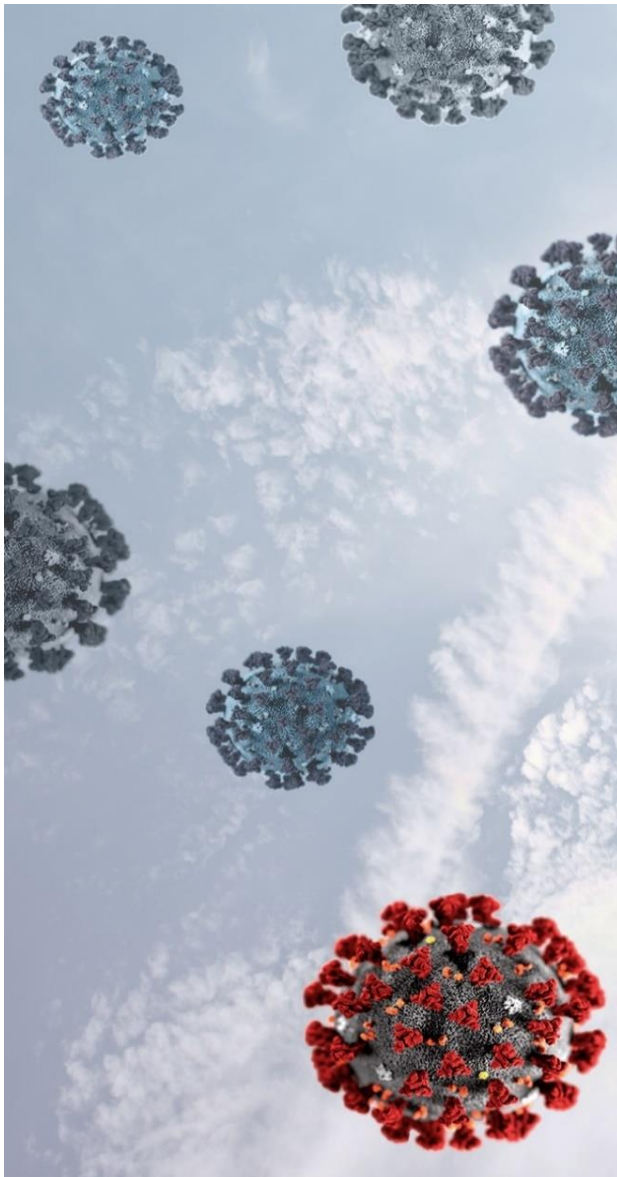


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# The impact of COVID-19 on private equity (fundraising, investment and investees)

Legal flash

July 7, 2020



The private equity industry has not been spared the effects of COVID-19 and is tackling a number of challenges that, although complex, could also lead to opportunities.

This legal flash focuses on matters we believe managers of national and international private equity and venture capital firms seeking to invest in Spain should review and analyze closely given the current economic situation, with the aim of adopting the appropriate measures to mitigate the adverse effects that may arise from the exceptional situation of the COVID-19 crisis.



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## Funds: relevant aspects

### Fundraising

- > **Review of investment agreements.** Preventive measures must be taken to avoid potential defaults in capital calls committed by limited partners (“LP”). Also, it is worth considering other options, such as extending commitment periods.
- > **Follow-on investments.** It is worth considering whether to broaden the definition of “follow-on investments” to provide greater flexibility to new opportunities.
- > **Organizational aspects.** It may be advisable to use alternative means of communication to hold LP meetings (online), and to use electronic signatures for commitments and communications with supervisors.
- > **Documentation of the fund.** It will necessary to review the fund’s documentation and, if appropriate, to update the risk factors.
- > **Sources of funding other than capital calls.** It is advisable to optimize the capacity and alternative sources of funding, bearing in mind the limitations appearing in the fund’s documentation.
- > **Appraisal.** It is advisable to review the appraisal criteria of holding companies, bearing in mind the [latest IPEV guidelines, dated March 31, 2020](#).

### Reporting obligations

- > **Spanish Securities and Exchange Commission (“CNMV”) requirements.** On March 27, 2020, the CNMV published the following reporting obligations for the management companies of collective investment firms ([link](#)):
  - The additional periods granted to draw up, audit and approve accounts are applicable to the annual accounts of venture capital firms (“VCF”) and closed-ended collective investment firms (“CCIF”), and their management companies. Thus, following the latest reform, it must be interpreted that the deadline to **draw up annual accounts** is September 1, 2020. Submission to the CNMV must be made within one month from that date. If the annual accounts had already been drawn up, they must be submitted to the CNMV once the two-month extension period is over (from the date on which the state of emergency is lifted) for the auditors to verify them.
  - The above criteria are not applicable to European social entrepreneurship funds (ESEF), European venture capital funds (EVCF) and European long-term



investment funds (ELTIF), given that under the regulations governing them, the deadline to submit the annual accounts to the competent supervisory authorities is June 30, 2020, even if the *European Securities and Markets Authority* (ESMA) further extends that deadline another two months ([link](#)) .

- Venture capital funds' **obligation to submit classified information** to the CNMV is still in force and will not be suspended. However, the CNMV will consider the causes for the late submission of the information for supervisory purposes, with prejudice to the firms having to inform the CNMV of any incidences as soon as possible.
- Likewise, obligations regarding the submission of **information required under the Alternative Investment Fund Managers Directive** (AIF procedure) and **replies to requests for information** from the CNMV have not been suspended either.

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## New investments

- **Foreign investment.** Following the legal amendments approved owing to COVID-19, yet in this case intended to be permanent following the health crisis, a preliminary study is required to ascertain the applicable regime before making any investment in Spanish companies because “direct foreign investment,” as defined in the regulations, are now subject to prior authorization if certain conditions are met. In the case of investments deriving from funds, it will be necessary to confirm on a case-by-case basis the control chain of the investor acquiring a stake in the Spanish company given that the regulations provide no specific rules on this issue. For more details, see our Legal Flash [on Foreign Investment in Spain: key aspects](#).
- **Transactions under way.** It will be necessary to conduct a detailed analysis of the contracts signed and the agreements reached by the parties. The response may differ depending on the stage the transaction is at and the type of M&A transaction or round of financing, i.e., whether the transaction is at the interim period or it has already closed, but a deferred payment is pending (whether fixed or earn-out), or whether what is pending is a round of financing with a commitment to provide funds already agreed in a venture capital investment agreement. Another significant factor is the agreed price mechanism, as differences will arise depending on whether a price adjustment or locked-box mechanism has been agreed.
- **Renegotiation.** Although Spanish law governs the principle of contract preservation, a contractual analysis will determine whether the terms and conditions can be renegotiated and even whether it is possible to terminate the agreement without penalty. To do so, it is necessary to analyze whether any of the following clauses have been agreed: (i) MAC/MAE clauses; (ii) covenants during the interim period; (iii) conditions precedent; (iv) *force majeure* clauses; (v) a repetition clause of R&W on



closure; or (vi) withdrawal clauses. In the absence of a specific contractual agreement, it will be necessary to refer to *force majeure* clauses, impossibility of contractual performance or *rebus sic stantibus* clauses, analyzed in the section on agreements.

- > **Structuring transactions involving investment in equity and debt.** These kinds of combined transactions can be structured in such a way as to minimize the risk of subordination of debt of the funding shareholder (and related persons). This helps strengthen liquidity and recover credit investment in an unfavorable scenario, while ensuring voting rights if restructuring occurred with a view to maintaining the expected value in equity. These structures add value to investments in the Spanish market in the long term, regardless of any incentive measures approved temporarily owing to COVID-19.
- > **Trends.** Although there is still considerable uncertainty as to the market's general reaction, everything suggests that the current decline in M&A transactions will continue for some time and that the market may transition from being pro-seller to pro-buyer, which would entail changes in price mechanisms (more closing adjustments and earn-outs and fewer locked-box accounts), in liability thresholds, M&A insurance policies (W&I insurance), and in the clauses negotiated in company purchase and investment agreements.

As far as venture capital is concerned, difficulties in closing certain financing rounds under way and in finding new investors are giving rise to bridge financing and to the final rounds being extended to meet the immediate financing needs in which funds are raised from current shareholders, with a trend towards using convertible loans. Likewise, target assessments will tend to drop in general terms, excluding some sectors that are benefiting greatly from the effects of the crisis.

Moreover, we are likely to see opportunities to acquire distressed production units undergoing insolvency proceedings, where it is possible to steer MBO and LBO transactions under favorable liability restructuring conditions, and an upward trend in alternative investments and loan-to-own strategies.

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## Portfolio: relevant aspects

### Corporate governance

- > **Online meetings.** The meetings of governing bodies can be held online, even if not expressly provided in the corporate bylaws, until December 31, 2020.



- > **Drawing up of annual accounts.** A three-month period has been approved to draw up annual accounts from June 1, 2020 (until September 1, 2020) without prejudice to companies that wish to draw them up earlier.
- > **The impact of COVID-19 on accounts.** In the case of companies whose financial year coincides with the calendar year, the consensus is to consider COVID-19 as an event occurring after closing that does not oblige companies to adjust their annual accounts, although the notes to the accounts must state the effects it may have on the business. It must be assessed in each case whether it is advisable to apply for the extension of the deadline to draw up the accounts given that, in all likelihood, the later they are submitted, the more stringent the auditors' criteria will be when appraising the effects. Also, a highly significant impact could make it obligatory to draw up the 2019 annual accounts following the principles of corporate insolvency.
- > **Ordinary general shareholders meeting and proposed distribution of profits.** The general meeting must be held to approve the accounts within two months from the deadline to draw up the annual accounts (we recommend holding the general meeting on October 31 or earlier). On holding the general meeting, it is necessary to consider:
  - whether it is advisable or possible to distribute dividends, evaluating, among other factors, the need for preserving the cash flow, clauses in agreements or bylaws concerning minimum or preferred dividends, or the labor inspectorate's interpretation of the restrictions on dividend distribution imposed on companies exempt from paying social security contributions on applying an ERTE;
  - amending the bylaws so they include the possibility of holding board and general meetings online;
  - reviewing, if applicable, directors' remuneration policies; and
  - evaluating other measures to strengthen the company's equity, such as credit capitalization.
- > **Fiduciary duties and directors' liability for damages.** In the current situation, in fulfilling their duties of diligence and loyalty and to avoid potential liability actions owing to damages resulting from breaching their duties, directors must:
  - exercise utmost caution;
  - keep informed at all times on the company's operation;
  - intensify transparency;
  - adopt any measures necessary at any given time relating to the crisis, bearing in mind the standard of diligence required of directors regarding strategic and business decisions (based on the business judgment rule), which is assumed to be fulfilled when they have acted in good faith, taking no personal interest in the matter being decided, having sufficient information and following appropriate decision-making procedures; and
  - within the group, adopt measures to avoid the parent company being categorized as the de facto director of the subsidiary and, within the subsidiary, ensure that the



instructions received reflect the group's interest and are awarded adequate compensation, even if this is indirect.

- > **Directors' liability for debts.** As regards directors' potential liability for corporate debt resulting from failure to institute insolvency proceedings when required, the exceptional measures adopted provide great peace of mind in this regard, as losses corresponding to 2020 will not be taken into account to ascertain whether the company has grounds for dissolution based on serious losses, and the assessment of the grounds for dissolution due to qualifying losses can only be carried out on determining the financial result of 2021 (i.e., in the case of companies whose financial year coincides with the calendar year, from January 1, 2022). This measure also has effects for tax purposes, as it will prevent the company of the consolidated tax group from being excluded as a result of having grounds for dissolution based on serious losses.
- > **Situations of insolvency.** In situations of insolvency, there is no obligation (although there is the possibility, which may be advisable in some cases) to file for insolvency proceedings until December 31, 2020 and, therefore, directors will not incur any liability for insolvency resulting from the delayed filing of an insolvency petition.
- > **Directors and officers liability insurance (D&O).** It is equally advisable to consider and review any directors and officers liability insurance taken out.

### Financing

- > **Existing financing.** COVID-19 regulations do not entail a general moratorium, nor a standstill on the duty to fulfill obligations under financing agreements or, if applicable, on enforcement actions. However, the situation arising from COVID-19 could affect existing financing agreements (payment obligations, financial ratios and proof of solvency, among others), which will require a case-specific analysis and, if appropriate, it may be necessary to request a waiver or specific exemption from lenders or to consider permanently modifying the terms of financing. Thus, the following issues should be taken into account:
  - The conditions required to make disbursements and, if applicable, whether a MAC affecting the investee's activity or financing condition could be argued to temporarily suspend certain provisions.
  - It is advisable to provide transparent and diligent reporting to financial institutions if the situation arising from COVID-19 health crisis could significantly affect the investee's ability to meet their payment obligations.
  - It is advisable to review the terms on making withdrawals from revolving and working capital facilities, even increasing them to obtain liquidity.
  - Companies having outstanding bonds should pay careful attention to the covenants included in their contractual documents.



- > **Refinancing.** Until March 14, 2020, approved refinancing agreements may be renegotiated. Until then, the general rule stating that a year must have passed since the previous request for approval will not be applicable.
- > **Spanish State Finance Agency (“ICO”) facility.** The Spanish State Finance Agency grants guarantees for the financing of financial institutions aimed at covering liquidity needs and certain investments. For more information, see our [legal flash on financial aid](#).
- > **Extraordinary insurance coverage facility granted by the Spanish Export Credit Agency.** Companies can apply for an insurance coverage facility granted by the Spanish Export Credit Agency (CESCE).
- > **CDTI, ENISA.** CDTI (the Industrial Technological Development Center) and ENISA (the National Innovation Company) offer financial aid and grants to entrepreneurial and research projects, and those from the technology sector.
- > **Capital markets.** Transactions involving promissory notes included on the Spanish Alternative Fixed-Income Market (MARF) can also benefit from ICO guarantee facilities. For more information, see our [legal flash on ICO facilities in paper programs with the Spanish Alternative Fixed-Income Market](#).
- > **Equity.** Companies considering the possibility of shareholders providing funds to face potential cash-flow pressures should ascertain, on a case-specific basis, the most advisable legal form to provide these funds (e.g., capital increases, shareholder contributions to equity, loans, convertible loans, participatory loans, credits, and subordinated debt), analyzing the tax regime, the treatment given to the credit arising from that provision of funds if an insolvency situation were to arise in the future (where, until March 14, 2022, loans and credits would be classified as an ordinary and not subordinated credit) and the suitability of different measures to avoid, if required, breaches of financial ratios agreed in bank financing or fixed-income transactions, or to remedy any such breaches.

### Agreements

- > **General recommendation.** The parties must act in good faith, so it is advisable that they notify the other parties as soon as possible of any contingency that could potentially prevent performance of the contractual obligations, and seek, through amicable negotiation, a solution satisfactory to all parties involved.
- > **Contractual obligations.** Except in specific cases (mainly, when a counterparty is considered to be in a situation of vulnerability, as in the case of lease agreements or consumer contracts, as detailed below), the authorities have not implemented any



concrete measures to regulate the effects of the crisis on contracts. Therefore, the parties must resort to regulations already existing under Spanish law.

- > **Force majeure and *rebus sic stantibus* clause.** The outbreak of COVID-19 and the decisions adopted by the authorities are tantamount to a case of *force majeure*. Depending on the circumstances, this may (i) discharge parties from contractual liability for breach, (ii) release parties from having to fulfill their obligations, or (iii) allow performance to be postponed if the effect of the *force majeure* is temporary. These potential consequences must be analyzed on a case-by-case basis, considering the nature of the obligational relationship, the wording of the contract, and the measures adopted by the authorities in each specific area. If the individual circumstances of the case do not qualify as *force majeure*, the parties may consider the possibility of renegotiating the agreement in cases where the unexpected disruptions have upset the financial balance between the contracting parties, making performance by one to the other unduly burdensome.
- > **Lease agreements.** As for lessees that fulfill the requirement of vulnerability set in each case, (i) different measures have been adopted establishing a moratorium on rent payments where the lessor is a large housing asset holder; (ii) eviction and foreclosure procedures due to rental arrears subject to the 1994 Spanish Urban Leases Act (“LAU”) affecting vulnerable households with no alternative housing options have been suspended for up to six months; and (iii) an extraordinary extension of up to six months has been granted for main residence lease agreements subject to the 1994 LAU. Also, in the case of non-residential lease agreements, a temporary moratorium on rent payments has been established for self-employed workers and SMEs that fulfill certain requirements.
- > **Consumer contracts.** As regards purchase agreements and services agreements that have been impossible to perform, consumers and users are entitled to terminate any agreement they have entered into within 14 days from the date on which performance became impossible. Termination will be effective if, within 60 days from the request for contractual termination, the parties are unable to agree on a proposal for the review of the agreement.

For more details, see our Legal Flashes on [RDL 11/2020](#), [RDL 15/2020](#) and [Contracts and coronavirus: initial considerations under Spanish law](#).

### Refinancing, insolvency and state liability

- > **Reopening of public tenders.** From May 7, 2020, the suspension affecting deadlines for public procurement procedures will be lifted and new contracting procedures can begin, as long as they are processed electronically.





- > **Mechanisms for compensating the effects of COVID-19.** Several mechanisms have been established for contracts that were affected or unable to be performed due to the situation caused by COVID-19 (such as the possibility to request suspension of successive service and supply agreements; the extension of the deadline for the initial enforcement or the extension of public contracts for supply and services other than those mentioned previously; and the suspension or extension of deadlines for works contracts). In these cases, the contractor may be entitled to receive compensation for the suspension or extension period for certain items and subject to certain conditions. Moreover, as regards public contracts for the concession of works and the concession of services, subject to certain conditions, reestablishing the economic and financial balance of contracts is now possible by extending the initial length of the contract by up to 15%, or by amending the financial clauses of the contract. For more details, see our legal flashes on [RDL 8/2020](#) and [RDL 17/2020](#).
  
- > **State liability.** The measures of suspension or restrictions imposed on certain business activities as a result of the state of emergency provide grounds to analyze the scope of the potential liability of the state. These measures are burdens imposed on all citizens to safeguard and protect the community's right to life and health, which means there is a legal obligation to comply with them. However, public burdens must be assumed based on the principle of equality. Therefore, compensation must be provided for damages that involve a unique sacrifice for a particular sector or company, imposed in the interest of the community, being greater than the general sacrifice imposed on all citizens and economic operators. For more details, see our legal flash on [State liability and COVID-19: key aspects](#)

### Employment and social security

- > **Temporary redundancy plans (“ERTE”).** Due to the effects of COVID-19, the target company may be implementing an ERTE (contract suspension or temporary reduction of working hours), affecting all or part of its staff, or it may be planning to resort to this measure. The justification may be on the grounds of *force majeure* (if the activity was affected by restrictions resulting from the state of emergency or in the case of infection or due to contention measures) or on the company's objective reasons (economic, productive or organizational). After the last regulations, from July 1, 2020, four new ERTE scenarios can be identified:
  - **“Transitional” ERTEs on the grounds of *force majeure*:** Companies that have not resumed their activity due to their geographic or sectoral characteristics, have the possibility to request new exemptions on social security contributions until September 30, 2020.
  - **ERTEs on the grounds of *force majeure* of companies that have resumed their activity:** Extension until September 30, 2020, of ERTEs on the grounds of *force majeure* requested under article 22 RDL 8/2020, with employees being called back where necessary to carry out the activity.



- **ERTE on the grounds of *force majeure*:** If a company cannot carry out its activity due to the **new restrictions or contention measures**, it must file for a new ERTE on the grounds of *force majeure* under article 47.3 of the Workers Statute.
  - **ERTEs due to objectives reasons (“ETOP”):** With procedural rules and special rules applicable to legal representatives during negotiations (not existing before June 27, 2020), there is the possibility of exemption of an established percentage of the social security contributions until September 30, 2020, and retroactive effects in cases of negotiation of an ERTE on the grounds of *force majeure*.
- **Restrictions affecting companies that carry out an ERTE.** If a target company has requested an exemption on social security contributions in the framework of an ERTE on the grounds of *force majeure* or of an ERTE ETOP, that company must commit to (i) maintain jobs for six months from the date it resumes its activity (or from June 27, 2020, if it is the first time the company accesses social security benefits); and (ii) not distribute dividends corresponding to the tax year in which the ERTE were carried out, unless it decides to pay the exempted contributions. Also, during ERTes, companies cannot request overtime from their employees or outsource the activity or hire new employees, whether directly or indirectly.
  - **Organizational measures.** The Spanish government maintains the validity of two organizational measures that are highly significant for companies until September 21:
    - The legal preference for remote working; from September 21, 2020 and until the health crisis is officially over, companies must promote remote working when possible as a preventive measure.
    - Employees that have needs for work-life balance in the context of COVID-19 can request adjustment and reduction of their working hours under special conditions.
  - **Moratorium and deferral of social security debts.** Companies have been able to request a six-month moratorium of the debts of April, May and June 2020, or deferred payment of social security debts for the March, April and May contributions, in the terms provided by the Spanish government.
  - **Prohibition to dismiss employees.** Until September 30, 2020, there is a prohibition to dismiss employees or terminate employment contracts on the grounds of COVID-19, and the suspension of the period computed for temporary contracts of employees affected by an ERTE will remain in force.
  - **Resumption of business activities.** All companies resuming activities must observe the necessary organizational and occupational risk prevention measures in their work centers to prevent the infection of employees and third parties, following the specific obligations published by the Spanish government and the autonomous regions for each business sector. It is highly advisable to have a protocol on resuming business activity, as



well as a contingency plan to avoid and deal with cases of infection or a new outbreak, in coordination with the company's health and safety service. Implementing health and safety measures is vital to prevent companies from having to face serious liabilities that may even extend to their directors. For more details, see our [Guidelines on resuming business activity in Spain](#).

For more details, see our legal flashes on [RDL 8/2020](#), [RDL 9/2020](#), [RDL 10/2020](#), [RDL 11/2020](#), [RDL 15/2020](#), [RDL 18/2020](#), [RDL 21/2020](#) and [RDL 24/2020](#), as well as our [legal flash](#) on social security benefits for companies.

### Tax

- > **Tax measures.** Unlike other jurisdictions, no significant tax measures have been approved specifically for this sector (except measures deferring the assessments of SMEs). However, investee companies may opt for other more exceptional measures to mitigate situations of illiquidity, such as the monetization of tax credits, the possibility of requesting the return of the certain tax payments, including (i) business activity tax (IAE) (e.g., in the case of industrial companies obliged to close down their factories, or by requesting the tax credit approved by the City Council of Madrid, benefiting certain activities carried out in the city); (ii) property tax (IBI) for real estate located in Madrid registered as being used for leisure and hospitality, commercial purposes, or for performances; and (iii) corporate income tax (IS) payments deriving from reversals of the impairment of shares, carried out as provided under Royal Decree-Law 3/2016, by challenging corporate income tax assessments corresponding to financial years 2016-2020 on the basis of the unconstitutionality of that Royal Decree-Law, or to try to claim the financial effect deriving from payments on account corresponding to corporate income tax for financial years 2016-2020 exceeding the amount that would have resulted if Royal Decree-Law 2/2016 had not been approved. The constitutionality of this Royal Decree-Law has already been questioned by the Court of Appeals before the Spanish Constitutional Court, where it will be debated in the plenary of the latter court on June 16, 2020.
  
- > **Corporate income tax.** As well as the extended deadlines to draw up and approve the annual accounts for 2019 mentioned above, a longer term has been approved for filing a second self-assessment of corporate income tax if on the date the first self-assessment should have been filed—which must be submitted by the given deadline—the approved annual accounts are not available. In this case, the first self-assessment of corporate income tax must be submitted along with the following information (depending on the degree of preparation on the date of submission):
  - Audited annual accounts
  - Drafted annual accounts
  - Accounts available



Once the annual accounts have been approved, if there were any discrepancies between the accounts and the accounting information used in the first corporate income tax self-assessment, it is possible to file a later supplementary assessment (including the corresponding interest, with no surcharges) or a corrective assessment, the deadline being November 30, 2020.

- **Restructuring.** Finally, at times like these in which certain investee companies of the portfolio may suffer significant losses, to minimize the tax impact, it is worth analyzing the consequences that restructuring in terms of equity and liabilities may have on these investee companies. It is worth assessing the advantages and disadvantages of the different restructuring options based on the objectives and purposes sought, and to identify the most appropriate financing structure, also determining the tax effects of the restructuring strategy as regards the net value of the assets and liabilities, as well as the repatriation of the shareholder's profits.

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