Alternative investments should be reviewed to address coronavirus related issues

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The COVID-19 pandemic has already had an obvious negative impact on investors across a wide swath of asset classes. While those who hold equity in publicly traded companies can check online investment statements to assess current asset values, alternative investments such as private placement fund investors (in private equity, venture capital, real estate, and hedge funds), do not have easy metrics to peruse for updates. Additionally, these types of investments are often structured in ways unique to the fund and could include provisions, such as capital calls, limits on withdrawal, and gating provisions, which may not be favorable given the recent market drop. The nature and degree to which any fund is impacted by COVID-19 will depend on such factors as the fund's stage and maturity, its investment objectives and strategies and its investor base. With the drop in public company values, uncertain cash flows for many businesses and general unclear nature of the crisis' full extent, reviewing the terms of such alternative investments is key to ensure that any losses, capital calls or other restrictions are addressed proactively.

On March 27, 2020, business owners and taxpayers received the third in a series of stimulus packages called the Coronavirus Act, Relief, and Economic Security Act (the "CARES Act") (H.R. 748). This Act contains little direct help for investors though it does have a few helpful provisions for the companies in which alternative investment funds might be invested. A summary of relevant CARES Act tax changes are listed below and separate Withers client alerts addressing the broader issues can be found at www.withersworldwide.com/weathering-the-coronavirus-outbreak.

Addressed below are issues that investors in alternative investment funds may wish to consider in light of the ongoing impact of COVID-19, both for existing fund investments and new investments.

Considerations for Existing Fund Investments

Actively monitor communication from the fund and verify fund viability

- Managers and fund sponsors should be actively reaching out to investors, not just waiting to respond to questions, to address the health of the portfolio and the mitigating actions being taken to limit exposure. Provisions or modeling of assumptions used to forecast fund performance in a recession or market turndown should be shared with investors. If the fund manager is not reaching out, actively do so. Key questions for investors to consider asking should include details about individual investments, market sectors and fund weighting. The long term viability of the fund is a key metric to be evaluated.

Reporting requirements should be getting met

- **Annual Reports.** Private funds are typically required to deliver their annual reports, including audited financial statements, to investors within a certain time period after their fiscal year-end. A common time period is 90 days after the fiscal year end. Governing documents of the fund will provide guidance of the exact timing and extent of reports required. Investors should be on the lookout for such reports and follow up with the fund should they not arrive. Any reports should address- hopefully – the impact of COVID-19 – along with providing information regarding the fund manager's actions taken to address the related issues and risks.
- **Tax Filings.** The US Treasury Department, through the IRS, extended most, if not all tax deadlines for the first half of 2020. As such, private placement funds, their portfolio companies, and investors will need to re-evaluate their tax compliance calendars and plan accordingly. The IRS's Notices 2020-17 and 2020-18 materially changed the 2020 tax compliance deadlines, automatically extending most April 15 deadlines to July 15, 2020 (including self-employment income taxes, as well as federal estimated income tax payments) and most states have followed suit as well. Investors should be mindful of any information needed to file their own tax returns and the effects of the COVID-19 pandemic, along with meaningful impact to their net worth or liquidity.
- **Portfolio Company and Fund Securities Law.** Some security law reporting has been allowed a grace period (especially in the public

investment realm), including Schedule 13F and Schedule 13G filing requirements.

Review side letter rights and obligations

- Many funds are subject to side letters, which outline terms and conditions specific to the investor arising out of their investment in the fund. Common provisions include additional reporting obligations, investor rights or restrictions, governance issues or the obligation to notify the investor when certain events occur. Investors should review their side letters to determine what rights or obligations might arise from events occurring due to COVID-19.

Consider liquidity and contractual arrangements

- **Liquidity.** Investors should determine what their obligations are, such as capital calls, in the event that portfolio companies or the fund itself be doing poorly in the current environment. Because it is often true that cash is king, there is an inevitable tension between investor and fund capital retention expectations.
- **Margin and credit facilities.** Investors should review the fund offering information and later statements to check whether the fund uses margin or credit. If the fund does use either, any losses could be compounded due to this leverage.
- **Debt.** Debt has long been used in private equity, venture capital, and real estate, in particular. While interest rates are low, this is often a useful (if not necessary) option for maximizing the impact of organizational and operational changes to portfolio companies. It was also enhanced by tax deductions for interest expenses payments. The CARES Act now expands the ability to take tax deductions for certain interest expenses, such as increasing the prior 30% adjusted taxable income (ATI) limit to 50%, and allowing taxpayers to use their 2019 ATI number rather than the 2020 numbers. The 2019 ATI number is generally expected to be higher than that for 2020, therefore resulting in a larger tax deduction for respective taxpayers.

Stay on top of valuation and asset losses

- Review fund statements to remain up to date on the valuation of all funds. Determine if any losses have been taken by the fund and whether other gains exist for the applicable tax year which can be offset against such losses.
- Investors with co-investment rights should also stay focused on new opportunities. Valuation firms are already suggesting that operating businesses and real estate valuations are expected to be down in 2020, in some cases with 10 to 30 percent decreases when compared to 2019 values, depending on geography and industry.

If looking to redeem, ensure that doing so makes sense

- Investors contemplating a redemption request should review fund documents to ensure that, when doing so, any conditions or requisite timing for such requests are met. Any “gates” which restrict such redemptions should be analyzed. The tax implications of such a redemption should be reviewed before a redemption request is made. The remaining life of the fund should also be considered as it could impact whether a redemption makes sense. For investors seeking liquidity, private alternative funds might not be the best option as they often have unfavorable terms at an early redemption, which is why investors often liquidate more readily tradable asset classes first.

Considerations for New Investments

Double down on due diligence

- Investors should revise and expand their due diligence to address the manner in which potential investments may be impacted by COVID-19, along with the potential impact of a recession.

Review key deal terms

- If an investor had been in the process of entering into a fund investment, the investor should reconsider key deal terms, including conditions to closing, the material adverse change (MAC) clause, representations and warranties and pre-closing covenants. “Tried and true” precedents and “market” deal terms may need to be adjusted and should be re-evaluated with current market conditions and the particular circumstances of the fund involved.

Optimize distressed asset opportunities

- Current market conditions will likely result in opportunities to invest in distressed assets. Investors should review the governing agreements and private placement memoranda of their prospective fund investment to determine whether the fund has the capability to make those types of investments given the investment objectives and strategy of the funds and the disclosure thus far provided to investors. Side letters should also be reviewed for similar allowances, restrictions and related notice requirements. Should the investor wish to invest in funds that allow for such distressed investments and a proposed investment fund does not have such flexibility, the investor can suggest that the fund objectives be updated to reflect the market or find another fund with such investments allowed.

Keep tax considerations in mind

- The points included above regarding valuations and expanded tax rules for interest expense tax deductions will have an important economic impact on investment strategies that involve turn-around or distressed asset targets.

The key takeaway from the above points is that investors should be carefully reviewing existing private fund investments to assess their personal impact from COVID-19 and what next steps make sense given the terms of those investments. All contemplated new fund investments should be revisited to ensure that the deal terms are still appropriate given the changes in the investment market and broader world.

CARES Act Could Impact Companies Held in Private Funds

Additionally, the CARES Act, targeted at taxpayers and employers, and by no means focused on helping private equity and other alternative funds, does contain certain provisions which might prove helpful for the right portfolio company held within a fund. These aids might mitigate losses by such companies and even allow for ongoing success, thus potentially preventing the recognition of losses.

Key provisions of the CARES Act which could favorably impact investment companies held by funds include:

1. **50% employee retention credit for employers closed cue to COVID-19.** The CARES Act provides eligible employers with a refundable payroll tax credit equal to 50% of certain "qualified wages" (including certain health plan expenses) paid to employees beginning March 13, 2020 through December 31, 2020 if the employer is engaged in an active trade or business in 2020 and suffers certain consequences to their business as a result of COVID-19.

2. **Small business loan forgiveness does not give rise to the cancellation of indebtedness income.**

3. **Tax treatment of economic stabilization investments.** The CARES Act authorizes the Treasury to make or guarantee up to $500 billion in debt and equity investments in businesses, states, and municipalities affected by COVID-19.

4. **NOLs; excess business losses.** The CARES Act allows a corporation's losses from 2018, 2019, and 2020 to be carried back for five years, and allows all corporate NOLs to fully reduce taxable income (rather than only 80% of taxable income under current law).

5. **Increase of the Section 163(j) limitation on business interest expense deduction from 30% to 50%.**

6. **Filing and payment extensions.** The CARES Act permits employers and self-employed individuals (other than taxpayers who have had indebtedness forgiven under the CARES Act) to delay payment of the 6.2% employer share of the Social Security tax (but not the 1.45% employer share of the Medicare tax) from the date of enactment through the end of 2020.

7. **Immediate expensing of costs associated with improving qualified improvement property.**

8. **Acceleration of alternative minimum tax (AMT) credits.**

Optimizing and Protecting your Investments Amid COVID-19

Overall, investors should be mindful of alternative fund terms when assessing their own liquidity and the financial impact from the COVID-19 pandemic. Certain terms, such as a capital call, could have short term implications. Others, such as whether the allowed investments of the fund are flexible enough to confront the investing realities of the market, will have longer term impact. Being aware and informed is the best defense against unpleasant surprises.

Click here to read more insights on how we can weather the coronavirus outbreak with you.

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