



Private Equity: Distress Implications of COVID-19

Addressing the fallout from COVID-19 and the related governmental response has become a full time job for many private equity funds and their portfolio companies. Almost all segments of the economy are impacted. Some portfolio companies saw revenues go to zero virtually overnight. Others are struggling to keep up with demand for their products or services. Although the specific impacts are different, all funds and their portfolio companies are dealing with a changing legal and regulatory landscape as well as issues ranging from credit facility defaults to employee and workforce management issues. Reopening has brought its own challenges with inconsistent government regulation, employee and customer health and safety issues, rollbacks, and the specter of litigation. Deploying new capital in this market is also challenging - although distressed opportunities are likely to be available particularly later this year and into next year.

As funds assess the impacts of COVID-19 on their portfolio and think about how to invest in this market, we highlight the following areas where O'Melveny can provide assistance. Working with our Coronavirus Task Force, O'Melveny provides support for our private equity clients as they confront the problems created by the pandemic. Our team looks forward to working with funds and their portfolio companies to help address the issues below.

Portfolio Credit Evaluation

Issue: Most portfolio companies have already made changes to their credit facilities to address the initial impact of COVID-19. In many cases, the first round of amendments and waivers did not provide permanent fixes as lenders and borrowers focused on survival in a very uncertain market. In many cases, the amendments and waivers did not address issues such as material adverse change, solvency, and other non-compliance caused by business disruption. The next round of covenant defaults is proving to be more challenging for borrowers as longer-term relief is necessary to justify further investment while the market remains sufficiently uncertain that lenders may be unwilling to provide more than an additional bandage.

Response: Not all credit documents are created equal. Funds must understand the risk within the portfolio under their current credit documents and develop strategies to mitigate that risk. It is critical to develop the right approach to lender negotiations - near or longer term - with the goal of limiting lender optionality. The analysis should include:

- Identifying areas of risk (e.g., negative and affirmative covenants as well as events of defaults including cross-defaults) within existing financing documents that may provide opportunity for

lenders to drive favorable negotiations as the market opens back up or permanent amendments or waivers are required.

- Identifying areas of opportunity within existing financing documents that could provide negotiating leverage for the fund or its portfolio companies in negotiations.
- Assessing the scope and nature of collateral and the effectiveness of perfection arrangements.
- Formulating positions on certain legal issues within the credit documents that can be consistently applied across your portfolio and help shape lender negotiations.

Managing the Workforce

Issue: The COVID-19 crisis has raised numerous labor and employment issues. Some of those are traditional issues in distressed situations such as the need to furlough employees or execute on a reduction in force. Some are somewhat unique to this crisis such as establishing a fully-remote workforce, addressing employee productivity, maintaining a safe workplace, and addressing employee stress. To protect their employees, workplaces, customers, and operations, portfolio companies may have to take dramatic new steps, including testing and collection of information about the medical condition of employees and customers, sharing of information with public health authorities, responding to government requests for information, and implementing procedures for social distancing and telecommuting or working remotely.

Response: Funds should address these issues consistently across portfolio companies to the extent possible. Responses should reflect best practices in light of the fast moving landscape. Understanding how to protect employee privacy, protect employee health, and comply with the myriad of state and local regulations on labor and employment issues requires real time information on new requirements and an assessment of market practices in light of the virus.

Litigation Assessment- Employee Issues

Issue: Litigation has already begun around employee risk and safety measures during the COVID crisis. The initial lawsuits argue that the employer did not or is not doing enough to keep employees safe from COVID-19. The lawsuits generally seek injunctive relief (i.e. fix the safety issues) rather than monetary damages. These cases, however, are instructive in that they provide some insights into how tort claims may arise in the COVID-19 world. Generally, workplace safety issues are addressed through state worker's compensation scheme and/or through federal/state regulatory oversight (i.e. OSHA process). This first round of lawsuits makes several arguments designed to try to take these claims outside of worker's compensation and/or OSHA. We also expect litigation over compliance with inconsistent guidance and application in different locations.

Response: There appear to be numerous available defenses to these suits but they are the beginning of what is likely to be an active area of litigation. Some early lessons for funds:

- Focus on assuring that your portfolio companies are complying with the letter and spirit of the state (and federal) safety guidelines.
- Establish complaint/response systems that address employee or third party complaints and have documented responses.
- Understand where your portfolio companies are making different decisions based on local or state guidance and take steps to mitigate the potential for litigation risk.
- Be aware of the patchwork of differing state laws and common law defenses in in states where you have substantial risk.
- Make sure your portfolio companies establish effective communication with employees by supervisors and the human resources department so that employees understand (i.e., trained and reminded) and are given the opportunity to take advantage of the safety measures being implemented.
- Take steps to avoid “common employer” type theories by managing risk across your portfolio.

Litigation Assessment - Contract Evaluation

Issue: Portfolio companies should evaluate performance under contracts in light of force majeure provisions, material adverse effect provisions, termination provisions contractual defenses and extra-contractual defenses (e.g. impossibility or frustration of purpose) in order to determine business opportunity and risk. As the crisis unfolds, litigation will likely increase around a variety of topics including breach of contract and compliance with laws and the many new orders and government programs that have been put in place.

Response: Funds must evaluate critical contracts at the portfolio company level. It is crucial to understand the litigation risks from the crisis, including related to contractual arrangements, and how such risks will impact your business and that of your portfolio companies. Identifying and anticipating trends in litigation allows you to take steps to mitigate risk to your business and operations.

Governance Practices

Issue: Good corporate governance protects the fund and the portfolio company directors and officers from future liability. Never is that more important than in times of crisis when emergency decisions made with incomplete information become the norm. After the fact, creditors, regulatory authorities, and auditors may scrutinize those decisions - all with the benefit of hindsight.

Response: The fund should review its corporate governance practices and update them as needed to ensure best practices in a consistent manner across all portfolio companies. This comprehensive approach limits risk and addresses each of the areas below:

- Determining the frequency and content of board meetings including training your team and members of management of portfolio companies on how to run effective board meetings and take appropriate minutes.

- Evaluating the composition and make-up of boards of directors or other governing bodies at your portfolio companies including when independent directors may be appropriate.
- Analyzing existing D&O insurance policies and recommendations as to any modifications to such policies.
- Analyzing your business insurance to assess whether it provides sufficient coverage or has material exceptions.
- Assuring competent disclosure, reporting, and transparency for all constituencies.
- Assuring compliance with fiduciary duties and understanding the application of those duties to the current situation.
- Optimizing corporate governance documents and agreements.

Working with Distress

Issue: Although many companies are obtaining breathing space from their lenders, the COVID-19 crisis is going to result in the need to restructure the debt of many portfolio companies and could result in deeper distress for some. Some companies will need to implement a significant restructuring even before the crisis fully resolves itself. Evaluating those options from the perspective of the best interests of the portfolio company and the fund is critical to avoiding adverse outcomes. In addition, many portfolio companies are going to have to work with distressed stakeholders such as customers, vendors and suppliers and lenders.

Response: Understanding all of the options for restructuring your portfolio company may help unlock value. You should consider out-of-court restructuring alternatives, in-court alternatives, and state law options such as receiverships and assignments for the benefit of creditors. It is also important to understand how to effectively manage and protect your rights against distress stakeholders while at the same time implementing business and legal solutions to protect your businesses.

The Changing Legal and Regulatory Landscape

Issue: The COVID-19 crisis has already changed the legal landscape in which businesses operate. The myriad of executive orders - often conflicting and open to interpretation - impacting businesses is staggering. The federal government and many state governments have also put in place programs to assist companies negatively impacted by COVID-19 such as the programs under the CARES Act. Additional governmental programs and support may become available at the federal and state level. Private equity portfolio companies should be aware of and take advantage of those programs where possible.

Response: The fund should engage actively with its portfolio companies to:

- Identify governmental actions that could adversely impact your businesses or create risk for their business operations.

- Highlight and evaluate programs and opportunities specific to your portfolio that may provide relief for your businesses.
- Assure that the decisions made by your portfolio companies about government program participation are consistent and documented in a manner that should mitigate risk to the fund later.

Deploying Capital and Planning for a Post-Virus World

Issue: The aftermath of the crisis is going to bring its own unique challenges. As markets begin to normalize, lenders will begin to evaluate companies more strategically as will distressed debt investors. Funds need to be prepared with a strategy to manage the aftermath in order to avoid adverse outcomes. In addition, many private equity funds may be looking to deploy capital in the aftermath of the crisis. Opportunities to acquire companies or their debt securities are likely to exist at attractive prices in many industries. Private equity funds may also see opportunity to provide junior capital at attractive returns as companies develop defensive strategies to avoid defaults.

Response: The fund should develop and be ready to deploy capital in your chosen structure and industry. Training your team on how to execute on a distressed acquisition quickly will give your team an advantage as opportunities arise. Similarly, understanding the market terms for structured equity products is important when thinking about how to deploy capital.

KEY CONTACTS



Peter Friedman | WASHINGTON, DC

Partner
+1 202 383 302
pfriedman@omm.com



Matthew Hinker | NEW YORK

Partner
+1 212 326 2157
mhinker@omm.com



Jeffrey Kohn | NEW YORK

Partner
+1 212 326 2067
jkohn@omm.com



Nancy Mitchell | NEW YORK

Partner
+1 212 326 2127
nmitchell@omm.com



Eric Zabinski | CENTURY CITY / BEIJING

Partner
Century City
+1 310 246 8449

Beijing
+86 10 6563 4200
ezabinski@omm.com

Century City • Los Angeles • Newport Beach • New York • San Francisco • Silicon Valley • Washington, DC
Beijing • Brussels • Hong Kong • London • Seoul • Shanghai • Singapore • Tokyo

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