ROPES & GRAY

COVID-19

IMPLICATIONS FOR PRIVATE EQUITY

*AS OF MARCH 3, 2020

THE NOVEL CORONAVIRUS (COVID-19) has significant implications for private equity firms. How will the virus and its spread impact investments and the markets generally? Our latest thinking is captured in this document, which we will update regularly as the situation evolves.*

FINANCING MARKETS STATUS

- The institutional debt markets have been in a holding pattern, and we have seen high yield offerings and opportunistic repricing put on hold. However, middle market direct lending activity is continuing for issuers with little exposure to China or travel-related sectors. Middle market borrowers are taking a close look to determine the impact of the pandemic on their financial covenants, and thinking about actions that might avoid tripping covenants or being proactive in seeking covenant waivers where a default is anticipated.
- Where portfolio companies rely on revolvers (or may need term loan draw-downs), carefully review likely liquidity needs (and worst-case needs) along with covenant compliance and MAE definitions. Consider drawing funds in preparation for future needs.
- Debt buybacks may become attractive if syndicated loans or bonds are traded at a significant discount to par. Sponsors and borrowers should consult with counsel to evaluate any restrictions in their debt documents, along with tax consequences, disclosure issues and other considerations before undertaking any debt buybacks.

EQUITY PRICING

- In situations where portfolio company performance is negatively impacted to the point that additional equity is needed for an equity cure or liquidity, thought will need to be put into the price at which new equity is invested and related terms (seniority, etc.).
- Depending on the nature of the portfolio company co-investors and their rights, a variety of options may be on the table, including creating mechanisms for effectively pricing the equity infusion at a later date when the total impact is clearer by initially investing in debt or preferred debt that converts at a price determined once the current situation is settled.

INTERIM COVENANTS

- We expect that M&A deals that do get signed (pending the resolution of the current situation) may require some degree of additional flexibility for the target company to make adjustments to their ordinary course past practices (e.g., relating to inventory purchases and A/R collection) during the pendency of the COVID-19 situation, so that they can make sensible adjustments in the face of supply chain, workforce and other issues that may arise.
- In addition, be mindful that there could be additional delays in securing government or third-party approvals as a result of a government shutdown (if it happens) or business closure. The outside date in new deals should account for that possibility.

FORCE MAJEURE CLAUSES

- A *force majeure* clause is a provision that often appears in commercial contracts and excuses a party's failure to perform as a result of unanticipated events outside of the party's control. The exact language of the provision will be necessary to formulate a view of whether any particular clause is implicated. It may make sense for portfolio companies to look at their key long-term contracts (supply, manufacturing, service, including transition service agreements and the like) to determine if these clauses are implicated. These clauses may very well require notices to be sent, and in some instances, may actually provide that the contract can be outright cancelled if the *force majeure* event continues for a set period of time (e.g., 30, 60, 90 days). This could be very impactful.

- In 2003 during the SARS outbreak, China's supreme court issued interpretation that *force majeure* would apply if the outbreak or measures implemented by the government would make the contract unable to be performed.

NOTICE PROVISIONS GENERALLY

Portfolio companies should be looking carefully at not only *force majeure* clauses, but also credit agreements, insurance policies, equity co-investor side letters, union contracts and any other contracts that may require notice or action in response to the current situation.

WORKFORCE PLANNING AND WORKPLACE SAFETY

Coronavirus implicates a number of legal requirements and business considerations for employers, including safe workplace obligations, potential business travel and meeting restrictions, employee leaves of absence, remote working and other accommodations, and discrimination concerns. Portfolio companies should consider establishing a workplace response plan so that managers understand their employers' legal obligations and business positions on matters such as work-related travel. Among the issues arising for employers are:

- Employers have a general duty under occupational safety and health laws to ensure a safe and healthful workplace that is free from serious recognized hazards. In light of that, many employers are proactively restricting or limiting international business travel or large company meetings and gatherings, and are requiring remote working for U.S. employees returning from certain non-U.S. jurisdictions, in line with CDC quarantine guidance. Employers also generally have the right to instruct visibly ill employees to stay away from the workplace, to prevent the spread of illness.

- Employers need to navigate disability discrimination/accommodation laws if, for example, an employee has a medical condition putting him or her at higher risk and requests to be excused from required travel or to work from home. Employers should also be careful about requiring medical exams or medical certifications unless job-related and consistent with business necessity.

- If employees are not able to work, either because they are sick (or a family member is sick) or because they are restricted from coming into the workplace and cannot perform their job functions remotely, employers are subject to federal, state and local wage laws with respect to whether or not such leaves are paid. For example, many states and cities have implemented paid sick leave laws in recent years, or employees may be entitled to job-protected unpaid leave.

- Discrimination and privacy considerations will also arise with respect to what employers may or may not ask employees about their health conditions — e.g., questions about whether employees have traveled to certain jurisdictions would be acceptable, but employers should avoid asking questions about whether an employee has had contact with people of certain national origin.

- If the market disruptions caused by the coronavirus persist, companies will also need to assess furlough and layoff issues, including the severance/benefits implications and the legal/political implications of such decisions in the current environment.

The above list can help employers to issue-spot where they may need to navigate federal, state or local laws in more detail. As a general matter, many of these issues will be fact-specific depending on the employee, the state, etc., and we are happy to advise on a case-by-case basis. We can also advise in more detail and can help draft any employer-specific workplace response plans.

INSURANCE

Consider availability of business interruption policies where applicable (though given current stage of coronavirus spread, one can expect heavy resistance from insurers on this).

DEFINED BENEFIT PLAN FUNDING

Portfolio companies that sponsor defined benefit pension plans or that contribute to multi-employer defined benefit pension plans will likely see significant decreases in the plans' asset values as we continue to see market declines. The companies may be required to contribute additional amounts to these plans to keep their funding at levels required under the pension plan rules. There may also be associated notice or other requirements under the companies' credit agreements related to these funding obligations.

RISK FACTORS

Risk factors relating to the current situation are going to become commonplace in PPMs, offering documents and public company disclosure. This will be relevant for preemptive rights offerings as well, which may be more company specific.

MATERIAL ADVERSE CHANGE CLAUSES

- Adding "pandemic" as an MAE definition exclusion (i.e., the pro-seller part of the MAE clause that defines what cannot be considered when determining whether an MAE has occurred) is going to become a standard seller ask as a result of the current situation. Many (but not all) versions of the MAE definition actually include this, as well as other exclusions that could be argued to pick up the current situation (e.g., adverse changes in the industry in which the target operates). We also suspect that related concepts will make their way into purchase agreements (e.g., references to government-imposed travel restrictions, quarantines, etc.).
- As always, the specific language will be key to understanding how any particular agreement is allocating this risk. For example, buyers and sellers would likely argue about whether this situation is currently a "pandemic," whether the particular acquisition target has been disproportionately impacted by the coronavirus outbreak (often a limitation on the industry-wide effect exclusion) and, if a requirement, whether the disproportionate nature of the impact relative to others is "material" (which often requires a long-term adverse effect rather than a short-term business downturn). The big takeaway is that until this situation plays itself out, the COVID-19 risk is going to be very hard to allocate between buyer and seller (and with lender commitments) with respect to any business that would be materially impacted by worst-case scenarios. To risk stating the obvious, this is likely to slow new deal activity with respect to any such businesses.

Our various practice groups continue to monitor this situation and we will make updates to this document as this progresses.

CONTACT

If you have any questions, please email
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