

COVID-19: Certain Considerations for Private Equity Firms and Portfolio Companies

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Existing Portfolio Companies

Liquidity Management / Available Borrowing

- Conduct “stress tests” of liquidity in various downside scenarios
- Prepare for loss of customers or suppliers, both short- and long-term
- Monitor deposit accounts and consider whether banks may have setoff rights against accounts
- Evaluate short-term liabilities and assess consequences of delaying certain payments (e.g., where necessary, impact of nonpayment of rent vs. nonpayment of a critical vendor or secured lender)
- Consider asking vendors to defer receipt of payment in exchange for back-end contract extension
- Assess costs and benefits of workforce reduction, including potential liabilities under the WARN Act and similar state laws, discussed further below on page 6
- Evaluate grace periods to cure or address defaults under debt financing agreements and commercial contracts, and, where appropriate, consider negotiating forbearance agreements or other amendments to defer liabilities
- Review borrowing availability under existing credit facilities (including revolver draws) and consider borrowing well in advance of liquidity shortfalls, as further business deterioration could negatively impact ability to satisfy borrowing conditions (e.g., solvency representations, no MAE representation and covenant compliance)
 - Note that certain borrowings may trigger springing financial covenants in revolving credit agreements (which if not satisfied could then trigger cross-defaults under other loans)
 - Consider ability to raise incremental liquidity on a junior, pari passu or senior basis
 - Review terms of revolvers (particularly in non-U.S. facilities) to confirm whether there is a “clean down” period during which the company cannot have any amount drawn

Debt Buybacks

- Company must have sufficient liquidity to continue operations post-buyback
- Sponsors must consider fund-level and shareholder agreements before participating in buybacks
- Analyze debt document provisions relating to buybacks to ensure compliance (e.g., may not be able to borrow from a revolver to fund a buyback)
- Debt repurchased by a company generally is cancelled; debt purchased by a sponsor remains outstanding (but typically may not be voted outside of bankruptcy going forward)
- For additional considerations regarding debt buybacks (e.g., material non-public information issues and tax considerations), click [here](#)

Existing Portfolio Companies (continued)

Stock Buybacks

- Market declines may present public companies with an opportunity to implement or broaden share buyback programs to support the company's share price
- Sponsors with positions in public companies must be mindful of Rule 10b-5 and other securities laws and regulations (e.g., restrictions on trading while in possession of material non-public information) before participating in such programs
- Directors should confirm available surplus and consider fiduciary duties in light of alternative uses of liquidity
- For additional considerations regarding public companies, click [here](#)

Debt Financing / EBITDA Add-Backs

- Some credit agreements expressly permit EBITDA add-backs for losses covered by insurance and/or contain other add-backs that may be utilized as a result of business closures
- The availability of business interruption insurance is an open question; for additional considerations regarding business interruption insurance, click [here](#)
- Many credit agreements permit add-backs for costs related to restructuring expenses and pro forma synergies and expected cost reductions, including related to special restructurings or reductions in force (sometimes subject to caps, though)
- Certain borrowers are seeking additional add-back flexibility (dubbed the "corona clause") that expressly permits add-backs for lost revenues for situations where businesses must be shuttered

Margin Loans / "Back Leverage"

- Sponsors who have partially monetized their investments in companies through incurring margin loans (or "back leverage") should analyze the terms of their agreements with financing counterparties
- Understanding how the valuation of the collateral is determined (and when it is adjusted) will be critical
- Sponsors should prepare for potential margin calls and create a plan for addressing them
- Sponsors should consider potentially negotiating changes to arrangements, including by providing fund-level guaranties that may limit (or eliminate) the need to post margin
- Consider ability to provide such guarantees under fund-level capital call facilities (and whether any waivers are needed)

Existing Portfolio Companies (continued)

Government Regulations / Assistance

- Establish or expand legislative/regulatory monitoring functions to keep pace with developments (e.g., restrictions that may impact operations or performance)
- Government is beginning to offer financial aid and other relief to businesses and individuals; companies should monitor and advise employees of availability
- For example, the U.S. government is deferring tax payments without penalty or interest for certain companies and individuals, providing small business loans and crafting legislation to enhance paid leave and other benefits

Risk Mitigation / Cybersecurity

- Review insurance portfolio for COVID-19-related coverage, including in respect of mitigation efforts
- Consider adding warnings or disclaimers to marketing materials or contracts, particularly for businesses in industries that host customers on or in company property
- Enhance technology system defenses and capacities and related monitoring and testing, in light of increased remote access usage; consider additional employee training on data security
- For additional considerations regarding risk mitigation and cybersecurity, click [here](#)

Audit Procedures

- Coordinate with independent auditors to prepare for potential difficulties, such as restrictions from entering physical facilities
- Consider impact on reporting obligations to shareholders and creditors if financial statements cannot be prepared and delivered when required under applicable shareholder or credit agreements
- Consider whether there is a risk of receiving a “going concern” qualification in upcoming audits and its impact on debt facilities and other contracts

Existing Portfolio Companies (continued)

Commercial Contracts

- Conduct operational assessment of supply chains and logistics
- Review contracts for provisions that may be implicated by COVID-19 (e.g., force majeure clauses, exclusivity provisions and termination rights and remedies)
- Force majeure clauses are contract-specific and set high bars, but COVID-19's declaration as a pandemic and the increasing restrictions being imposed on travel, gatherings and commerce may increase their availability
- Consider impact of delaying payments under existing commercial contracts if necessary to preserve liquidity
- For additional considerations regarding force majeure clauses, click [here](#)

Employees

- When changing practices and policies to promote health and safety, remember laws regarding compensation and absences, privacy (e.g., HIPAA) and anti-discrimination remain in place
- Expand lines of communication with employees (e.g., by providing regular updates on COVID-19 developments and the company's responses to them); ensure employees have a channel to voice concerns to management
- Temporary layoffs may implicate the federal WARN law requiring 60 days' advance notice of termination (or payments in lieu) if the layoff's duration lasts longer than six months
- Certain state and federal employment laws may impose liability on shareholders and/or directors for unpaid employee obligations; this risk is heightened for shareholders and/or directors exercising operational control over the company's employment practices
- For example, New York law imposes joint-and-several liability for unpaid wages on the ten largest shareholders or LLC members of New York corporations and LLCs, as well as of foreign corporations and LLCs to the extent they have employees working in New York
- State-specific "mini-WARN" laws may have different rules for the amount of advance notice and the length of the layoffs that trigger application of the statutes
- Federal legislation known as the Families First Coronavirus Response Act may provide paid and additional unpaid sick and caregiver leave, but at present is not expected to prohibit layoffs (subject to compliance with other existing laws); for additional information about this legislation, click [here](#)
- Paul, Weiss is leading a pro bono campaign to assist individuals in need with understanding and accessing available resources, more information about which is expected to be made available [here](#)
- For additional considerations regarding employment laws and workforce disruptions, click [here](#)
- For additional guidance for employers issued by federal, state and city agencies, click [here](#)

Existing Portfolio Companies (continued)

Senior Management

- Update or develop clear decision-making processes that account for COVID-19 related disruptions to travel, communications, etc.
- Address potential absence of key personnel with redundancy and broader succession planning
- Review compensation packages to ensure they remain fair and properly incentivize management (e.g., consider adjusting performance targets or altering mix of cash and equity-based compensation)
- For additional considerations regarding performance-based compensation, click [here](#)

Board Duties / Function

- Fiduciary duties remain the same to the extent not waived (waiver available only in alternative entities and, in corporations, for corporate opportunities, in each case, only if the entity's governing documents so provide)
- Remember that sponsor-appointed directors owe the same duties to all shareholders; beware of conflicts, including if sponsors hold preferred equity or portfolio company debt
- Boards of companies with solvency issues may need to consider creditor interests in addition to shareholder interests
- Boards may want to establish executive/strategic committees to enable faster response to COVID-19
- Directors may have personal liability for certain actions, such as failure to pay payroll, severance or certain taxes (e.g., payroll, trust fund and sales/use)

Closing Risks for Pending Transactions

Material Adverse Effect

- Buyers and sellers are actively looking at signed but not yet closed transactions to determine whether MAE and other conditions have been satisfied
- Courts are very reluctant to find an MAE in the M&A context, with only one successful assertion of an MAE to date in Delaware
- MAE definitions usually (i) do not specify events or dollar thresholds that qualify as an MAE, leaving the decision to courts, and (ii) exclude many categories of effects, including “acts of God,” natural disasters and sometimes epidemics, but often only **to the extent** those effects do not disproportionately adversely affect the subject party versus others in the industry
- Courts have not applied any bright-line tests, but DE and NY law both require the effects be “durationally significant”
- COVID-19 could have long-term impacts on some companies, but it is currently difficult to determine whether those impacts would be disproportionate on any company
- Although debt financing agreements typically use a similar MAE definition as the related acquisition agreement, loans have a fixed, usually shorter duration, and lenders may analyze effects differently than buyers and sellers
- For example, lenders may argue that their interests relate to a borrower’s ability to make payments in the nearer term, rather than the long-term interests that courts have considered in the context of an acquisition
- For additional considerations regarding MAE matters, click [here](#)

Existing Debt Financing Commitments

- Lenders are generally funding financings committed prior to COVID-19 market upheaval
- However, many committed financings are being done with “flex” terms being exercised
- If a “flex” situation seems likely, carefully consider deal changes that impact near-term liquidity of the company, as liquidity is paramount in this environment
- Changes that add financial maintenance covenants that apply in the short term should be carefully scrutinized
- Closely coordinate with lenders on pending transactions given fluidity of situation

Closing Risks for Pending Transactions (continued)

Bring-Down Condition

- Acquisition agreements customarily include conditions that each party has performed its pre-closing covenants and must “bring down” its representations and warranties at the closing
- The bring-down standard for most representations is often an aggregate MAE, whereas for covenants it is usually compliance “in all material respects”
- Targets’ responses to COVID-19 may result in breaches of covenants, even if inadvertent (e.g., failure to operate in the ordinary course), such that a target cannot certify it has performed as required
- Financial cooperation covenants that require targets to deliver current financial statements, “required information,” comfort letters and related financial information could also create closing risks if targets are unable to comply

New Investments and Investment Strategies

Deal Sourcing / Due Diligence

- Normal M&A activity (public and private) is down significantly
- Slowdown could be partially offset by uptick in distressed and restructuring investing activity
- Buyers should adapt due diligence processes to include legal and business evaluation of COVID-19's impact

Key Transaction Agreement Terms / R&W Insurance

- Transaction terms that have become “market” may need to be reconsidered for COVID-19 (e.g., financing provisions, conditionality, termination rights and remedies, MAE definitions, certain interim operating covenants, special indemnities and certain representations and warranties)
- For example, targets may need additional flexibility under operating covenants to address COVID-19 and outside dates may need to be extended to account for longer regulatory clearance periods
- Buyers should anticipate COVID-19-related matters being excluded from R&W insurance coverage, or at least subject to heightened scrutiny from underwriters

Merger Review

- Expect delays in review and approval of transactions by merger review authorities worldwide, and discuss with counsel during negotiations
- Acquisition financing may need to have later outside dates in light of extended merger review process
- Encompasses not only competition and antitrust, but also other areas of governmental focus, such as national security (e.g., CFIUS)
- Countries heavily impacted by COVID-19 may struggle to maintain customary timelines
- For example, for HSR filings in the U.S. during the emergency:
 - All filings (and exhibits) must be made electronically and no early terminations will be granted
 - FTC and DOJ are advising parties to be proactive and flexible on extending timelines for pending matters
- For additional considerations regarding merger review, click [here](#)

New Investments and Investment Strategies (continued)

Non-Traditional Strategies

- Non-traditional opportunities (e.g., distressed situations, direct lending, PIPEs and convertible debt) may supplant private equity firms' traditional investment strategies
- Sponsors should review their funds' investment mandates to confirm whether new opportunities can be accommodated and consult with their advisors on compliance and regulatory matters
- Sponsors should carefully review target companies' existing capital structure and governance arrangements to ensure that a structured security is permitted (e.g., restrictions on debt or senior/pari passu securities, preemptive rights, cross-acceleration/default provisions)

Debt Financing Strategies

- New commitments in the large- and middle-markets have become scarce, and, when available, economic terms are notably more lender-friendly than only a few weeks ago (and include more "flex" terms)
- As the traditional syndicated market slows, consider alternative sources of capital (e.g., direct lenders)
- Sponsors may look to existing subscription line facilities, margin loans or other alternative financing arrangements
- Check whether fund documents contain borrowing limitations or requirements to reserve unfunded capital commitments to satisfy borrowings
- There is likely to be an uptick in liability management and creative strategies to enhance liquidity (e.g., uptiering, "drop-downs")

Acquisitions of Public Company Stock

- Confirm absence of material non-public information before acquiring stock and upon exit (if target provides information under non-disclosure agreement)
- Consider impact of Schedule 13D, Schedule 13F, HSR and other regulatory filings on timing and disclosure
- Confirm no Section 16(b) issues (in the event sponsor owns or will acquire 10% or has director appointment rights)
- Consider restrictions under state antitakeover statutes (e.g., Section 203 of the Delaware General Corporations Law and other state analogues), poison pills or ownership limits (e.g., REIT provisions)
- Consider derivatives strategies, such as total return swaps, as a means of acquiring positions more quickly

Fund-Level Considerations

Investment Mandate

- Consider the investment mandate and whether it provides flexibility to go beyond typical buyouts to include new opportunities that may arise (e.g., distressed investing, direct lending, investing in portfolio company debt or making open-market purchases of public equities)
- Consider new funds or products that take advantage of the opportunities that may arise

Ongoing Offerings

- Consider seeking term extensions to provide additional time to weather a potential long-term financial downturn and build value
- Consider seeking commitment period extensions to get ahead of opportunities and ensure flexibility to draw on unfunded commitments
- Consider seeking amendments to recycling provisions to provide broader flexibility to recycle proceeds
- Consider the impact of changing valuations on any subsequent closings and evaluate buy-in process and pricing
- Consider the valuation provisions of fund documents to ensure compliance, as changing valuations of portfolio companies may impact the calculation of management fees, distribution waterfalls, clawbacks and fee waivers
- Review follow-on limitations and consider if other means of credit support are available (e.g., portfolio company guarantees)
- Consider asking LPs in funds that are in liquidation or wind-down to “reallocate” unfunded commitments into new distressed or other non-traditional strategies as a more efficient way of LPs’ underwriting “new” commitments
- Implement procedures for how the sponsor will proactively share information with LPs regarding the manner in which funds and portfolio companies are dealing with issues arising out of COVID-19’s impact on operations
- Review whether the fund documents have flexibility to go beyond the customary 90- or 120-day delivery timeframe for financial statements or if the offering documents have disclosure relating to delayed reporting or force majeure risk; delays beyond 120 days may have an impact on Custody Rule compliance; however, the SEC’s FAQs on the Custody Rule provide that it would not recommend enforcement action for a fund’s failure to distribute audited financial statements within the 120-day deadline “under certain unforeseeable circumstances”
- Review whether alternative means of holding LP meetings are permitted under the fund documents (e.g., webcasts)

Fund-Level Considerations (continued)

New Offerings

- Consider building in offering period and commitment period extension mechanics
- Consider creating broader flexibility to recycle proceeds without regard to a specific timeframe or other than solely during the commitment period; consider the ability to treat special purpose vehicles as portfolio companies for purposes of enhancing recycling flexibility
- Consider a broader definition of follow-on investments to take advantage of likely consolidations in certain industries and to address the liquidity needs of portfolio companies
- Consider adjusting economics and reducing the preferred return rate given the low interest rate environment
- Consider the inclusion of warehousing provisions to allow it or its affiliates to warehouse investments while funds are in the offering period or are unable to obtain financing for an acquisition
- Consider preserving flexibility to lend to funds or portfolio companies if traditional financing sources are not available
- Ensure fund documents permit cross-collateralization across multiple vehicles and products to enhance credit profile
- Consider providing alternative means of holding LP meetings (e.g., webcasts)

Access to Capital

- As some LPs may be experiencing delays in their diligence and approval processes, consider altering the number and sizing of closings, as well as practical considerations such as the use of e-signatures
- Consider accelerating capital calls or otherwise actively planning to ensure needed liquidity for investments and reserves
- Consider alternatives for avoiding LP defaults (including extended time periods for capital calls)
- As use of leverage increases, consider borrowing limitations in fund documents and any requirement to reserve unfunded capital commitments for purposes of satisfying borrowings and other contingent liabilities
- Review capacity and optimum use of credit facilities and other leverage to ensure that they are most effectively managing capital needs
- Review derivative contracts to get ahead of any net asset value triggers, margin calls or other contingent obligations that may arise in connection with outstanding derivatives transactions
- Consider fund-to-fund sales and secondary transactions as exit opportunities

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