ALLEN & OVERY

Covid-19 coronavirus - advice for the U.S. Private Equity industry

April 2020

The Covid-19 crisis continues to impact the global economy in unprecedented ways. Shelter-in-place orders and non-essential business closures around the world have disrupted operations across all sectors, sending ripple effects through supply and demand chains and causing major dislocations in the equity and debt markets. This pandemic and the ensuing economic fallout raises a mix of pressing concerns and complex legal issues for private equity sponsors and their portfolio company management teams. At the same time, the events surrounding the Covid-19 epidemic may also present private equity sponsors with unique and urgent opportunities to deploy capital, both in their existing portfolio companies as well as in connection with new investments.

We have received numerous questions from our sponsor clients regarding the US federal response to Covid-19, as well as their contractual rights, loss mitigation strategies, and transactional considerations going forward. While we have seen a number of legislative summaries and targeted law firm memoranda dealing with specific initiatives and client concerns, this alert seeks to pull together a cohesive and comprehensive summary of all of the advice we have been rendering to our private equity sponsor clients and their portfolio companies, cutting across a wide array of legislative, regulatory, and practical considerations.

Specifically, this alert discusses:

(1) potential sources of federal relief available to portfolio companies;

(2) US employment law considerations arising under Covid-19-related legislation;

(3) US tax law considerations arising under Covid-19-related legislation;

(4) possible sources of liquidity and credit facility issues;

(5) portfolio company material contract considerations, including insurance coverage, efficient breach, and commercial lease-specific issues;

(6) bankruptcy relief;

(7) transactional and risk allocation considerations for pending and potential transactions, including the impact of material adverse effect provisions and representation and warranty insurance; and

(8) Delaware law considerations for both private and public corporates.

Note that while the analyses set forth herein are limited to the laws of the United States, the State of New York, and (with respect to corporate law) the State of Delaware, Allen & Overy is one of a small number of truly global elite law firms, with 44 offices in 31 countries, and is uniquely positioned to provide tailored multijurisdictional advice across all Covid-19-related legal issues. Given the fact-specific and nuanced application of many of the topics described below, we welcome the opportunity to discuss your concerns directly.

1. Federal relief

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act (the **CARES Act**), a $2.2 trillion stimulus package that, among other things, expands relief options available to certain US small businesses through the Small Business Administration (the **SBA**), including the creation of a new class of Section 7(a) lending, Paycheck Protection Loans (each, a **PPP Loan**), and an expansion of the existing Section 7(b) Economic Injury Disaster Loans (each, a **EID Loan**). The CARES Act also provides for a loan and loan guarantee program intended to help distressed businesses that do not qualify for small business relief, including a program specifically designed for mid-sized businesses with between 500 and 10,000 employees.

As explained below, based on current guidance from the SBA, private equity-backed portfolio companies will likely <u>not</u> qualify for the PPP Loans or the EID Loans outside of certain very specific exceptions; instead, the CESA (b)(4) Program and the Main Street Lending Program (once each such program is implemented) will likely present more viable relief options for private equity-backed portfolio companies. Bear in mind, however, that all of these funding programs remain subject to further guidance. We will continue to closely monitor developments in CARES-act related funding programs, and will provide updated guidance as and when we can.

1.1 Paycheck Protection Loan Program.

(a) **Qualifying Borrowers**. Any business entity[1] will be eligible to apply for a PPP Loan if such entity (1) is organized for profit, (2) has a place of business located in the United States, (3) operates primarily within the United States or makes a significant contribution to the US economy through payment of taxes or use of American products, materials or labor, (4) has no more than 500 employees,[2] and (5) was in operation and had either employees (for whom it paid wages and payroll taxes) or a paid independent contractor on February 15, 2020.[3] Based on the interim final rules published by the SBA on April 2 and April 3, 2020, unless expressly exempted by the CARES Act (more on that shortly), portfolio company applicants will be subject to the SBA's affiliation rules requiring aggregation of such portfolio company's employees with the employees of its affiliates.

(i) ***Affiliation Rules***. Based on the latest guidance from the SBA, affiliation for PPP Loan purposes will be determined by the ability to control (even if not exercised), where control can be found based on equity ownership (including (x) minority ownership where the minority owner can prevent a quorum or otherwise block board and/or shareholder action and (y) contingent ownership based on stock options, convertible securities and

[1] Pursuant to 13 CFR 121.105, the entity may take the legal form of an individual proprietorship, partnership, limited liability company, corporation, joint venture, association, trust or cooperative, except that where the form is a joint venture there can be no more than 49 percent participation by foreign business entities in the joint venture.

[2] Businesses must count all individuals employed on a full-time, part-time, or other basis, including employees obtained from a temporary employee agency, professional employer organization, or leasing business, but excluding volunteers.

[3] <u>Note</u>: The SBA's guidance on PPP Loans published on April 2, 2020 provided that in addition to meeting the 500-employee threshold, applicants needed to also qualify as a "small business concern" as defined in the Small Business Act, which would require consideration of the receipt-based size standards in the SBA Size Standard Table set forth at 13 CFR 121.201 and could render ineligible businesses with under 500 employees that exceed any such receipt-based standard. This guidance is wholly-inconsistent with the CARES Act and, although it has not been rescinded or replaced yet, the subsequently-posted SBA guidance on affiliation rules for the PPP Loans makes clear that PPP Loan eligibility does not require consideration of these receipt-based standards. Further, the PPP Loan application, itself, requires that borrowers certify as to meeting the 500-employee threshold (and does not mention any receipts-based standard).

agreements to merge), common management (i.e., an officer or director holds controlling positions in 2 or more companies), or identity of interests based on close family relationships (specifically, spouse, parent, child, sibling or the spouse of any such person). In short, under current SBA guidance, any portfolio company applicant controlled by a private equity sponsor will likely be affiliated with (and will have its employees aggregated with the employees of) all other controlled portfolio companies of its ultimate private equity sponsor. Thus, subject to the limited CARES Act exceptions outlined below and further administrative guidance, most portfolio companies controlled by private equity sponsors will not be eligible to participate in the PPP Loan program at this time.

(ii) ***Affiliation Exceptions***. The CARES Act waives the affiliation rules for the following types of borrowers: (i) certain hospitality businesses (specifically, those assigned a North American Industry Classification System code beginning with 72) with not more than 500 employees in the aggregate, (ii) any franchise assigned a franchise identifier code by the SBA, and (iii) any business concern receiving financial assistance from a company licensed under the Small Business Investment Act (such a company, an **SBIC**, and such exception, the **SBIC Exception**).

The SBIC Exception presents a gray area for portfolio companies. Because SBIC financing eligibility[4] is subject to different affiliation rules than the PPP Loan program (which rules will not affiliate applicants with controlling shareholders that are venture capital operating companies, registered investment companies, or unregistered 3(c)(1) funds), the SBIC Exception may provide an alternative route to PPP Loan eligibility for portfolio companies otherwise disqualified from the PPP Loan program due to affiliation. Portfolio company applicants should first confirm whether any of their current lenders or investors are SBICs. Even if they are not already receiving SBIC funding, portfolio companies might look to take advantage of the SBIC Exception by securing new debt and/or equity financing from an SBIC[5] and then applying for a PPP Loan (thereby circumventing the affiliation rule complications). **However**, based on current SBA guidance, it is not clear whether businesses that are not currently funded by an SBIC can become eligible for PPP loans by simply securing new funding from an SBIC. Moreover, given the first-come, first-serve nature of the PPP Loans, it is unclear whether this strategy would be practical.

(iii) ***Expanded Waivers?*** Since the enactment of the CARES Act, the SBA affiliation rules have received intense public scrutiny, with venture capital[6] and private equity[7] trade associations and multiple members of Congress[8] lobbying Treasury Secretary Mnuchin and SBA Administrator Carranza to relax affiliation rules for PPP Loan purposes. House

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[4] Generally, an entity is eligible for SBIC financing if it

- (1) is organized for profit,
- (2) has a place of business located in the United States,
- (3) operates primarily within the United States or makes a significant contribution to the US economy through payment of taxes or use of American products, materials or labor,
- (4) has at least 51% of its employees and assets located within the US,
- (5) together with its affiliates (a) qualifies as small under the SBA Size Standard Table industry-specific threshold set forth at 13 CFR 121.201 or (b) has a combined tangible net worth not in excess of $19.5 million and an average net income (post-federal income tax (excluding carry-over losses) for the preceding 2 fiscal years not more than $6.5 million, and
- (6) does not engage in any of the prohibited activities in 107.720 (i.e., re-lending, factoring, passive businesses, real estate businesses, farmland purchases, project financings, foreign investments, associated suppliers, financing licensees or businesses contrary to the public interest).

[5] According to the SBA, typical financing terms are as follows: (1) debt-only: between $250,000 to $10 million, with interest rates between 9% and 16%, (2) equity only: between $100,000 and $5 million, and (3) mixed financings (debt and equity): between $250,000 and $10 million, with interest rates between 10% and 14%

[6] See NVCA Letter to Mnuchin and Carranza (March 27, 2020).

[7] See SBIA Letter to Mnuchin and Carranza (April 2, 2020).

[8] See, e.g., Letter from Representatives Pelosi and Khanna to Mnuchin and Carranza (March 31, 2020), Letter from Representatives Gottheimer, Reed, Crow and Rodgers to Mnuchin and Carranza (March 31, 2020), and Letter from Representative Waters to Mnuchin and Carranza (April 1, 2020).

Minority Leader McCarthy has expressed confidence that venture-capital backed portfolio companies will ultimately be eligible for PPP Loans.[9] To date, however, the SBA-published guidance has not provided for additional affiliation rule waivers except for certain faith-based organizations. It remains possible that the SBA will provide additional guidance. Obviously, any relaxed affiliation rules would lead to a flood of additional applications. As such, portfolio company management teams should prepare the applications and supporting materials described in Section 1.1(e) of this Alert.

(b) **PPP Loan Size**. The maximum amount of any PPP Loan is the lesser of (x) $10 million and (y) the sum of (i) 250% of the borrower's average monthly payroll costs[10] (measured over the 1-year period prior to the loan funding date) and (ii) the outstanding amount of any EID Loan (as defined below) made between January 31, 2020 and the date the PPP Loan is made available to such borrower.

(c) **Qualifying Uses/Loan Forgiveness**. PPP Loans are intended to cover the cost of maintaining payroll costs, rent and mortgage expenses for the 8-week period following loan funding (the **PPP Covered Period**). To that end, the sum of the following payments made with PPP Loan proceeds during the PPP Covered Period will be forgiven at the end of the PPP Covered Period: (i) payroll costs, (ii) interest payments on mortgage obligations existing prior to February 15, 2020 (but not on any prepayment or payment of principal), (iii) rent payments pursuant to leases in existence prior to February 15, 2020, and (iv) certain utility payments, including electricity, gas, water, transportation, and phone and internet access for service incurred in the ordinary course of business prior to February 15, 2020. The CARES Act permits certain other uses of proceeds, but such uses will not be eligible for loan forgiveness. The latest guidance from the SBA also provides that at least 75% of the amount forgiven must have been used for payroll.

The amount otherwise forgiven will be reduced proportionally by any reduction in the number of employees retained by the borrower as compared to the prior year. There is a further dollar-for-dollar reduction in loan forgiveness equal to the reduction of salary/wages of any employee (making less than $100,000 per year) in excess of 25% of such employees salary/wages for the most recent full quarter during which the employee was employed prior to the PPP Covered Period. A borrower, however, will not be penalized by these reductions for termination of an employee and/or reduction of an employee's salary (in excess of 25%) made between February 15, 2020 and April 26, 2020, as long as the employee is rehired and/or the salary is restored by June 30, 2020. Forgiven amounts will not constitute cancellation of indebtedness income for US federal tax purposes.

(d) **PPP Loan Terms**. Based on the latest guidance received from the SBA, if and to the extent that a PPP Loan has a remaining balance after the forgiveness described above, it will have a maturity of 2 years and an interest rate of 1.0% per annum. The SBA PPP Loans are non-recourse to the borrower and not subject to the credit elsewhere, personal guaranty, collateral, and guaranty or annual fee requirements typical of SBA Section 7(a) loans. PPP Loan lenders must defer payments under the PPP Loan for at least 6 months (and up to 1 year) from loan funding, and there shall be no prepayment penalties. The SBA will guarantee 100% of PPP Loans through December 31, 2020, which guarantees will thereafter be reduced to 75% for loans exceeding $150,000 or 85% for loans less than $150,000.

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[9] See Axios, Kevin McCarthy: Startups Will Be Eligible for Coronavirus Stimulus Loans (April 2, 2020).

[10] "Payroll costs" are defined as the sum of such borrower's salary, wage, commission and other compensation, payment of cash tip or equivalent, payment for vacation, parental, family, medical or sick leave, allowance for dismissal or separation, payment required for the provisions of group health care benefits, including insurance premiums, payment of any retirement benefit, or payment of state or local tax assessed on the compensation of employees. Payroll costs shall not include the prorated portion of any compensation in excess of $100,000 per year paid to a given person, compensation of any employee whose principal place of residence is outside of the US, certain payroll taxes (including FICA and income tax withholding), and certain payments for family and sick leave for which a tax credit is available under Section 7001 or Section 7003 of the FFCRA (as defined below).

(e) **Timeline, Application Process**. The PPP Loans are administered through the SBA Section 7(a) Program, but applications should be made directly to participating lenders, not the SBA. Loan applications went live on April 3, 2020, and will be available until June 30, 2020. **Note**: PPP **Loans will be processed on a first-come, first-served basis**. According to Economic Council Director Kudlow, as of 9:30 a.m. EDT on April 6, 2020, 130,000 PPP Loans – representing an estimated $38 billion – had been committed. President Trump and other US federal officials have indicated that they will seek further appropriations for this program if and when needed.

Qualifying portfolio companies interested in applying for a PPP Loans should submit this PPP Loan Application and documentation necessary to establish eligibility (i.e., payroll processor records, payroll tax filings, bank records, and Form 1099-MISC as applicable) to a participating lender.

1.2 Economic Injury Disaster Loan Program

In lieu of (or in addition to) a PPP Loan, a portfolio company may be eligible to receive a grant (an **EID Grant**) and a longer-term loan under the SBA's Economic Injury Disaster Loan Program (an **EID Loan**).

(a) **Qualifying Entities**. Any business concern with not more than 500 employees located in a declared disaster area (which, as of March 13, 2020, includes all states, tribes, territories and the District of Columbia) is eligible to apply for an EID Loan and an EID Grant as an advance thereon. EID Loan applicants are subject to the same broad affiliation rules as are PPP Loan applicants. Unlike the PPP Loan program, however, the CARES Act does not provide any waiver of the SBA affiliation rules. Thus, it is even less likely that a private equity-backed portfolio company will qualify for these EID Loans.

(b) **Permitted Uses**. EID Loan proceeds are to be used by borrowers to cover payroll obligations and other working capital needs or normal business operating expenses. One notable usage permitted for EID Loans (but not for PPP Loans) is meeting the borrowers' increased costs due to supply chain interruption.

(c) **EID Loan Terms**. Terms and conditions of EID Loans vary. EID Loan amounts are based on actual harm suffered, up to a maximum amount of $2 million. EID Loans can feature up to 30-year terms, and interest rates may not exceed 3.75% per annum for small businesses or 2.75% per annum fixed for nonprofit organizations. The CARES Act eliminated the need for personal guarantees for EID Loans up to $200,000, but for any loan in excess of that amount, each principal owning in excess of 20% of the borrower's equity must provide a personal guarantee. The CARES Act also waived the credit elsewhere requirement and the requirement that the borrower be in business for the 1-year period before the applicable disaster (so long as the borrower was in business prior to January 31, 2020). Borrowers must provide collateral for all EDI Loans over $25,000.

(d) **EID Grants**. Borrowers that self-certify as eligible can apply for an EID Advance (and **EID Grant**) in an amount up to $10,000, to be provided within 3 days after receipt of such borrowers applications. These advances can be applied to any of the allowable purposes described above. If an applicant receives an EID Grant and is subsequently denied an EID Loan, such applicant need not repay the EID Grant.

(e) **Interplay with PPP Loans**. The CARES Act allows a borrower who already has applied, or is in the process of applying, for an EID Loan to apply for a PPP Loan if it will not duplicate the borrower's use of the EID Loan. Further, if a borrower received a EID Loan related to Covid-19 between January 31, 2020 and the date at which the PPP Loans become available to such

borrower, then the borrower may refinance that EID Loan into the PPP Loan for loan forgiveness purposes, it being understood that any portions of such EID Loan that do not meet the loan forgiveness requirements outlined above will remain a loan (but subject to the terms of the PPP Loan). If the borrower took out a PPP Loan and took advantage of an EID Grant, the amount of such EID Grant would be subtracted from the amount forgiven in respect of the PPP Loan.

(f) **Application, Timing**. EID Loans are available now, and interested companies can access the streamlined EID Loan for Covid-19 relief here. Expanded eligibility for these EID Loans will sunset after December 31, 2020.

1.3 Coronavirus Economic Stabilization Act Program

In addition to the PPP Loan and the expansion of the EID Loan Program, the CARES Act also provides for $454 billion in financing to banks and other lenders that make direct loans or guaranties to certain eligible business impacted by Covid-19 (the **CESA (b)(4) Program**). As this funding will not be routed through the SBA (and thus subject to the affiliation rules described above), we would expect this CESA (b)(4) Program to be the federal relief route taken by most private equity-backed portfolio companies. However, the CARES Act only authorizes, but does not fully establish, the precise mechanics of applying for relief under the CESA (b)(4) Program. We are still awaiting how this program will ultimately be operationalized via regulation and administrative guidance and will provide an update when possible.

(a) **Eligible Businesses**. A business concern is eligible to participate in the CESA (b)(4) Program if it (i) is created and organized in the US and has significant operations and a majority of its employees located in the US, and (ii) has incurred losses as a result of Covid-19. Further eligibility restrictions may be implemented in forthcoming regulations and administrative guidance.

(b) **Terms, Restrictions**. The Secretary of the Treasury is given broad discretion over the form and terms of the loans provided under the CESA (b)(4) Program, but applicable requirements under Section 13(3) of the Federal Reserve Act related to collateralization, taxpayer protection and borrower solvency will still apply to each such loan. The following restrictions apply to borrowers that receive direct loans under the CESA (b)(4) Program (note: these would not apply to other forms of aid, including secondary purchases, syndicated loans and other securities or capital markets transactions):

- Borrower may not pay dividends or other capital distributions while loan is outstanding and for 12 months thereafter;
- Borrower may not repurchase listed stock of the borrower or any parent company while a loan is outstanding and for 12 months thereafter, except as required by contracts in effect on the date of the enactment of the CARES Act; and
- Borrower must agree to the following employee compensation caps for a period ending 12 months after the loan is repaid (where compensation includes salary, stock and bonuses): (i) any officer or employee whose 2019 annual compensation exceeded $425,000 cannot receive compensation in excess of their 2019 compensation in any consecutive 12-month period or severance pay in excess of twice their 2019 compensation, and (ii) any officer or employee whose 2019 annual compensation exceeded $3 million cannot receive total compensation in excess of an amount equal to $3 million plus 50% of the excess over $3 million.

(c) **Mid-Sized Business Loan Program**. As part of the CESA (b)(4) Program, the US government will seek to establish a loan program specifically targeting mid-sized businesses (including

nonprofits) with between 500 and 10,000 employees. The CARES Act requires that any such loans to mid-sized borrowers would feature annualized interest rates no higher than 2% per annum, and that for the first 6 months of financing under the program, no principal or interest would be due. The CARES Act would also require that any borrower applying for a direct loan under this program would be required to make the following good faith certifications:

- the loan is necessary for ongoing operations of the borrower;
- any proceeds will be used to retain at least 90% of the borrower's workforce until September 30, 2020;
- the borrower intends to restore not less than 90% of its workforce that existed on February 1, 2020, no later than 4 months after the declared public health emergency in respect of Covid-19 is terminated;
- the borrower is domiciled in the US, with significant operations and employees in the US;
- the borrower is not in bankruptcy;
- the borrower will not pay dividends with respect to common stock, or buy-back shares during the term of the loan;
- the borrower will not outsource or offshore jobs for the term of the loan and 2 years after completing repayment;
- the borrower will not abrogate existing collective bargaining agreements during the term of the loan and 2 years after completing repayment; and
- the borrower will remain neutral in any union organizing effort for the term of the loan.

Again, further requirements and restrictions may be implemented in forthcoming regulations and guidance. We will be closely monitoring developments with the CESA (b)(4) program, including the mid-sized business component thereof. As and when further information becomes available, we will provide updated guidance. Keep in touch with us to stay apprised of the latest developments.

1.4 Main Street Lending Program

On March 23, 2020, the Federal Reserve stated that it "expects to announce soon the establishment of a Main Street Lending Program to support lending to eligible small-and-medium sized businesses, complementing efforts by the SBA." The CARES Act clarifies that its provisions for assistance to midsize businesses as part of the Coronavirus Stabilization Act of 2020 would be in addition to (and would not limit) the Main Street Lending Program. We expect that the program, when established, will include detailed eligibility requirements and have numerous "strings attached," consistent with programs authorized by the CARES Act.

We will be closely monitoring developments with the Main Street Lending Program. As and when further information becomes available, we will provide updated guidance. Keep in touch with us to stay apprised of the latest developments.

2. US employment law considerations

Any private equity sponsor or portfolio company considering layoffs or across-the-board wage reductions in response to Covid-19 should first consult with counsel to understand all of its contractual and statutory obligations with respect to any such action. Those businesses retaining their workforce, should consider the expansion of paid sick leave and FMLA under the Families First Coronavirus Response Act (the **FFCRA**), which was signed into law on March 18, 2020.

Among other things, the FFCRA offers all US businesses with fewer than 500 employees offsetting tax credits to provide employees with paid leave, either for the employee's own health needs or to care for family members. The legislation will enable employers to keep their employees on their payrolls, while at the same time ensuring that employees are not forced to choose between their paychecks and the public health measures needed to combat the virus. Note that the FFCRA does not alter an employer's obligations with respect to applicable state and local laws, which may be more generous than the FFCRA.

Generally speaking, where a company has more than 50 but less than 500 employees, it is a "covered employer" for the purposes of the FFCRA and must provide:

(a) to all employees: (i) 2 weeks (up to 80 hours) of paid sick leave at the employee's regular rate of pay where the employee is unable to work because the employee is quarantined (pursuant to federal, state, or local government order or advice of a health care provider), and/or experiencing Covid-19 symptoms and seeking a medical diagnosis; or (ii) 2 weeks (up to 80 hours) of paid sick leave at 2/3 of the employee's regular rate of pay because the employee is unable to work because of a bona fide need to care for an individual subject to quarantine (pursuant to federal, state, or local government order or advice of a health care provider), or care for a child (under 18 years of age) whose school or child care provider is closed or unavailable for reasons related to Covid-19, and/or the employee is experiencing a substantially similar condition as specified by the Secretary of Health and Human Services, in consultation with the Secretaries of the Treasury and Labor; and

(b) to employees that it has employed for at least 30 days up to an additional 10 weeks of paid expanded family and medical leave at 2/3 of the employee's regular rate of pay where an employee is unable to work due to a bona fide need for leave to care for a child whose school or child care provider is closed or unavailable for reasons related to Covid-19.

The FFCRA specifies that the emergency leave described therein is in addition to any leave the employer already offers their employees. Employees may use their 2-week emergency paid sick leave during the first 2 unpaid weeks of FMLA leave, before paid FMLA leave begins. FFCRA also prohibits covered employers from changing their paid leave policies to avoid compliance.

The employer-paid sick leave liability is capped at $5,100 for full-rate sick pay and $2,000 for 2/3 sick pay.

See Section 1.3(b) of this Alert for executive compensation limits related to the CESA (b)(4) Program.

3. US tax considerations

In addition to potential sources of federal funding outlined in Section 1 of this Alert, the FFCRA and the CARES Act also include several important tax provisions, many of which should benefit private equity sponsors and their portfolio companies.

3.1 FFCRA

(a) FMLA and Paid Sick Leave Tax Credits

In connection with the FMLA leave and paid sick leave required under the FFCRA, the FFCRA provides for a series of refundable tax credits, which may offset the cost of providing paid emergency leave. These tax credits may be used against employer-side Federal Insurance Contribution Act contributions, to which several caps and restrictions apply.

In response to expected cash flow concerns with employers bearing the up-front costs of paid sick and FMLA leave, the CARES Act amended the FFCRA to (i) allow employers to request an advance of the anticipated tax-credits and (ii) provide penalty relief for employers who do not deposit employer-side Social Security taxes in anticipation of receiving the tax credit.

3.2 CARES Act

(a) Employee Retention Credit

Eligible employers[11] are allowed a refundable payroll tax credit equal to 50% of qualified wages[12] paid to certain employees from March 13, 2020 to December 31, 2020, up to $10,000 per employee.

This credit is not available to any employer that takes out a PPP Loan.

(b) Delay of Payment of Employer Payroll Taxes

Employers and self-employed individuals may postpone the employer portion of certain payroll taxes otherwise due between the date the CARES Act was enacted and January 1, 2021. Deferred payments are due in 2 equal installments, with 50% of the deferred amount due December 31, 2021 and the remaining 50% due December 31, 2022.

Employers may not take advantage of this deferral if they take advantage of the PPP Loan forgiveness under the CARES Act.

(c) Modification of Net Operating Loss (NOL) Rules

The 2017 Tax Cuts and Jobs Act (**TCJA**) limited NOLs arising after 2017 to 80% of taxable income and eliminated the ability to carryback NOLs to prior taxable years. The CARES Act temporarily modifies this provision for taxable years beginning before January 1, 2021 by delaying the 80% limitation for 2020 and prior taxable years and allowing corporate NOLs from 2018, 2019 and 2020 to be carried back for up to 5 years. This allows corporations to carryback NOLs to taxable years for which the corporate tax rate was 35%, as compared with the current corporate tax rate of 21%.

The CARES Act does not permit a taxpayer to use NOL carrybacks to offset the repatriation tax under Section 965 of the US Internal Revenue Code of 1986. However, the CARES Act allows a taxpayer to elect to exclude any taxable year to which Section 965 applies from its NOL carryback.

[11] An employer is an "eligible employer" for any calendar quarter (i) during which its operations were fully or partially suspended due to orders from a governmental authority relating to Covid-19; or (ii) during the period beginning with the first calendar quarter in 2020 for which the employer's gross receipts declined by more than 50% measured on a year-over-year basis and ending with the 2020 calendar quarter following the calendar quarter for which such eligible employer's gross receipts exceed 80% of gross receipts measured on a year-over-year basis.

[12] "Qualified wages" includes wages and compensation, including health benefits and, (i) with respect to eligible employers that, on average, employed more than 100 full-time employees during 2019, only includes wages paid to employees not providing services due to the circumstances described above (i.e. wages paid to a furloughed employee); and (ii) with respect to employers that, on average, employed 100 or fewer full-time employees during 2019, includes all wages paid to employees during the time periods described above, regardless of whether the employees are furloughed or actively working.

The CARES Act also relaxes certain taxable income limitations on the use of corporate NOLs that would otherwise apply for taxable years beginning in 2021 and provides special carryback rules for real estate investment trusts and life insurance companies.

In addition to providing direct tax benefits and additional cash flow to current portfolio companies, these provisions may provide private equity sponsors with valuable tax assets to consider when negotiating future acquisitions and dispositions.

(d) **Acceleration of Corporate Alternative Minimum Tax (AMT) Credits**

The TCJA repealed the corporate alternative minimum tax and allowed corporations to recover certain AMT taxes paid as a refundable credit against their regular tax liability, but only over a 4-year period beginning in 2018. The CARES Act accelerates the refund timeline by allowing corporate taxpayers to claim the full refund over 2018 and 2019, or if the taxpayer elects, entirely in 2018.

(e) **Relaxation of Business Interest Deductions**

The TCJA generally limited the amount of business interest allowed as a deduction to 30% of adjusted taxable income (**ATI**). The CARES Act increases this limitation to 50% of ATI for 2019 and 2020, except for taxpayers that elect out of this increase. Taxpayers may elect to use their 2019 ATI in calculating their 2020 deductible interest expense.

Note that special rules apply to partnerships, and the increased 50% limitation is only allowed for a partnership's 2020 taxable year.

4. Avenues to liquidity; existing credit facilities

Facing immediate revenue losses, substantial reductions in forecasted revenue, and an uncertain timeline for recovery of the global capital markets, the first order of business for most companies during this Covid-19 crisis is maximizing liquidity and access to cash. Below, we discuss some potential avenues that private equity sponsors and their portfolio companies can pursue to seek additional liquidity under their existing credit agreements.

4.1 Drawing Down on Existing Lender Commitments

In recent weeks, companies finding themselves in need of liquidity have opted to drawdown on their committed revolving facilities to bolster weakened or decimated cash flows resulting from the Covid-19-related market turmoil. Loans borrowed under revolving credit facilities may be borrowed, repaid and reborrowed at the borrowers election, subject to a limited and customary set of conditions – typically a bringdown of the borrower's representations and warranties under the credit documents (which will often include a no "material adverse effect" representation and a representation as to the solvency of the borrower and its subsidiaries at the time of borrowing) and no default under the credit facility (which includes compliance with affirmative covenants to provide certain notices of defaults and other material events). However, borrowers will need to consider the future impact of any drawdowns under their revolvers, as many recent facilities typically include springing financial covenants where the obligation to periodically test the borrower's financial condition is triggered once a threshold percentage of the revolving facility's commitment has been drawn. In contrast, delayed draw term loan facilities, another potential committed source of additional financing under certain credit agreements, may not be as readily available as a solution to a portfolio company's unexpected liquidity crunch, as their availability is usually subject to a more extensive set of conditions, including, typically, that proceeds be used to fund specified acquisitions or investments and satisfaction of a leverage condition to draw. However, if for example, a company has

used existing cash to make acquisitions, some credit agreements may permit use of delayed draw term loans to replenish such used amounts, and this flexibility may have some utility in this environment.

4.2 Special Considerations for Asset-Backed Facilities

Borrowers with asset-backed loan (**ABL**) facilities should pay careful attention to the values of the assets securing any ABL, especially as they relate to borrowing base tests. As the value of inventory and receivables of a portfolio company decline, such businesses may be hit with heightened reporting requirements, stricter cash management and financial covenant compliance requirements, and even "top up" requirements to post additional collateral to make up for the decline in collateral value, all of which should be weighed against any such business's need for liquidity and the availability of alternative sources of capital.

4.3 Alternative Sources of Debt; Compliance Considerations

In addition to drawing funds using existing lines of credit, companies may want to seek alternative sources of funding. This may be due to existing, immediate needs or, proactively, due to concerns about the impact of a continuing pandemic in future fiscal quarters. Whether seeking loans using the federal relief described in Section 1 of this Alert, junior lien debt, mezzanine debt, or preferred equity, borrowers should conduct a careful review of the covenant package contained in their existing credit documents prior to the incurrence of any such additional obligations, since credit agreements outside of the rarified investment grade space expressly restrict the incurrence of additional debt, the granting of security over the assets of the borrower and its restricted subsidiaries and the prepayment of subordinated debt prior to the maturity of its existing loans. It is worth noting, that many such baskets test at time of incurrence of the relevant loan, so borrowers seeking, for example, federal relief, do not need to wait for lender consent before applying for such relief, but would need any approvals by the time the relief loans are actually provided.

While covenant packages vary widely and are highly negotiated, in the past decade, the baskets negotiated by private equity sponsors in their portfolio companies' credit facilities have expanded to (1) permit the incurrence of significant amounts of additional debt outside of the existing facilities (including, *pari passu* debt and debt outside the guarantor group) and (2) give borrowers and their sponsor-controlled parent entities flexibility to restructure the borrower's existing debt and equity structure outside of a formal bankruptcy proceeding, all without requiring the prior consent of the existing lenders. Notably, should a sponsor be willing to contribute equity, as discussed in further detail below, there is often a contribution debt basket that allows additional, usually unsecured, debt to be incurred in an amount up to 2x the amount of equity contributions.

Many recent sponsor-backed credit agreements allow the borrower to designate certain subsidiaries as "unrestricted" subsidiaries (subject to certain negotiated restrictions), which may freely conduct business, including the incurrence of debt and granting of liens on its assets, unencumbered by the covenants contained in the borrower's credit agreement.

In reviewing what flexibility a borrower has under its existing credit agreement, borrowers should keep in mind what other restrictions or conditions apply to utilization under such exceptions, in addition to caps on amounts. For example, many incremental or incremental equivalent baskets are subject to restrictions on maturing inside the term of the existing loans, "most favored nation" pricing protection and the requirement to subordinate any such debt to the liens securing the existing loans through subordination or intercreditor agreements that are satisfactory to the existing lenders. Relatedly, credit agreements may require that the terms of new debt be no less favorable to the borrower. Therefore, new or more restrictive terms required by new financing sources may not be possible without lender consent under the existing credit agreement. Understanding these limits will be important in order to coordinate appropriate communications to both new and existing lenders to obtain needed funds.

4.4 Sponsor-Sourced Liquidity: Equity Contributions and Shareholder Loans

Rather than relying on the open market to source new debt commitments, private equity sponsors with ample cash on-hand should consider whether they can act as a source of liquidity for their existing portfolio companies, either through an infusion of additional cash equity or through the making of shareholder loans.

(a) **Equity Cures**. Existing credit agreements often give sponsors the ability to cure short-term diminution of a portfolio company's financial condition through a straight injection of equity following such companies' default under financial covenants. However, while an equity cure contribution may be a practical solution to the alternative of a called event of default, credit agreement cure provisions should not be relied upon as a permanent (or even long-term) fix to a company's financial deterioration, since most agreements impose a cap both on how much equity can be injected to "cure" a financial covenant default (typically, no over-cure amounts are permitted), and to the number of times that such cure may be used, both during any fiscal year and during the time that the borrower's loan remain outstanding.

(b) **Other Equity Contributions**. Equity contributions that are not used for equity cures may also be used to provide other flexibility (in addition to injecting needed cash) under certain baskets, including building up future dividend, junior debt prepayment and investment capacity (and in some recent credit agreements, such builder baskets are permitted to be used to incur debt and grant liens). Note here that usually credit agreements will prohibit duplicate use of equity contribution as a basket builder, so understanding these provisions will be especially important if using equity contributions to provide for additional debt capacity as in the 200% debt basket described in Section 4.2 above.

(c) **Shareholder Loans**. Finally, to the extent shareholder loans are made, review of the restrictions on junior debt prepayment and affiliate transactions provisions will also be required, in order to understand what terms are permitted and whether or how such loans can ultimately be repaid. In this regard, note that shareholder loans carry with them additional bankruptcy-related risks that should be discussed with borrower and sponsor's appropriate counsel.

4.5 Amendment, Refinancing, and Loan Buy-Back Transactions

The decimation of actual or projected revenues resulting from social distancing mandates and other proposed or enacted Covid-19 measures taken by U.S. and foreign governments may have already put companies operating in certain industries outside of the possibility of compliance under their current credit agreements. Given that there is no clear timeline for containment of the Covid-19 outbreak or recovery of the global capital markets, private equity sponsors looking for longer-term solutions to its portfolio companies' cash flow issues outside of a chapter 11 restructuring (see Section 6 of this Alert) may prefer to either amend its existing credit facility, buyback outstanding term loans or refinance the loan(s) entirety.

(a) **Amendment, Refinancing**. The past month has already seen borrowers approaching their lenders for relief under their existing agreements, whether in the form of financial covenant "holidays" lasting through the duration of a borrower's extraordinary downturn, or the deeming of a company's consolidated EBITDA figures for the fiscal quarters impacted by the outbreak. Under normal circumstances, amendments made at the request of a private equity sponsor or a borrower have been subject to the payment of amendment fees to consenting lenders – however it appears that in the Covid-19 context lenders may be willing to forgo this requirement.

Other tools in the lender's toolkit that sponsors and borrowers should be aware of are requests to adjust the underlying deal structure to add additional protections for the lenders, including the

imposition of maintenance covenants in previously "covenant lite" documentation, the reemergence of anti-cash hording covenants (particularly in connection with borrowers' request to draw all or a significant portion of their revolving commitments to hold as cash on their balance sheets), the negotiation of sponsor payment guarantees and/or the requirement to post cash and other liquid assets into secured accounts in favor of the secured lender to pay off all or a part of the borrowers outstanding loan obligations.

(b) **Loan Buy-Backs**. The impact of the pandemic on the global secondary market for loans has also opened up the opportunity for a company or its private equity sponsor to enter into debt buy-back transactions in respect of such company's outstanding syndicated term loans. The underlying credit agreement will typically contain restrictions on the ability of the borrower or its private equity sponsor to buy into its existing debt when trading at below par. For the borrower, such buybacks typically may be conducted via a dutch auction pursuant to procedures specified in the credit agreement, or as open market purchases, the purchase loans must be cancelled upon buyback, and usually, the proceeds of revolving loans cannot be used to make such purchases.

Private equity sponsors, in contrast, can purchase their portfolio companies' loans through the open market, and such loans can continue in their same form until maturity– however, the amount of loans which can be purchased by a sponsor or its affiliates (other than qualifying debt fund affiliates) are typically capped at a percentage (typically, 25-30%) which would prevent the sponsor from having a blocking vote in any chapter 11 insolvency process, and as a condition of its purchase the sponsor and its affiliates agree that they will be disenfranchised for voting and other informational purposes relative to true third party lenders for the entire period that they hold the company's loans.

When conducting buy-backs or repurchases, a review of the relevant assignment provisions in the credit agreement will be necessary, to see what restrictions (in addition to caps) may be in place, including with respect to any requirements to make no material information representations, as certain credit agreements do have such requirements. Note: that there may be accounting and/or tax consequences for below-par buy-backs, so appropriate tax counsel should be consulted when considering such a transaction.

5. Portfolio company material contracts: self-diligence, insurance, and efficient breach opportunities

In addition to actively managing their cash to maximize liquidity and, where possible, drawing on available lines of credit to build a cash position for a sustained period of disruption to normal operations, sponsors and their portfolio company management teams should undertake a thorough review of the portfolio company complex's material contracts in order to better understand their current insurance coverage and potential legal exposure, as well as identify efficient breach opportunities to back out of (or delay payments under) contractual commitments in order to preserve their liquidity. Further, such a review may also help sponsors identify their most at-risk portfolio companies and prioritize asset allocation accordingly.

In assessing their material contracts, companies should take particular note of force majeure provisions and other affirmative defenses to non-performance such as impossibility and frustration of purpose. These provisions cut both ways, and sponsors will need to understand how to both argue for these provisions (when canceling and renegotiating supplier and service provider agreements) as well as defend against them (when seeking to retain key customer contracts and maximizing future cash flow).

5.1 Business Interruption Insurance Coverage

Portfolio companies may maintain business interruption insurance (**BI Insurance**), which generally insures against the risk of material damage to property that forces a company to partially or fully close down. Typical BI Insurance policies cover physical damage to commercial properties from events such as floods, earthquakes, fires, or other natural disasters. While some BI Insurance policies include an extension for infections diseases, such extensions are the exception rather than the rule. Indeed, following prior viral outbreaks such as rotavirus, SARS, and others, many BI Insurance policies were drafted to expressly exclude any communicable or contagious disease-related losses. Similarly, contingent business interruption insurance (**CBI Insurance**) - which typically insures against losses resulting from an interruption in the policyholder's supply chain due to damage to a supplier's property – is typically focused on physical damage, and may not cover Covid-19 damages. We have, however, seen cases filed against insurers in multiple US jurisdictions where policyholder plaintiffs are asserting that the presence of Covid-19 constitutes physical damage to property.

Policyholders should be mindful of any notice requirements in their BI Insurance or CBI Insurance policies. If and to the extent, the policy requires the policyholder to attempt to mitigate damages, the policyholder should be prepared to demonstrate how it is mitigating losses.

Assuming the policy does not exclude Covid-19-related losses, and the policyholder has complied with all other notice requirements and conditions, the policyholder must still prove that it was the Covid-19 outbreak or the resulting government restrictions that caused the claimed losses. This can be a difficult burden to meet. For example, if a policyholder voluntarily shut down due to safety concerns, it could complicate the policyholder's recovery under a BI Insurance policy as the insurer will argue that it was the policyholder's voluntary shutdown (not the Covid-19 outbreak or any government action) that caused the losses. Moreover, to the extent there was already a general downturn in business in the area prior to the voluntary shutdown or mandated closure, such a downturn would also undercut the policyholder's damages claims. Similar issues would apply to analysis of any complications with the business's supply chain under a CBI Insurance policy. As always, any assessment of recovery under a policy is a fact-intensive inquiry and should be assessed on a case-by-case basis.

Going forward, be sure to keep an eye on potential state and federal efforts to require insurance companies to retroactively cover Covid-19 business interruption and loss of use claims. As of April 1, New Jersey (A-3844), Massachusetts (S.D. 2888), Ohio (H.B. 589), and New York (A-10226) had all introduced such bills (through New Jersey's was ultimately withdrawn before a vote, and no vote had yet been held on the other 3). On March 18, 2020, 18 members of the United States House of Representatives wrote a letter to the CEOs of 4 insurance trade organizations,[13] requesting coverage for business interruption claims arising from the Covid-19 outbreak. We will be monitoring developments on this front, and will provide updated guidance as and when we can.

5.2 Force Majeure

As a general matter, force majeure provisions excuse parties from nonperformance when an unanticipated event or series of events, through no fault or negligence of the party seeing excuse of its nonperformance, prevents performance of the contract. Force majeure clauses appear in many different contexts across industries and should always be assessed on a case-by-case basis.

(a) **Force Majeure Event**. The first step in this analysis is determining whether Covid-19, the economic fallout therefrom, or any of the various legislative actions taken in response thereto falls

[13] The Council of Insurance Agents & Brokers, The Independent Insurance Agents & Brokers of America, The American Property and Casualty Insurance Association and The National Association of Mutual Insurance Companies.

within the scope of contractually defined force majeure events. A generic reference to "act of God," without more, is unlikely to be triggered by the Covid-19 outbreak or ensuing fallout, while specific references to "epidemic," "pandemic," "disease outbreak," "public health crisis," "National Emergency," "acts of civil or military authority," "acts, regulations, or laws of government," "disruption of supply chain," or "disruption of labor force" could trigger the provision. If the force majeure clause enumerates specific events and includes catchall language such as "other similar causes," New York courts interpret the catchall language as limited to events of the same kind or nature as enumerated. Where a force majeure provision's list of enumerated events purports to be non-exclusive, New York courts are split on whether to treat such list expansively or narrowly. Going forward, we expect to see inclusion of terms such as "pandemic" or "disease outbreak" incorporated into force majeure clauses.

(b) **Unforeseen Triggering Event; Absence of Fault/Control**. New York law implies into every contract a requirement that a party seeking to invoke a force majeure clause must establish that (i) the triggering event was unforeseen or unanticipated at the time of contracting and (ii) it is not at fault for (or was not in control of) the triggering event.

The implied foreseeability requirement reflects New York public policy that contracts should expressly allocate the risk of known or foreseen events. If, for example, the contract was executed after Covid-19 was a known risk, the force majeure defense may be more difficult to establish.

With regards to the no fault requirement, the important distinction is between an event that *itself* prevents performance (which may constitute force majeure) and a party's *response* to an event (which, unless the clause is sufficiently broadly drafted, will not constitute force majeure). Thus, standing alone, poor macroeconomic conditions or financial hardship rarely, if ever, provide a basis to invoke a force majeure clause.

(c) **Contract Cannot be Performed**. Other than holding that mere financial burdens do not generally suffice, New York courts have not exhaustively addressed the question of what degree of impediment to performance must be shown to successfully invoke a force majeure clause. Of course, the level of showing is determined by the contractual language. Some clauses require impossibility. Others refer to seemingly lower burdens, such as impracticability or "hindrance." Where the contract requires a showing of impossibility or illegality, the force majeure clause may be triggered by government regulations that specifically prohibit fulfillment of the contract (i.e., non-essential business closure orders). New York courts have not addressed in any detail the meaning of "impracticability," as used in force majeure clauses, but impracticability may be established when it would make no economic or societal sense to require performance. Separate from force majeure, in sale-of-goods cases, the U.C.C. contains provisions addressing commercial impracticability of performance that may apply when the contract fails to address the issue. See N.Y. U.C.C. § 2-615(a).

(d) **Notice**. Many force majeure clauses contain notice requirements, and failure to give timely notice or to give notice in the required manner may prevent the party invoking the force majeure clause (whether for purposes of terminating the contract or excusing nonperformance thereunder) may be denied the benefit they seek. Given the current work-from-home orders in effect across the nation, it may be difficult for parties to comply with all formal notice requirements in a contract, and the parties may wish to propose alternative methods of providing notice under the contract for so long as the Covid-19 crisis continues.

5.3 Common Law Affirmative Defenses

If a New York-law governed contract is silent on force majeure and MAE (or any such force majeure clause or MAE Clause does not encompass the Covid-19 outbreak or ensuing fallout), the common law doctrines of impossibility and frustration of purpose may be available to the party seeking excuse of its nonperformance.

(a) **Impossibility**. Under doctrine of impossibility, a party's duty under a contract is discharged when, due to an unanticipated event, and without fault of the party seeking discharge, such duty becomes impossible to perform. The party asserting this defense bears the burden of proving the triggering event (1) was unforeseeable and (2) rendered its performance of its obligations under the contract objectively impossible (not merely more expensive or difficult). The New York courts apply this doctrine narrowly.

(b) **Frustration of Purpose**. The doctrine of frustration of purpose will excuse a party from a contractual duty where an unforeseen event renders the contract in question virtually worthless (not merely more expensive or burdensome). Rather than demonstrating that performance is impossible, the party attempting to avoid performance must demonstrate that the frustrated purpose is so completely the basis of the contract that, without it, the contract would have made little sense. As with impossibility, New York courts apply this doctrine narrowly.

5.4 Commercial Lease Considerations

In addition to the more general contract considerations described above, sponsors and their portfolio company management teams should take note of the following in respect of their commercial lease agreements.

(a) **Continuous Operating Requirements**. Some leases include provisions expressly requiring the tenant to operate in the premises without interruption, even if the tenant is otherwise satisfying its rent obligations. Such covenants can take many forms, requiring that a tenant operate on certain days or between certain hours, and, often, declare that failure to satisfy the continuous operating requirements constitutes an event of default. Tenants defending against a landlord seeking to enforce a continuous operations-related default should consider force majeure or, alternatively impossibility or frustration of purpose.

(b) **Casualty Clauses**. Casualty clauses typically provide tenants and landlords with the option to terminate a lease (or, alternatively, require the landlord to provide the tenant with a rent abatement) in the event that the property is substantially damaged. These clauses tend to focus on physical availability of the building and are intended to cover events such as fires, floods, or explosions. As these provisions tend to focus on physical damage, it is unlikely they would provide tenants with any termination or abatement relief due to the Covid-19 pandemic.

(c) **Condemnation Clauses, Eminent Domain**. These provisions typically provide the landlord or tenant with the right to terminate the lease in the event of that the government takes the property via eminent domain (or takes an action that permanently deprives the landlord and/or the tenant of their use of the property). Where a government action deprives the tenant of use of the property, but only for a limited time, these provisions also typically provide that the tenant is entitled to a rent abatement for the time it is deprived of its use of the leased space. While a tenant might be inclined to argue that the mandatory closure constitutes a government taking, such a tenant could have difficult time prevailing on a claim for compensation given that these closures are likely to be characterized as permissible exercises of the state's police power.

(d) **Untenability Clauses**. Tenants with significant bargaining power may have negotiated for a provision entitling the tenant to rent abatement during any period when the premises is "untenable." Such a tenant might be able to argue that government-mandated closures render the premises untenable and, on such basis, may seek rent abatement.

(e) **Co-Tenancy Clauses**. Where a tenant leases space in an office park or multi-unit building, the lease might contain a provision whereby the tenant's rate is abated in the event other tenants in the park break their lease or cease operations. Given widespread business closures, such a provision could help a tenant get some relief under its lease.

(f) **Monetary Default; Eviction Moratorium**. If a tenant elects not to pay rent (whatever the excuse), a landlord will likely have the right to deliver a notice of monetary default, requiring the tenant to promptly cure the rent default. Failure to cure the default, might entitle the landlord to accelerate the full amount of the lease, draw down on the associated letters of credit, look to tennant's guarantor, and/or evict the tenant.

Despite that landlords are fully entitled to declare monetary default under the lease agreement for nonpayment of rent, landlords may have trouble enforcing their rights and evicting the tenants for the foreseeable future. In response to the nationwide Covid-19 outbreak, many jurisdictions have closed their courts (including housing courts) for non-emergency matters. New York both announced a postponement of all non-essential court functions and, on March 13, 2020, announced a 90-day moratorium on evictions of commercial tenants. Many jurisdictions are likely to follow suit. Tenants should note that as of now, the moratorium only relates to eviction proceedings, not rent obligations which (subject to excuse as described above) will still be due.

5.5 Lessons from Post-Financial Crisis Litigation.

Economy-altering events like Covid-19 can have a significant impact on the judiciary's analytical approach. As in prior recessions, we expect that equitable considerations will weigh heavily in the courts' resolution of contractual claims arising out of the Covid-19 pandemic.

For example, in a number of New York opinions concerning financial products following the 2008 financial crisis, courts placed a high degree of emphasis on the factual narratives and relative sophistication of the parties, and applied relaxed pleading standards in assessing motions to dismiss. While the termination of a contract or suspension of performance due to a force majeure event or an MAE in the context of Covid-19 presents a different set of issues, the general lessons from the 2008 crash should factor into any litigation analysis. Specifically, courts are likely to be more inclined to weigh fairness considerations when dealing with claims resulting from the Covid-19 crisis. Against this somewhat unpredictable backdrop, it is important to develop a cohesive litigation strategy prior to making any decision regarding the termination or suspension of performance under an agreement.

5.6 Preserving Relationships.

Every business considering its risk mitigation options during these unprecedented times should bear in mind that, eventually, the Covid-19 outbreak will subside and the economy will recover. In order to ensure its own recovery and maximize its growth going forward, every business will need to lean on its longstanding business relationships. Just because a company has a legal right to terminate its contract does not necessarily mean it is in such company's best interests long-term (or even short-term) to cancel that contract.

Given the scale of the financial fallout from the Covid-19 pandemic (and the economic pain that looms on the horizon), there will likely be greater willingness amongst key creditor constituencies to amend their

contractual obligations and/or to agree to mutually-beneficial restructurings. For example, in retail and food service businesses where landlords often are the largest creditor group, landlords may be more willing to provide lease concessions in the face a threatened "rejection" of their leases in bankruptcy during a time of broad-based market upheaval with grim prospects for reletting their premises. Likewise, financial creditors may look to avoid realizing losses on their loans through enforcement actions at time when asset values are substantially impacted by the Covid-19 uncertainties. In such cases, many lenders may be prepared to agree on amended credit terms and additional bridge funding to facilitate the expected return to more normalized business activity.

6. US bankruptcy considerations

Given the liquidity concerns outlined above, maintaining a standing workforce will be challenging. Furloughs and in some cases layoffs will adversely impact a portfolio company's ability to ramp up operations when the current restrictions are lifted and normal operations can resume. Likewise, key suppliers, landlords and taxing authorities may require payments in this critical time. Where the liquidity maximization and efficient breach strategies described above prove insufficient, the portfolio company may have no alternative but to consider formal bankruptcy relief.

In some cases, relief available under the US Bankruptcy Code may be the most prudent means of effecting an orderly operational wind-down and liquidation. In others, a filing could potentially provide the means for an existing equity sponsor to preserve the long-term value of its investment, including through new investments. The feasibility of a given sponsor-driven strategy in bankruptcy will depend on the value of the enterprise and the availability of sponsor- or third-party provided post-petition financing. Consensus among creditors and other stakeholders will be a key factor to implement bankruptcy transactions that would allow existing equity to remain intact, either in whole or in part.

The importance of broad creditor support is driven by the general rule applicable to chapter 11 reorganization plans that a dissenting class of unsecured creditors must be paid in full under a plan before any equity interest holders may receive or retain any property in connection with the plan. However, in some circumstances a sponsor may be able to propose a fully consensual chapter 11 plan of reorganization where creditors' interests are either left unaffected by the plan or affected creditors consent to a proposed treatment of their claims. If a fully consensual plan is not possible, a sponsor may still be positioned to propose a "new value" plan where in effect the sponsor makes a new investment to buy back the debtors' equity at a level that a bankruptcy court concludes is the fair, market-tested, value of those interests. Alternatively, in some cases a sponsor may also look to acquire parts or substantially all of the filing entities' business free and clear of existing liens and claims in 1 or more sales conducted through the bankruptcy process.

The US Bankruptcy Code provides relief to effect restructurings and liquidations and to give effect in the United States to relief obtained in foreign insolvency proceedings. The feasibility of any given strategy to invoke formal bankruptcy proceedings will depend on the value of the enterprise, the availability of sponsor- or third-party provided post-petition financing, and consensus among stakeholders. Early engagement with experienced financial and legal advisors to develop a robust and pragmatic strategic approach is essential. Relief available under the US Bankruptcy Code includes:

(a) low bar to access relief under the US Bankruptcy Code on the basis of a debtor having a place of business, domicile or property located in the United States, even if such property is of *de minimis* value (e.g., bank account; retainer paid to professional advisors; US law-governed debt obligations);

(b) imposition of the "automatic stay" and similar injunctive relief to protect the debtor and its property (wherever located, as the stay has extraterritorial effect in plenary cases) to provide the

debtor a "breathing spell" to focus on stabilizing its business and formulating a strategy or plan to administer the proceedings;

(c) access to new debt financing on a secured and unsecured basis to fund operations and the costs of administration through the availability of so-called "debtor in possession" financing and use of available cash collateral, subject to certain conditions and court approval;

(d) ability to reject or assume executory contracts and unexpired leases of non-residential real property, with the additional ability to limit claims of landlords under long term lease arrangements;

(e) power to "cramdown" dissenting creditor classes through a plan of reorganization if certain conditions can be satisfied;

(f) ability to sell assets (and whole operating businesses) outside of a plan of reorganization where the sale is made "free and clear" of existing claims and encumbrances, thereby allowing a debtor to maximize the value of its assets while giving buyers some comfort that they will not be responsible for the existing debts of the debtor;

(g) power to make foreign insolvency schemes and plans enforceable against creditors and other stakeholders in the United States;

(h) compulsory fact gathering through witness depositions and document production is broadly available and may be critical in cases involving fraud and mismanagement; and

(i) ability to seek appointment of a trustee to displace management or an examiner to investigate fraud and mismanagement or accounting irregularities.

7. Transactional considerations

In light of the significant impact of the Covid-19 pandemic on the global economy, parties are reviewing and revising relevant provisions of acquisition agreements and conducting additional diligence on pending and potential transactions in an attempt to obtain greater certainty of closing. As a result of the Covid-19-related economic fallout, buyers and sellers may be in a position to reassess valuations, adjust pricing mechanisms and implement new methodologies for interim operations.

7.1 Pending Transactions

Sponsors who were in the process of negotiating a deal prior to the escalation of the Covid-19 outbreak here in the US, and have since been slow-playing the deal until markets stabilize, may take this opportunity to challenge financial projections and valuations, and to seek more favorable terms. Given the need for heightened diligence (see Section 7.2(a) of this Alert), parties should consider extending the exclusivity window for diligence and negotiations.

Where a sponsor (or its portfolio company) has already entered into an M&A transaction (presumably prior to the rapid escalation of the Covid-19 outbreak in the US), the sponsor should consider whether the transaction documents contain any provisions that would allow the sponsor or its counterparty to terminate the transaction, avoid certain obligations, or otherwise alter their respective rights. Sponsors should also be mindful of issues arising under related arrangements, including acquisition financing and representation & warranty insurance coverage.

(a) **Acquisition MAE**. The most obvious potential touchpoint is a "material adverse change" or "material adverse effect" (an **MAE**) provision. MAE clauses in the acquisition context are highly negotiated and should always be analyzed on a case-by-case basis. As a general matter, an MAE clause provides a buyer with a walk away right where during, the period between signing and closing, the target experiences an event or series of events that so severely impact its long-term value that the buyer effectively loses its benefit of the bargain. There is no bright-line test for proving an MAE under New York or Delaware law, but it is an undeniably high bar; the party asserting the provision must demonstrate that the triggering event materially threatens the earnings potential of the target (or the asset) in a durationally-significant manner. Moreover, negotiated MAE clauses often exclude effects related to general economic conditions as well as effects stemming from epidemics or other natural disasters (subject in each case to disproportionate effects on the party in question as compared to the industry in which it operates). The fact-intensive nature of the inquiry means that MAE-specific claims are unlikely to be resolved at an early stage of litigation. Coupled with the high evidentiary bar and the uncertainty of medical progress on the disease (and the recovery of the US economy), this means that pursuing such a claim would likely be both expensive and burdensome, with no guarantee of success.

(b) **Bring Down Conditions, Interim Operating Covenants**. Acquisition agreements that are not simultaneous sign-and-close transactions typically include conditions bringing down the parties' representations to closing and requiring that each of the parties has performed its pre-closing covenants. Often, the bring-down standard for representations is an MAE, but buyers with considerable leverage and/or specific concerns may have negotiated for lower standards. Compliance with covenants is usually based on an "all material respects standard." Given the massive disruptions caused by the Covid-19 crisis, it is possible that a target will be unable to bring down certain of its representations and/or comply with certain of its covenants.

(c) **Financing MAE**. On the flip-side, every buyer will need to consider whether Covid-19 will complicate its ability to close, specifically its ability to draw on acquisition financing. Although acquisition debt financing documents typically use the same MAE definition as the related acquisition agreement (suggesting the same high hurdle faced by the acquirer), a lender might argue that an MAE in the financing context is subject to a different, lower standard that focuses on the acquirer's ability to meet its short-term debt service requirements rather than the long-term enterprise value considerations animating the acquisition MAE inquiry. See Section 4 of this Alert for additional discussion of financing issues.

(d) **R&W Insurance**. Representation and warranty insurance (**R&W Insurance**) is increasingly used as an alternative to traditional indemnification in M&A transactions, covering losses (in excess of the applicable retention) resulting from breaches of the representations and warranties in the purchase agreement as of the date of signing (and as of the closing). Where a policy has already been bound for a transaction pending closing, there could be some argument for coverage for unknown breaches of representations that the buyer discovers post-acquisition. For example, there could be breaches related to Covid-19 under broadly-worded representations on undisclosed liability, absence of changes, inventory and accounts receivable. Coverage under an R&W policy is always fact-sensitive, and the impact of this Covid-19 pandemic remains fluid.

(e) **Necessary Filings, Regulatory Approvals**. Necessary Filings, Regulatory Approvals. Regulatory agencies (including the US Department of Justice, US Federal Trade Commission, and the European Commission Directorate-General for Competition) and state administrative departments (including corporation divisions) are facing staffing shortages, remote working, and partial or complete physical shutdowns, and therefore may be slower in responding to applications and filings. HSR early termination is available again, after being initially suspended, but on a limited basis. Sponsors should consider the potential impact of any such delays on transaction

timing, which may be due, in some cases, to requests by antitrust authorities for additional time to review deals. In a debt-financed transaction, the buyer must be especially wary of the long-stop dates in the acquisition agreement and the financing documents; failure to properly account for these delays in both the acquisition agreement and the financing agreement could leave a buyer obligated to make an acquisition but without the necessary funding to do so. A&O is actively monitoring the impact of COVID-19 on merger review processes around the world and is regularly updating the following chart: https://www.allenovery.com/en-gb/global/news-and-insights/publications/covid-19-coronavirus-global-merger-review-update

7.2 Potential Transactions

In the coming months, sponsors sitting on excess dry powder and cash-rich activists will find themselves uniquely positioned to pounce on undervalued assets, distressed debt scenarios, and depressed public equity prices. Acquisitions in this tumultuous market will require thorough diligence, creative financing strategies, and careful drafting.

(a) **Due Diligence**. While due diligence is a critical component of every transaction, it takes on even greater importance for any private equity sponsor considering a distressed acquisition in this uncertain environment. Acquisitive sponsors should pay particular attention to any target's material customer and supplier contracts and provisions therein that could excuse or delay performance in light of the Covid-19 outbreak. See Section 5 of this Alert for a more in-depth discussion of force majeure provisions and other affirmative defenses to contractual non-performance.

Some other touchpoints that will factor into valuations and could impact the negotiations and terms of purchase agreements include:

(i) how business closures and travel restrictions are impacting key employees and affecting the target's operations and workflow;

(ii) how dependent the target is on supply chains in areas heavily impacted by Covid-19;

(iii) the ability of the target and its material suppliers, service providers and other third parties to perform their respective obligations under material contracts, and whether the target is covered by business interruption insurance;

(iv) the expected impact of the Covid-19 pandemic and the ensuing economic fallout on the target's inventory, and how quickly (if at all) the target can resupply via its normal supply chain;

(v) if the target's normal supply chain is significantly impacted, whether there are reasonable alternatives available and, if so, how those alternative arrangements will impact the target's margins;

(vi) extent of target's leverage (i.e., near term debt obligations, high interest obligations, financial covenant flexibility) (see Section 4 of this Alert for credit facility considerations, which may also apply to any target);

(vii) collectability of the target's accounts receivable, and whether counterparties are actively seeking to extend terms;

(viii) whether revenue is dependent on customers being physically present, or if pick-up and/or delivery alternatives are viable; and

(ix) whether the target's business model (or more accurately, customer preferences) are likely to change permanently.

Currently, travel restrictions and business closure orders will complicate in-person diligence. Parties that require site inspections, environmental site assessments and/or physical inventory counts will need to plan accordingly, and can consider extending pre-signing diligence periods and/or agreeing to handle certain in-person diligence post-signing (with a closing condition relating to the buyer's completion of due diligence).

(b) **Pre-Closing Covenants and Representations and Warranties**. Parties should consider the potential impact of Covid-19 on ability of the target to comply with interim operating covenants. Parties will need to consider what constitutes "operating in the ordinary course of business consistent with past practice," and what exceptions to interim covenants will provide adequate flexibility. Parties should also consider the ability to bring down representations and warranties at closing. Buyers should be on the lookout for expanded non-reliance provisions in acquisition agreements, and should be ready for Covid-19-related disclosures in acquisition agreement disclosure schedules.

(c) **R&W Insurance**. In the wake of the Covid-19 crisis, R&W insurers have already taken a range of approaches to coverage. While some carriers are approaching it on an industry-by-industry basis, others have requested blanket exclusions to coverage relating to the virus. We note that some recent transactions since the escalation of the outbreak have included express exclusions for losses arising out of Covid-19, loss of key personnel due to the virus, losses arising out of supply chain interruption due to the virus, and losses arising from (or relating to) business interruption or downturn solely to the extent arising out of the virus or any government or regulatory sanctioned loss relating thereto. Without coverage for these types of risks, the allocation of risk and the reach of the related representations, warranties and indemnities becomes even more critical.

We are also learning that all R&W insurers are paying closer attention to the diligence process, particularly with respect to businesses heavily reliant on supply chains, travel and customer and employee relationships. We will keep an eye as the insurance market settles on exclusions relating to Covid-19 and the short and long-term impact on a buyer's use of the product. If the market settles on broad-based exclusions, buyers may become less likely to use the product, particularly in competitive auctions, whereas if exclusions for Covid-19 become narrow or non-existent, the product likely will remain a critical component of competitive M&A processes.

(d) **Necessary Filings, Regulatory Approvals**. As with pending transactions, sponsors should expect delays in securing regulatory approvals and third-party consents in jurisdictions around the world, and should draft transaction documents accordingly (as discussed above, any mechanisms accounting for delay should also be incorporated in associated financing documents).

(e) **Investment Mandates, Other Fund-Level Considerations**. As and when sponsors identify attractive acquisition or disposition opportunities, they should be sure to consider fund-level investment mandates and any applicable investment restrictions (i.e., geographic, industry-specific, security type, etc.) in order to insure they have sufficient flexibility to pursue such opportunities. Sponsors should be sure that any such opportunities are consistent with strategies and risk factors disclosed to their limited partners. Sponsors should also assess the effect of this Covid-19 crisis on fund lifecycle and consider whether an extension of the investment period or term would be appropriate.

From an investor relations perspective, sponsors may experience an increased demand from investors for transparency regarding portfolio investments and cash management. To the extent a sponsor is considering changes to its fund terms, investor liquidity arrangements or mandate, the sponsor should be mindful of the restrictions its fund documents and disclosure (including the role of its LPAC and investor consent requirements), and should follow its internal policies and procedures. To remain as agile as possible in this market, and be ready to make any necessary changes to fund strategies and/or documents, sponsors should maintain open lines of communication with their limited partners.

8. Delaware law considerations (for private and public portfolio companies)

Despite being faced with a host of novel issues stemming from this pandemic (legal and otherwise), portfolio company management teams – whether helming a private or public firm – must not lose sight of their fiduciary obligations and other corporate law considerations.

Note: the following considerations are based on Delaware corporate law. If you have questions about the implications for other corporate entities (whatever the form) in other states or countries, please let us know.

8.1 Considerations for All Corporates

(a) Remember: sponsor-appointed directors owe their fiduciary duties to all of the portfolio company's common shareholders, and must act in the best interests of the company and its shareholders, not a particular shareholder. Directors should be mindful of conflicts of interest, especially where the sponsor holds portfolio company preferred stock and/or debt or may be considering transactions with its portfolio company such as injecting additional capital.

(b) Where a portfolio company is or may be insolvent, directors' duties shift and directors are required to consider creditors' interests in addition to those of the company's shareholders. See Section 6 of this Alert for a more detailed discussion of insolvency-related considerations.

(c) Across their portfolio companies, sponsors should develop and/or update decision-making and succession processes that account for Covid-19-related disruptions to travel, communications, and meetings. To ensure their portfolio company boards remains as responsive as possible, for each portfolio company, sponsors might consider empowering a single board committee (say, Executive, Audit or Risk) to make decisions on behalf of the board in Covid-19-related emergency situations where the entire board cannot be convened. Be aware that a limited number of decisions (generally those requiring shareholder approval) are non-delegable and may only be made by the full board.

(d) To the extent possible, portfolio company management and directors should try to follow typical corporate formalities (notice/waiver, advance circulation of agendas and supporting materials, keeping minutes, etc.). Sponsors and their portfolio company management teams should be sure to review and amend (as necessary) portfolio company constitutive documents to allow for virtual board and shareholder meetings, and should be mindful of notice requirement with respect to changes to the date, time and location of meetings.

(i) Where a shareholder base is sufficiently large, portfolio companies will need to consider use of specialized service providers to handle virtual voting at the annual meeting.

(e) Sponsors and portfolio companies alike should take this time to review the sufficiency of their respective D&O insurance coverage, particularly in the context of making sure directors are protected in any bankruptcy situation.

8.2 Public-Company Specific Considerations

(a) Sponsors typically keep a close eye on accumulations in their portfolio company's stock, and should be extra vigilant in today's market. The recent Covid-19-related selloff and the persistent turmoil in the markets ever since has left the door open for third parties (including interested acquirors and activist shareholders) to acquire material stakes in portfolio companies at materially-depressed prices. After years of dismantling anti-takeover defenses, we have already seen examples of some companies preemptively implementing rights plans in order to ward off surprise attacks. Be sure to discuss any takeover defenses and the implications thereof (including careful communication of a clear rationale to shareholders and proxy advisors) with counsel prior to implementation.

(b) By that same token, sponsors may see the recent market dislocation as an ideal opportunity to acquire shares on the market or cause the portfolio company to institute or ramp-up share buybacks to support its stock price. Sponsors and portfolio company management should remain mindful of their Securities Law obligations (namely that neither has any material non-public information (**MNPI**) when participating in such buybacks), and should be wary of that buying back shares could disqualify or limit the portfolio company's ability to participate in federal relief programs such as the CES(b)(4) Program. Before engaging in any buyback-related activity (whether pursuant to a plan or otherwise), companies should consult with counsel.

(i) Companies may be considering implementing or cancelling an existing 10b5-1 plan. Management should bear in mind that such 10b5-1 plans cannot be implemented or amended while the company is in possession of MNPI. Further, while the company can cancel its 10b5-1 plan even when in possession of MNPI, doing so could weaken the affirmative defense to insider trading such plan was originally intended to provide.

(ii) Portfolio company executives might also be considering cancellation of executive selling plans for optical and value considerations. Management should remember that the cancellation of any one plan should not dictate cancellation of other plans.

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