choice of law analysis), according to Berman.

Suing the Manager

An investor that believes it has a claim for breach of contract or specific performance should review relevant provisions of the fund documents to see if any contractual provision was breached, continued Berman. When evaluating contract claims, statutory claims and common law claims, Berman indicated that investors or their counsel should review in the fund documents:

1. mandatory arbitration or mediation clauses;
2. choice of law and forum-selection clauses; and
3. indemnification provisions.

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An investor should also consider whether to sue for damages or rescission of the investment, added Berman. In many jurisdictions, breach of fiduciary duty claims may only be brought on behalf of a class of investors. In addition, claims against managers for negligence can be barred by exculpation clauses in the fund documents.

See "How Fund Managers Can Use Non-Reliance Clauses to Protect Themselves From Investor Claims of Misrepresentation" (May 23, 2019); "Contractual Provisions That Matter in Litigation between a Fund Manager and an Investor" (Oct. 2, 2014); and "Stanley Druckenmiller's Counsel Provides a Tutorial for Negotiating Exculpation, Indemnification, Redemption, Withdrawal and Amendment Provisions in Hedge Fund Governing Documents" (Feb. 6, 2014).

In Berman's experience, hedge fund fraud and other manager and service-provider misconduct rises dramatically during periods of volatility and stress. To prepare for those claims, investors should carefully document any suspected instances of misconduct by managers.

See "Fund Misrepresentations Inducing Investment: Claims and Remedies Available to Fund Investors and Protections Available to Promoters, Fund Managers and Directors" (Sep. 13, 2012); and "Hedge Fund Investor Accuses Paulson & Co. of Gross Negligence and Breach of Fiduciary Duty Stemming from Losses on Sino-Forest Investment" (Mar. 1, 2012).

In many places, including New York state courts, access to courts is now limited to emergency and essential matters. As a result, injunctive relief may not be available until that situation changes, and investors may have to address manager misconduct in actions for damages after the crisis subsides. That is not a big problem because applicable statutes of limitation are long enough to be able to bring claims after the coronavirus crisis ends, and many jurisdictions are tolling statutes of limitation while the crisis is ongoing. Investors could also consider bringing suit in a jurisdiction where courts are operating more normally.

Investors are likely to be concerned that, if they cannot bring suit now, a manager may become judgment-proof, Berman added. That is always a risk. As in past instances of manager fraud, any person or entity with a deep pocket that assisted the manager will be a potential target, including independent directors, administrators and auditors. That is no different from litigation in "normal" times.

See "Second Circuit Upholds Dismissal of Hedge Fund Investors' Securities Fraud and Negligence Suits Against Fund Auditors, KPMG and Ernst & Young, Based on their Alleged Failure to Detect Madoff Fraud" (Sep. 27, 2012); and "MAXAM Fund Sues Auditors Over Madoff Losses" (Feb. 26, 2009).

Removing a Manager

Some fund documents provide that a specified percentage of investors have the right to remove the fund's manager under certain circumstances. Investors should consider whether it is advisable to do so, Berman said. An investor that assumes any of the manager's duties, however, could expose itself to liability as a fiduciary to other investors.

It may be very difficult to identify other fund investors, Berman said. In rare instances,

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a fund's governing documents may give an investor the right to inspect the fund's books and records. When that is not possible, the investor could pursue informal avenues, including seeking information from placement agents. Subject to any confidentiality provisions imposed on investors in the fund's governing documents, an investor may also publicize its desire to connect with other investors, Beaumont added.

Involving a Regulator

Involving a regulator can be risky, Beaumont cautioned. For example, the SEC could impose a receiver that, depending on the circumstances, could be a significant help or a significant hindrance. Nevertheless, if an investor has no access to the courts, the best way to seek emergency relief could be to involve a regulator.

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