Private Funds and Liquidity Management

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Introduction

Liquidity management continues to be an important topic in the private fund industry. The recent COVID-19 pandemic and the substantial uncertainty surrounding its effect on local and global markets have enhanced the topic's prominence. Although the suddenness and extremity of this pandemic are truly unprecedented, the strategies and tools for fund managers to successfully navigate resulting liquidity challenges are already in place.

Open-End Funds

Open-end funds (such as hedge funds) are traditionally able to offer periodic liquidity based on the assumption that their assets are liquid, have readily known values and can be quickly sold.[1] In any liquidity crisis, however, these assumptions may prove incorrect about some or all of a fund's holdings. Issues related to market illiquidity are magnified when open-end fund managers find themselves facing a growing number of redemption requests as investors seek immediate cash to manage their own liquidity challenges. Certain open-end funds that face substantial redemption requests or hold a portfolio that has sustained significant losses may no longer be viable, with dissolution as the only option. However, other funds may find that certain liquidity management tools included in their governing documents may help them weather the storm.

One such widely recognized tool is an open-ended fund's ability to suspend redemption requests and/or the payment of redemption proceeds in certain circumstances, provided that such circumstances for suspending redemptions are expressly disclosed in the fund's governing documents.[2] A less drastic, and, thus, a more palatable tool for many open-end fund managers is to rely on gates to manage redemption requests. Investor-level gates require an investor to stagger its redemption over multiple redemption dates. Open-end funds sometimes instead provide for gates at the fund level (e.g., caps on redemption based on a designated percentage of the aggregate redemption requests received by a fund or class during a given period). However, we have found fund-level gates to be a less effective device as they can create panic and increase demands for redemption from investors who fear being left behind with the least saleable assets in a failing fund.[3]

Open-end funds also typically provide the manager with general authority to distribute assets in kind as a way to satisfy redemptions. Investors can either receive distributions of fund assets directly in kind from the fund or through distributions of interests or shares in special purpose vehicles, which house such assets until they are liquidated.[4] The flexibility to distribute assets in kind helps to limit an increased concentration of illiquid assets and a depletion of cash in an open-end fund to the detriment of non-redeeming investors.

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"Side pockets" may also be a useful mechanism to manage illiquidity by enabling managers to segregate illiquid assets from those that are more liquid. Redeeming investors often do not have the right to redeem amounts attributable to "special investments" until the investment is realized. It is worth noting, however, that investors are not always willing to accept inclusion of side pockets in fund documents, particularly where the fund's investment strategy would not otherwise require illiquidity.[5]

Notably, these liquidity management tools may not only be useful in and of themselves, but also in negotiations with investors. That is, open-end fund managers that are armed with

the authority to suspend redemptions or to redeem investors in kind may have some bargaining power, in certain circumstances, to negotiate with existing investors to add other liquidity management mechanisms into a fund's governing documents where such tools did not previously exist.[6] For example, an open-end fund manager may propose that investors agree to the addition of an investor-level gate where such tool was not originally included in the fund's governing documents. In return, the fund manager would agree to avoid invoking more drastic liquidity management measures, such as the suspension of redemptions.

Co-investment opportunities pursued in alternative vehicles or segregated classes may serve as a means for open-end fund managers to invest in less-liquid or more concentrated investments without creating a liquidity mismatch that can complicate redemptions, cash management and investor relations with respect to the main pool. Activism and distressed debt strategies are particularly conducive to co-investment opportunities. Open-end fund managers may determine to offer co-investment opportunities for at least five reasons: (i) illiquid investment opportunities in liquid funds; (ii) concentration and capacity issues; (iii) cultivation of goodwill with investors and creation of a track record in illiquids; (iv) expertise and access; and (v) an opportunity to distinguish product offerings.[7] Co-investment capital is sometimes raised through creation of new classes in existing feeder funds, avoiding the delays and costs incurred in launching an entirely new investment vehicle.[8]

Private Equity Funds

In contrast to open-end funds, private equity funds typically do not provide investors with a voluntary right of redemption, and, thus, a liquidity crisis for private equity funds at the fund level tends to be less severe. Still, a liquidity crisis, such as that caused by the pandemic, may impact the underlying portfolio companies in which such private equity funds invest, particularly those portfolio companies in hard-hit industries (e.g., travel and entertainment).

General partners of private equity funds whose portfolio companies have liquidity needs, should confirm the availability of credit lines for portfolio companies and consider drawing on those credit lines where appropriate. They should also review the terms of their funds' governing agreements and their agreements with existing investors, including co-investors, to ensure they understand the leverage limits and how these can be exceeded if necessary. Leverage limits are typically measured at the time leverage is incurred, but declines in asset values can make it difficult to incur additional leverage, and replacement leverage is often problematic for the same reason.[9]

In addition, general partners may seek to create new preferred equity classes in their existing flagship funds or at the portfolio company level, especially in a distressed scenario where it is difficult to attract and add additional debt.[10] This type of fundraising can often be completed quickly. Limited partner consent will likely be required if the preferred equity is added at the fund level. In most cases, private equity managers will allow all existing investors to participate in the new class.

Limited partners in private equity funds may seek liquidity at the fund level, even though they do not have a contractual right to it. Furthermore, private equity funds nearing their maturity dates may continue to hold assets as to which a successful exit has not been achieved. To appease disgruntled investors, general partners may allow limited partners to transfer their fund interests or shares on the secondary market. There has been an increase in activity on the secondary market during the pandemic, with bidders offering to assume private equity fund interests and their related commitments from cash-hungry investors at a discount.[11]

Finally, liquidity crises sometimes lead to limited partners defaulting on their capital calls. General partners typically have substantial discretion to decide what action to take against a defaulting investor, if any. Electing not to take any action against defaulting investors may lead to complaints from other investors. Uncured defaults also may suggest a lack of confidence in the fund's holdings and prospects, encouraging other limited partners to default or pursue other actions against the general partner. Though a private equity fund manager does not necessarily have to exercise the same remedy against each defaulting investor, it should have a rationale for any remedy chosen (or not chosen) and why it is in the best interest of other investors in the fund (and not, for example, driven by the fund manager's outside relationship with the defaulting investor).[12]

Conflicts

In challenging markets such as those created by COVID-19, non-market-correlated strategies and distressed strategies can thrive. However, this shift to particular strategies, plus the need to infuse capital into existing holdings, can lead to conflicts, particularly where the same fund sponsor invests in different levels of the capital structure of portfolio companies for different pools of investor capital. Advance disclosure as to how these conflicts will be resolved is critical. Fund sponsors should evaluate, with counsel, whether they need to supplement the offering materials of funds open for fundraising and funds that have investors that have the right to redeem, and what disclosures and consents are required from limited partners and advisory boards of private equity funds when these conflicts arise.[13]

During extraordinary markets such as that caused by the pandemic, the interests of the investors themselves aren't always aligned — some want liquidity now, even at a hair cut, while others want the portfolio retained until market conditions improve.[14] Similarly, some investors may be eager to allow the fund sponsor to shift direction to take advantage of new market conditions, while others do not want the fund's investment program to change course. The challenge for the fund sponsor is to balance these objectives and avoid drifting, without the requisite consent, from the expressed investment program and terms of the fund.

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1. *See* "Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools In Practising Law Institute Seminar," *The Hedge Fund Law Report*, Vol. 5, No. 43 (Nov. 15, 2012).
2. *See SRZ Publication* "Considerations During Volatile Markets for Hedge Funds and Credit, Direct Lending and Distressed Funds," (March 16, 2020).
3. *See* "What Are Hybrid Gates, and Should You Consider Using Them When Launching Your Next Hedge Fund?" *The Hedge Fund Law Report*, Vol. 4, No. 6 (Feb. 8, 2011).
4. *See* "Hedge Fund Managers Using Special Purpose Vehicles to Minimize Adverse Effects of Redemptions on Long-Term Investors," *The Hedge Fund Law Report*, Vol. 2, No. 15 (April 16, 2009).
5. *See* "Six Important Lessons for Hedge Fund Managers, Investors, Administrators and Others in Structuring Side Pockets and Monitoring Their Use," *The Hedge Fund Law Report*, Vol. 4, No. 8 (March 4, 2011).
6. *See* "When Can The Liquidators of Non-U.S. Hedge Funds Access U.S. Bankruptcy Courts to Obtain Ancillary Relief for Fund Investors?" *The Hedge Fund Law Report*, Vol. 4, No. 32 (Sept. 16, 2011).
7. *See* "Co-Investments Enable Hedge Fund Managers to Pursue Illiquid Opportunities While Avoiding Style Drift (Part One of Three)," *The Hedge Fund Law Report,* Vol. 7, No. 7 (Feb. 21, 2014).
8. *See SRZ Publication* "Ideas for Raising Capital During the COVID-19 Dislocation," (March 26, 2020).
9. *See* "Private Equity Sponsors — Considerations for Private Equity Sponsors Related to the Effects of COVID-19," *SRZ Alert* (March 16, 2020).
10. *See SRZ Publication* "Private Funds — Market Trends Report," (May 13, 2020).
11. *See* "Ideas for Raising Capital," *supra* at 8.
12. *See* "Considerations During Volatile Markets," *supra* at 2.
13. *See* "Considerations for Private Equity Sponsors Related to the Effects of COVID-19," *supra* at 9.
14. *See* "Considerations for Private Equity Sponsors Related to the Effects of COVID-19,: *supra* at 9.