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Insights: Potential Litigation and Issues the Private Equity Industry May Face in the Future

The COVID-19 pandemic and the ensuing economic fallout raises a mix of pressing concerns and complex legal issues for private equity firms and their portfolio company management teams. The analysis below considers both potential litigation as well as certain other legal issues and considerations, cutting across an array of legislative, regulatory, and practical considerations.

Potential Litigation

1. Contractual Disputes

Private equity firms that have signed but not yet closed transactions prior to the outbreak of COVID-19 may be considering whether the outbreak is a valid basis for triggering material adverse change ("MAC") clauses in the transaction documents. At the same time, sellers and targets may be concerned that the situation presents buyers and investors with the chance to easily invoke MAC clauses to walk away from what they may now consider to be a "bad deal." Additionally, private equity portfolio companies that operate in or rely on production or supply chains in the severely affected sectors may have to report losses, trigger events of default under their loan documents, or breach the terms of their operational agreements if they do not manage to obtain subsidies from their governments, rent forbearance or rebates from their landlords or waivers from their lenders, or if they cannot get deadlines extended by invoking force majeure and/or MAC clauses in the relevant agreements.

Private equity firms and their portfolio companies should undertake a thorough review of the portfolio company's material contracts 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. 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 as well as defend against them.

A. Force Majeure Clauses

As a general matter, force majeure clauses 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. A force majeure clause is never implied under common law and will only arise in contracts where the parties have specifically agreed to it.

i. **Force Majeure Event:** Contracts often define what constitutes a force majeure event, and businesses should carefully review force majeure clauses in their contracts. To that end, a company

will need to determine whether COVID-19,[1] the economic fallout therefrom, or any of the various legislative actions taken in response thereto falls within the scope of the contractually defined force majeure events.[2] A generic reference to an "act of God," without more, is unlikely to be triggered by the COVID-19 outbreak or ensuing fallout. On the other hand, specific references to "epidemic," "disease outbreak," "public health crisis," "National emergency," "acts of civil or military authority," "acts, regulations, or laws of government,"[3] "disruption of supply chain," or "disruption of labor force," could trigger a force majeure clause. If the force majeure clause outlines specific events and also includes catchall language such as "other similar clauses," New York courts interpret the catchall language as limited to events of the same kind or nature as outlined.[4]

ii. **Unforeseen Event and Absence of Fault and Control:** Next, assuming COVID-19 qualifies as a triggering event, a party must analyze what impact the triggering event has on the party's required performance. It is common for force majeure clauses to require that the triggering event make performance "illegal or impossible." New York law, for example, 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[5] and (ii) it is not at fault for—or was not in control of—the triggering event.[6]

iii. **Contract Cannot be Performed:** Other than holding that mere financial burdens do not generally suffice, New York courts have not entirely 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

[1] There is no current case law that specifically addressing pandemics. There is one case, *Rembrandt Enterprises, Inc. v. Dahmes Stainless, Inc.*, No, C15-4248-LTS, 2017 WL 3929308 (N.D. Iowa Sept. 17, 2017), that involved the avian flu wiping out a poultry farmer's birds and the assorted contract defenses that resulted when the farmer's business suffered thereafter. While the similarities between avian flu and COVID-19 are evident, this case may only be limited to instances where some events destroys certain products. Indeed, while it was the avian flu that wiped out the birds, the avian flu could stand in for other non-pandemic events as well, such as fire or some other natural disaster. Although the court allowed the case to proceed to trial, this case may not be as instructive as other non-pandemic cases.

[2] "Ordinarily, only if the force majeure clause specifically includes the event that actually prevents a party's performance will that party be excused." *Kel Kim Corp. v. Cent. Mkts.*, 519 N.E.2d 295, 296 (N.Y. 1987).

[3] Direct government action, such as a prohibition on certain activities can be the predicate for a successful invocation of a force majeure clause. *See, e.g., Harriscom Svenska, AB v. Harris Corp.* 3 F.3d 576, 580 (2d Cir. 1993) (reasoning that government prohibitions can be a predicate for a force majeure event). *But see Kyocera Corp. v. Hemlock Semiconductor, LLC.* 886 N.W.2d 445, 450 (Mich. Ct. App. 2015) (finding indirect government actions that hindered performance did not constitute a force majeure event). Given the travel restrictions resulting from COVID-19, there might be a sufficient "curtailment of transportation facilities" to trigger the clause, and, state and local declarations of emergency, closures, or bans might be considered "government regulations" that trigger the clause.

[4] *See, e.g., Team Mktg. USA Corp. v. Power Pact, LLC*, 41 A.D.3d 939 (N.Y. App. Div. 2007); Kel Kim Corp. v. Cent. Mkts., 131 A.D.2d 947 (N.Y App. Div. 1987), aff'd 519 N.E.2d 295 (N.Y. 1987).

[5] The implied foreseeability requirement reflects New York's 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.

[6] Analysis of the no fault requirement involves an important distinction between an event that itself prevents performance (which may constitute force majeure) and a party's response to an event (which, unless the force majeure 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. *See, e.g., Aukema v. Chesapeake Appalachia, LLC*, 904 F. Supp. 2d 199, 210 (N.D.N.Y. 2012).

showing of impossibility or illegality, the force majeure clause may be triggered by government regulations that specifically prohibit fulfillment of the contract.[7]

iv. **Notice:** In the event a party decides to trigger a force majeure clause, many contracts require notice within a certain amount of time of learning of the triggering event. 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 quarantine orders in effect across the country, 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 pandemic persists.

B. Common Law Affirmative Defenses

If a contract, specifically a New York-law governed contract, is silent on force majeure and material adverse change ("MAC") clauses, the common law doctrines of impossibility and frustration of purpose may provide certain relief.

i. **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 (i) was unforeseeable and (ii) rendered its performance of its obligations under the contract objectively impossible and not merely more expensive or difficult.[8]

ii. **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 and 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.[9]

C. Transactional Issues in Pending Transactions

Given the significant impact of the COVID-19 pandemic on the global economy, parties should review and revise relevant provisions of acquisition agreements and conduct additional diligence on pending and

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[7] New York courts have not addressed in any detail the meaning of "impracticability," as used in force majeure clauses, but such common law affirmative defenses such as impracticability may be established when it would make no economic or societal sense to require performance. Indeed, 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).

[8] New York courts apply this doctrine narrowly. "[W]here impossibility or difficulty of performance is occasioned only financial difficultly or economic hardship, even to the extent of insolvency or bankruptcy, performance of a contract is not excused." *407 E. 61st Garage, Inc. v. Savoy Fifth Ave. Corp.*, 244 N.E.2d 37, 41 (N.Y. 1968).

[9] As with impossibility, New York courts apply this doctrine narrowly. *See, e.g., Gander Mountain Co. v. Islip U-Slip LLC*, 923 F. Supp. 2d 351 (N.D.N.Y. 2013).

potential transactions 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.

Private equity firms that were in the process of negotiating a deal prior to the escalation of the COVID-19 outbreak here in the U.S., 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. Where a private equity firm or its portfolio company has already entered into a transaction, the private equity firm should consider whether the transaction documents contain any clauses that would allow the sponsor or its counterparty to terminate the transaction, avoid certain obligations, or otherwise revise their respective rights. Private equity firms should also consider issues arising under related arrangements, including acquisition financing and representation and warranty insurance coverage.

i. **Material Adverse Change ("MAC") Clauses:** MAC clauses "are a common feature of many contracts" and serve a number of functions.[10] Most importantly, the MAC definition sets the parameters for when a buyer is permitted to terminate the transaction if there is a material adverse event affecting the target company or business.[11] MAC clauses are common in purchase or merger agreements because they allow a buyer to avoid a deal in the event of an abrupt material financial challenge.[12]

   Whether the COVID-19 outbreak and its effects constitute a material adverse event that could trigger a MAC termination right is unknown. Currently, the full effect of the COVID-19 pandemic is not yet clear and it is thus likely too early to conclusively determine whether a MAC clause would be triggered.[13] In the meantime, those in the private equity industry should closely monitor and maintain documentary records showing the impact of the COVID-19 pandemic on the business at issue in order to evaluate whether the situation threatens a MAC. In addition, private equity firms and their portfolio companies should continue to approach contract performance in good faith and maintain thoughtful and commercial reasonable communications with their counterparties.

   Whether MAC clauses are triggered will depend heavily on the specific wording of the MAC clause and the particular circumstances of the business at issue.[14] New York courts will interpret MAC clauses within the context of the entire agreement and in conjunction with the parties' intent.[15] Under

[10] *In re Lyondell Chem. Co.*, 567 B.R. 55, 122 (Bankr. S.D.N.Y. 2017).

[11] The typical MAC is defined as any development, event, condition, state of facts, etc., that have had, or would reasonably be expected to have, a material adverse effect on the business, assets, financial condition or results of operations of the subject party, but excludes various categories of broader market or industry risk. Common exclusions from the MAC definition include effects related to (i) general economic, business, financial, credit or other market conditions and (ii) any epidemic or other natural disaster or act of God, but often only to the extent such effects do not disproportionately adversely affect the subject party versus others in the industry.

[12] 4C N.Y. Prac., Com. Litig. § 89:32 (4th ed).

[13] Any subsidies provided by the government, for example, will likely be taken into account in determining whether a MAC clause would be triggered.

[14] Whether a party can rely on the impact caused by the COVID-19 outbreak to trigger the MAC clause under a particular agreement will depend heavily on (i) how the clause is drafted; (ii) how the clause will be construed under the agreement's governing law; and (iii) the actual impact on the business at issue.

[15] *See Newmont Mining Corp. v. Anglogold Ashanti Ltd.*, No. 17-CV-8065, 2020 WL 1285543, at *17 (S.D.N.Y. Mar. 18, 2020) ("Courts will consider 'whether the alleged material adverse change was within the contemplation of the parties at the time they executed the

Delaware law,[16] a MAC is deemed to have occurred if a facts-based inquiry shows that the effects "substantially threaten the overall earnings potential of the [party] in a durationally-significant manner."[17] As recently confirmed *Akorn, Inc. v. Fresenius Kabi AG*,[18] the only Delaware case to have found an MAC in the M&A context, these effects must be material when viewed from the longer-term perspective—a "short-term hiccup in earnings" will not suffice.

While there is no bright-line test for properly invoking a MAC clause, it is nonetheless a very high bar and requires something more than a short-term downturn in business or business prospect. Moreover, negotiated MAC 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).[19] Notwithstanding that these provisions are often heavily negotiated, there is typically no express definition of the specific events or dollar amount of value loss that would constitute an MAC. As a result, it is left to the courts to determine whether there has been an MAC and there can be a wide array of results since the courts do not apply a bright-line test.

In short, there is no standard analysis as to whether the effects of the COVID-19 outbreak on a particular business would justify a party's refusal to close on a deal under a MAC analysis. By its nature, this will be a fact-specific inquiry. Further, even if the COVID-19 outbreak is a materially adverse event for a particular company, the effects of the outbreak may qualify as an exclusion under the epidemic/force majeure and/or market exceptions to the MAC definition. The question then will be whether the COVID-19 outbreak has had a disproportionate impact on the particular business, which again, is a fact-specific inquiry.[20] As it concerns the rapidly evolving nature of COVID-19, MAC clauses will likely become more relevant in pending mergers and acquisitions given global market volatility.

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agreement, whether it was within the control of the parties, and the magnitude of the impact on the relevant party's business.'") (citing *In re Lyondell Chem Co.*, 567 B.R. at 123).

[16] Notable cases include *Frontier Oil Corp. v. Holly Corp.*, No. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005) and *In re IBP, Inc. Shareholders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001).

[17] *In re IBP, Inc. Shareholders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001).

[18] No. 2018-0300-JTL, 2018 WL 4719347 (De. Ch. Oct. 1, 2018).

[19] The fact-intensive nature of the inquiry means that MAC-specific claims are unlikely to be resolved at an early stage of litigation. However, pandemic-related downturns may generally be excluded from MAC clauses. In *Akorn*, the sole Delaware case involving the successful invocation of a MAC clause, the MAC clause at issue generally excluded pandemic and other force majeure events from constituting a material adverse change. 2018 WL 4719347, at *50-51. The parties' MAC clause did, however, provide that should there be a pandemic or other force majeure event that disproportionately impacts the to-be-acquired company, then its impact could be taken into account to determine whether there was a material adverse change. *Id.* Whether the company was disproportionately affected by a pandemic or other force majeure change was to be compared against the target industry as a whole. Id. Given the widespread impact of COVID-19, it would be incredibly difficult for a company to argue that it, compared to the rest of its industry, was disproportionately impacted by event stemming from COVID-19.

[20] This all depends on the particular language of the relevant MAC clause. As the COVID-19 outbreak continues, it's likely that sellers will negotiate for more specific references to pandemics and epidemics in the exceptions to the definition of an MAC, just as terrorism exceptions became more commonplace following the events of September 11, 2011.

2. Veil-Piercing Risks

When one corporate entity is under such extensive control by another that the first is merely an alter ego of the second, a court may permit a plaintiff to reach through the corporate structure to gain recovery. In other words, private equity firms and managers may be held responsible for the actions of the firm's portfolio companies.[21] Courts allow plaintiffs to pierce the corporate veil and hold the private equity fund liable for the actions of its portfolio companies, particularly if the portfolio company has engaged in criminal behavior such as corruption, money laundering, tax evasion, or if the portfolio company is undercapitalized. There are also instances where plaintiffs have attempted to render parent companies liable for subsidiaries' environmental, health, and safety liabilities, including if the parent exercises a degree of supervision or control, or if the parent has issued relevant policies and guidelines.[22] Through this mechanism, limited liability does not mean immunity from liability, and under certain circumstances a plaintiff can hold the ultimate shareholders or owners liable for company obligations.

Most states, though not all, choose the law of the state of incorporation when considering the veil-piercing claims under the "internal affairs doctrine."[23] That doctrine generally states that the law of the state of incorporation—typically Delaware, given the State's popularity as a state of incorporation—controls the "internal affairs" of a corporation. For corporations incorporated in Delaware, even if a claim is brought in New York or Illinois, Delaware law will nonetheless typically apply to the veil-piercing claims under the internal affairs doctrine.[24] This is particularly important because the law in Delaware (like New York's and Pennsylvania's) is regarded as particularly favorable to owners and managers resisting a veil-piercing claim. California, on the other hand, is typically considered an easier jurisdiction to pierce the veil in.[25] And rather than looking to the state of incorporation, California courts generally apply California law to alter ego claims.[26] Another difference between states is whether veil piercing is treated as an equitable matter for the judge to decide or a factual question for the

[21] See generally *Marchan v. John Miller Farms, Inc.*, 352 F. Supp. 3d 938, 943 (D.N.D. 2018) (denying motion for summary judgement after concluding that plaintiff "will need to pierce the corporate veil to reach its owner [a private equity firm], in order to obtain substantial recovery").

[22] This can be a difficult scenario for a private fund manager dealing with a struggling portfolio company investment—the company fails and ensuing legal claims can be brought not only against the portfolio company but also against the fund.

[23] *See, e.g., Maltz v. Union Carbide Chems. & Plastics Co.*, 992 F. Supp. 286, 300 n.12 (S.D.N.Y. 1998).

[24] *See, e.g.*, *Fletcher v. Atex, Inc.*, 68 F.3d 1451, 1456 (2d Cir. 1995).

[25] *See, e.g.*, Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1052-53 (1991) ("[There is] a perception that public policy in California… favor[s] piercing the corporate veil…. As a group, the New York decisions seem somewhat more restrictive on piercing than cases from the rest of the country…. [There may also be] a general leaning toward protecting corporations [from piercing] in [Delaware].").

[26] No California case has applied the law of the state of incorporation to veil piercing claims. To the contrary, statements made in California cases strongly suggest that the "internal affairs doctrine" would not apply to a veil piercing claim. *See, e.g.*, *Lidow v. Superior Court*, 206 Cal. App. 4th 351 (2012) (holding the internal affairs doctrine does not apply when a corporate officer alleges that the corporation violated public policy); *Oncology Therapeutics Network Connection v. Virginia Hematology Oncology PLLC*, No. C 05-3033 WDB, 2006 WL 334532, at *17 (N.D. Cal. Feb. 10, 2006) (interpreting California law in a diversity case and concluding that the "internal affairs doctrine" does not apply to choice-of-law questions involving the alter ego/veil piercing doctrine).

jury. In Delaware, for example, a judge decides veil-piercing claims.[27] Texas, on the contrary, is an outlier, where such claims are left to the jury.[28]

These differences between state laws are of note because choice-of-law determinations in veil piercing cases are, unlike in breach of contract lawsuits, not governed by a contractual clause; indeed, by definition no contract could exist between the plaintiff seeking to pierce the corporate veil and the parent corporation, otherwise there would be no need to pierce the veil. Instead, the applicable law will be determined by the choice-of-law provisions of the forum state. Most often, courts apply either the law of the state of incorporation of the entity subject to piercing or the law of the forum state.

A. General Standards in Delaware

Different courts have developed various factors to determine whether to pierce the corporate veil. Delaware law, which governs many veil piercing claims, provides robust piercing protections. A plaintiff seeking to pierce the corporate veil in Delaware needs to show that the corporation, through its alter ego, created a sham entity designed to defraud investors and creditors. Or rather, Delaware requires a plaintiff to demonstrate "an element of fraud" or something like it.[29] This is a very high standard. Delaware courts consider the following five factors:

- Whether the entity was adequately capitalized;
- Whether the entity was solvent;
- Whether corporate formalities were observed;
- Whether the controlling shareholder siphoned company funds; and
- Whether the company generally functioned as a façade for the controlling shareholder.[30]

Due in large part to the fraud requirement, Delaware courts grant dismissal or summary judgment of alter ego claims with greater frequency than do the courts of many other jurisdictions. California, conversely, has a less rigid set of criteria which does not require a finding of fraud or a "sham" entity. Instead, California has a long non-exhaustive list of factors that courts can look to such as whether the entities comingled funds, employed the same employees, or failed to maintain arm's-length relationships.[31] Overall, California uses the doctrine when the separate existence of the corporation would promote injustice or bring about inequitable results.

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[27] *See, e.g.*, *Sonne v. Sacks*, 314 A.2d 194, 197 (Del. 1973); Mark A. Olthoff, *Beyond the Form—Should the Corporate Veil Be Pierced?*, 64 UMKC L. REV. 311, 331 (1995) ("Several state courts have held that the issue of piercing the corporate veil is one which may be resolved by the jury. These states [only] include Tennessee, Mississippi, North Dakota, North Carolina, Iowa, Florida, Texas, and Georgia, as well as the District of Columbia.").

[28] *Casdeberry v. Branscum*, 721 S.W.2d 270, 273 (Tex. 1986) (holding that the question of whether the corporate veil should be pierced is regarded as a factual matter for jury determination).

[29] *See, e.g.*, *Winner Acceptance Corp. v. Return on Capital Corp.*, No. 3088-VCP, 2008 WL 5352063, at *5 (Del. Ch. Dec. 23, 2008).

[30] *See Mason v. Network of Wilmington, Inc.*, C.A. No. 19434-NC, 2005 WL 1653954 (Del. Ch. July 1, 2005).

[31] California utilizes a non-exclusive, multi-factor test to make veil-piercing determinations. This long list is of almost twenty factors. *See Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP*, 69 Cal. App. 4th 223, 249–50 (Cal. Ct. App. 1999).

While courts may go about assessing veil piercing claims differently, at its core the doctrine is about fairness and holding accountable those in control of an entity's actions. To minimize potential liability for such claims a private equity fund should consider doing the following:

- Keep separate books and records for both companies;
- Have separate meetings of the board and keep separate minutes;
- Make the board composition of the entities different;
- Keep separate accounts, including bank accounts, for both companies;
- Require the use of separate email addresses and letterhead for any individuals with positions in both entities;
- Where possible, maintain an arm's length relationship in business dealings between related entities; and
- Adequately capitalize any corporation for its line of business.

3. Labor and Unemployment Considerations

A. Worker Adjustment and Retraining Notification ("WARN") Act

In recent years, there has been a tendency for workers who lose employment at a private equity fund's portfolio company as a result of a plant closing or a layoff to sue the private equity fund for violations of the Worker Adjustment and Retraining Notification Act ("WARN").[32] Private equity firms and investment management companies with fewer than 100 employees may be subject to liability under the WARN Act if their portfolio company violates the WARN Act. Under the WARN Act, a plaintiff need not establish the high standard for piercing the corporate veil under traditional law but can claim that the owner of a company—in addition to the company itself—is liable as a "single employer" based upon having sufficient interrelatedness and control over the employment practices of the company.[33]

Indeed, under the "single employer" theory, even a distant parent company that is sufficiently linked with, and/or in control of, a subsidiary is deemed to be a "single employer" with that subsidiary. Since it's likely that a portfolio company that closes a plant or lays off a substantial portion of its workforce may be failing financially—as may be the case in response to COVID-19—the terminated employee will look to the private equity firm as the "deep pocket" source of compensation, claiming that the private equity firm is liable because it made the termination decision with the portfolio company as a "single employer" under the WARN Act.

Generally speaking, the WARN Act offers protection to employees, their families and communities by requiring employers with more than 100 employees to provide written notice to such affected employees

[32] 29 U.S.C. § 2101 et seq. and 20 C.F.R. §§ 639.1 to 639.10. *See, e.g.*, *Guippone v. BH S&B Holdings LLC*, 737 F.3d 221, 227-28 (2d Cir. 2013) (question as to whether parent company was a single employer with its subsidiary under the WARN ACT); *Czyzewski v. Jevic Transp. Inc.* (*In re Jevic Holding Corp.*), 492 B. R. 416, 417 (Bankr. D. Del. 2013) (granting defendant's motion for summary judgment after finding that three of the factors and notably the de facto control factor weighed more in favor of finding no single employer); *In Re Tweeter OPCO, LLC*, 453 B.R. 534, 536 (Bankr. D. Del. 2011) (for WARN Act purposes, the court found that entity related to debtor in chain of ownership to be part of the single employer).
[33] *See NLRB v. Rockwood Energy*, 942 F.2d 169, 173 (3d Cir. 1991) (parent company and two subsidiaries classified as a single employer).

and local government entities sixty days in advance of covered plant closings and covered mass layoffs. In addition, many states have adopted their own WARN Act regulations and employers must abide by both federal and state guidelines.[34] Notably, the WARN Act provides exceptions to the sixty-day notice requirement, including the unforeseeable business circumstances exception and the faltering company exception. Whether the unforeseeable business circumstances exception applies due to the COVID-19 related closures and layoffs remains untested, and the U.S. Department of Labor ("DOL") has not issued guidance related to the application of the exceptions in light of the COVID-19 pandemic. Importantly, the exception does not eliminate the requirement to send out WARN notices. Rather, it renders shortened notices sufficient.[35]

In certain instances, former employees of a private equity fund's portfolio company may sue the fund under a "single employer" doctrine because a portfolio company has not provided the requisite notice of an employment loss.[36] Often in these situations, the portfolio company has ceased operations or is on the verge of doing so, and it may be difficult to obtain a meaningful recovery from such company.[37] In response, the former employees assert their WARN Act claims against the private equity owner of the failed company looking for "deep pockets." If the "single employer" claim is successful, the former employees will be able to recover from the defendant private equity firm. Courts will typically apply a "single employer" test to determine "single employer" liability to the specific facts of the case. A parent company and its subsidiaries may be deemed a "single employer" for purposes of the WARN Act depending on the subsidiaries' degree of independence from the parent corporation.[38]

DOL regulations have set out five factors to be considered when evaluating the "single employer" doctrine with respect to WARN Act liability: (i) common ownership; (ii) common directors and/or officers; (iii) de facto exercise of control; (iv) unity of personnel policies emanating from a common source; and (v) dependency of operations.[39] Courts in various jurisdictions, including courts in Delaware and the U.S. Courts of Appeals for the Third and Fifth Circuits, have adopted a five-factor balancing test based on the above-mentioned five factors and generally apply the same test. And yet, the DOL balancing test is not a

[34] Employers also must comply with state "mini" WARN Acts. For example, California, Delaware, Hawaii, Illinois, Iowa, Maine, Massachusetts, Minnesota, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oregon, Tennessee, Vermont and Wisconsin all have statutes that require covered private employers to take certain actions when conducting plant closings and layoffs. *See, e.g.*, (N.Y. Lab. Law §§ 860 to 860-i (2011) and N.Y. Comp. Codes R. & Regs. Tit. 12, § 921 (2011)), employers with fifty or more employees within New York, excluding part-time employees, or fifty or more employees including part-time employees within the state that work in aggregate at least 2,000 hours per week, are covered and must provide ninety-days' notice in advance of NY-WARN covered business closings and layoffs; (CA. Labor Code §§ 1400 to 1408) only a covered establishment which is "any industrial or commercial facility" that employs or has employed at least seventy-five people in the preceding twelve month period is covered.
[35] *See* § 3(b) of the WARN Act sets forth three conditions under which the notification period may be reduced to less than 60 days, most notably the "unforeseeable business circumstances" exception under 3(b)(2)(A).
[36] *In re Jevic Holding Corp.*, 492 B. R. at 417 (granting defendant's motion for summary judgment after finding that three of the factors and notably the de facto control factor weighed more in favor of finding no single employer).
[37] *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 134 (1st Cir. 2013) (approximately two years after Sun Capital purchased Scott Brass Inc., Scott Brass Inc., filed for bankruptcy).
[38] *In re Jevic Holding Corp.*, 492 B. R. at 417 (granting defendant's motion for summary judgment after finding that three of the factors and notably the de facto control factor weighed more in favor of finding no single employer).
[39] 20 C.F.R. § 639.3(a)(2). However, the DOL has advised that these five non-exclusive factors do not trump applicable state corporate law (specifically, principles of piercing the corporate veil) and federal labor law (including the Labor Management Relations Act ("LMRA")) for determining whether affiliated entities comprise a single employer.

"mechanical exercise"[40] but rather an "inquiry into whether the two nominally separate entities operate[] at arm's length."[41] Generally, if only the first two factors are present—common ownership coupled with common management—liability is not established. Typically, the last three factors are the determinative ones and among these, de facto of control is the most important.[42] The fourth factor looks to whether there was unity of personnel policies, and is "analogous to a determination of whether the companies had a centralized control of labor operations."[43] The fifth factor considers whether there was a dependency of operations between the two companies. Courts will look to the existence of arrangements such as the sharing of administrative or purchasing services, interchanges of employees or equipment and commingled finances.[44]

Too much interference in the management and financial decision-making process of a portfolio company can have significant consequences in terms of liability. Private equity firms can mitigate "single employer" liability risk with proper advance planning and structuring. They may want to consider the following list of protective measures:

- The portfolio company should have and be responsible for creating its own human resources, labor, employment and personnel policies, rules and procedures; ensure decision-making in this area is independent;
- The portfolio company should negotiate its own labor and employment agreements;
- Allow the portfolio company to have at least one or more independent directors and independent officers; directors and officers should act on behalf of the portfolio company. It is appropriate for a

[40] The Third and Fifth Circuits have determined that the DOL test alone is the most appropriate test because it was created with the situations underlying WARN in mind. *See, e.g. Administaff Cos., Inc. v. N.Y. Joint Board, Shire & Leisurewear Div.*, 337 F.3d 454, 457-58 (5th Cir. 2003) (applying DOL standards to determine WARN Act liability and declining to consider NLRA joint employer test to determine liability); *Pearson v. Component Tech. Corp.*, 247 F.3d 471, 490 (3d Cir. 2001) (holding the DOL test should be used to determine WARN Act liability in the case of both a secured lender and parent/subsidiary relationship). Although the Second Circuit has not adopted a specific test for intercorporate WARN Act liability, case law indicates that the DOL factors should be considered. Indeed, the closest the Second Circuit has come to addressing the appropriate standard for parent/subsidiary WARN Act coverage was in a recent 2017 decision. *See Coppola v. Bear Stearns & Co., Inc.*, 499 F.3d 144, 150 (2d Cir. 2007) ("the DOL factors may be relevant to the question of whether the entities' relationship is in fact that of the parent and subsidiary").

[41] *Pearson*, 247 F.3d at 495.

[42] Two courts in the Southern District of New York have applied the DOL test to assess intercorporate WARN Act liability of investors, emphasizing the importance of a related entity's de facto control of the decision to trigger a mass layoff or plant closure. *See Guippone v. BH S & B Holdings LLC*, 681 F. Supp. 2d 442, 446 (S.D.N.Y.2010) (granting several investors' motion to dismiss following finding that defendants were not a single entity); V*ogt v. Greenmarine Holding, LLC*, 318 F. Supp. 2d 136, 140-41 (S.D.N.Y. 2004) (granting several investors' motions to dismiss, but denying others' based on specific factual allegations regarding the relationships of the defendants to the underlying bankrupt company). Accordingly, an otherwise distant investment firm could risk liability for an affiliate's WARN Act violations if it is a decision-maker with respect to an office closing or layoff. According to the Third Circuit, a "particularly striking" showing of de facto control can warrant "single employer" liability even in the absence of the other factors. The de facto control factor involves a determination as to whether one company "was the decision-maker responsible for the employment practice giving rise to the litigation. *Pearson*, 247 F.3d at 504. A 2013 Delaware Bankruptcy Court decision held that de facto control is not present where the parent corporation exercises control pursuant to the ordinary instances of stock ownership, but exists only where "the parent has specifically directed the allegedly illegal employment practice that forms the basis for the litigation." *In re Jevic Holding Corp.*, 492 B. R. at 426 (Bankr. D. Del.2013).

[43] *Young v. Fortis Plastics, LLC*, No. 3:12-CV-364, 2013 WL 5406276, at *6 (N.D. Ind. Sept. 24, 2013); *see also Hampton v. Navigation Capital Partners, Inc.*, 64 F. Supp. 3d 622 (D. Del. Aug. 19, 2014).

[44] The fifth factor considers whether there was a dependency of operations between the two companies. Courts will look to the existence of arrangements such as the sharing of administrative or purchasing services, interchanges of employees or equipment and commingled finances. *Pearson*, 247 F.3d at 495.

parent to have common directors and/or officers with a subsidiary, so this factor alone is insufficient for finding liability;

- With board oversight and input from the fund, the portfolio company's management team should strive to control day-to-day operations of the company and decisions as to potential layoffs or plant closures, as well as other major decisions. If an investment company is alleged to have been a decision-maker responsible for the bankruptcy or employment decision underlying the WARN violation, it will weigh heavily in favor of finding liability;[45]
- Professional advisors to the portfolio company's board and management team should be hired directly by the portfolio company as opposed to relying on advisors to (or hired by) the private equity fund, especially regarding layoff or plant closing decisions[46]; and
- Each company should maintain its own books and records, have its own bank accounts, and prepare its own financial statements.

Other Potential Issues and Considerations

1. Securities and Exchange Commission ("SEC") Reporting Obligations and Public Disclosure

The outbreak of COVID-19 provides fertile ground for the latest wave of event-driven securities litigation, with two putative class actions recently filed against Inovio Pharmaceuticals and Norwegian Cruise Lines in Pennsylvania and Florida, respectively.[47] Similar suits are likely to follow. These lawsuits underscore the care companies must exercise when issuing public statements regarding COVID-19, as well as the need for companies to carefully evaluate and assess how the potential financial and business impact of COVID-19 might affect their disclosures and performance guidance. This is particularly important for the private equity industry and fund managers specifically. The SEC can be expected to examine how fund managers respond to COVID-19 and whether their responses were consistent with their fiduciary duties. The SEC is likely to scrutinize any deficiencies that may have been overlooked and potentially hidden by the strong economy.

- Private equity managers should review all reporting requirements set forth in fund offering and governing documents and agreements such as side letters in order to determine whether investors will need to be advised that delivery of quarterly and annual reports, audited financial statements, and tax reports may be delayed due to the impact of the crisis on service providers and/or, if applicable, delay in the receipt of financial information from any portfolio company or waivers or extensions of delivery timeframes need to be sought, as set forth in these documents and agreements;
- Managers should gauge the ability to meet regulatory filing requirements in light of potential COVID-19 business disruptions.[48]

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[45] *Id*. at 471.
[46] *Id*.
[47] *See McDermid v. Inovio Pharmaceuticals, Inc., et al.*, No. 2:20-cv-01402 (E.D. Pa. Mar. 12, 2020) (asserting claims under Sections 10(b) and 20(a) of the Securities Exchange Act arising from statements made by CEO concerning the company's ability to provide a COVID-19 vaccine); *Douglas, et al. v. Norwegian Cruise Lines, et al.*, No. 1:20-cv-21107 (S.D. Fla. Mar. 12, 2020) (alleging that despite the looming and potentially drastic effects of COVID-19 on tourism and the cruise industry, Norwegian issued a series of disclosures in February 2020 that discussed a positive outlook for the company and "touted" the company's procedures to protect the health and safety of guests and crew. Plaintiff claims that these statements were false or misleading because Norwegian was allegedly "providing customers with unproven and/or blatantly false statements about COVID-19 to entice the purchase of cruises").
[48] The SEC recently issued an order granting relief relating to the Form ADV and Form PF filing and delivery requirements. In issuing this relief, the SEC stated that it recognizes the challenges registered investment advisers and exempt reporting advisers may face as a

- Economic impacts may adversely affect the performance of a private equity firm's investments. Managers should consider adding risk factors related to recent developments. Risks could address, among other things, the (i) impact of the virus and market volatility on fund performance; (ii) the possibility of significant breakdowns, delays, and other disruptions to the economy, systems, and reporting; (iii) and liquidity constraints, among others.
- The SEC will likely look at whether a fund manager made false or misleading statements to its limited partners, investors or clients regarding the severity of the impact of the crisis on its funds;
- Valuation of privately-held investments will be a key area of focus, particularly the process surrounding potential write downs and related presentations or reporting to investors; and
- The SEC will also likely examine whether, in responding to the crisis, a fund manager took measures to benefit itself or certain investment vehicles at the expense other limited partners.

2. Coronavirus Aid, Relief, and Economic Security ("CARES") Act 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 U.S. small businesses through the Small Business Administration ("SBA"), including the creation of a new class of Section 7(a) lending, Paycheck Protection Loans ("PPP" loan), and an expansion of the existing Section 7(b) Economic Injury Disaster Loans ("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.

Based on current guidance from the SBA, private equity-backed portfolio companies will likely not qualify for the PPP loans or the EID loans outside of certain very specific exceptions; instead, once implemented, the Coronavirus Economic Stabilization Act of 2020 ("CESA") (b)(4) Program and the Main Street Lending Program will likely present more viable relief options for such companies.[49] However, that such eligibility remains subject

result of COVID-19, including disruptions to transportation and the imposition of quarantines around the world that may limit access to facilities, personnel, and third-party service providers. The relief provided under the Advisers Act (Advisers Act Order) provides up to an additional forty-five days for Advisers to satisfy the filing and delivery requirements for certain items, provided that, among other conditions, reliance is necessary or appropriate due to circumstances related to the current or potential effects of COVID-19. *See* Order Under Section 206A of the Investment Advisers Act of 1940 Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder, Investment Advisers Act Rel. No. 5463 (Mar. 13, 2020), https://www.sec.gov/rules/other/2020/ia-5469.pdf. However, there are still certain disclosures and filings required for registrants when taking advantage of the above relief. The SEC has acknowledged that this situation is fluid and that the Commission may provide extensions or relief with additional conditions it deems appropriate.

[49] On April 9, 2020, the Treasury Department and the Federal Reserve Board released the details of their previously announced Main Street Lending Program to promote liquidity in the lending market for small to medium sized businesses. The Treasury Department will use $75 billion of the $454 billion in funds allocated by Congress under section 4000(b)(4) of the Coronavirus Economic Stabilization Act of 2020 ("CESA") – a sub-part of the broader $2 trillion relief package contemplated by the CARES Act–and will leverage the Federal Reserve's emergency lending powers under Section 13(3) of the Federal Reserve Act to allow U.S. banks, depository institutions and savings and loan companies to make available up to $600 billion for the purchase of loans issued by lenders to small and medium sized businesses. *See* U.S. Treasury Department, *Treasury and Federal Reserve Board Announce New and Expanded Lending Programs to Provide up to $2.3 Trillion in Financing* (Apr. 9 2020), https://home.treasury.gov/news/press-releases/sm968.

to further guidance and we will need to continue to closely monitor developments in CARES Act-related funding programs.[50]

A. Paycheck Protection Program Loan ("PPP" Loan)

PPP will authorize up to $349 billion in forgivable loans to small businesses to pay their employees during the COVID-19 crisis. However, the PPP likely will not be useful for most private equity majority-owned businesses other than those in the hospitality industry (North American Industry Classification System ("NAICS") Code 72) because of the SBA's affiliation rules.[51]

i. **Qualifying Borrowers:** Any business entity[52] will be eligible to apply for a PPP Loan if such entity (i) is organized for profit; (ii) has a place of business located in the United States; (iii) operates primarily within the United States or makes a significant contribution to the American economy through payment of taxes or use of American products, materials or labor; (iv) has no more than 500 employees; and (v) was in operation and had either employees (for whom it paid wages and payroll taxes) or a paid independent contractor on February 15, 2020. Based on the interim final rules published by the SBA on April 2 and April 3, 2020, unless expressly exempted by the CARES Act, 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.
   - **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 a certain minority ownership where the minority owner can prevent a quorum or otherwise block board and/or shareholder action and a certain contingent ownership based on stock options, convertible securities and agreements to merge), common management, (i.e., an officer or director holds controlling positions in two 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 firm 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.[53]

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[50] It is expected that the Treasury Department and Federal Reserve Board, as well as participating banks, will provide additional guidance in the coming weeks.

[51] *See* U.S. Small Business Administration, Small Business Administration Compliance Guide Size and Affiliation (Mar. 2014), https://www.sba.gov/sites/default/files/affiliation_ver_03.pdf.

[52] 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 forty-nine percent participation by foreign business entities in the joint venture.

[53] *See* U.S. Department of Treasury, Affiliation Rules Applicable to U.S. Small Business Administration Paycheck Protection Program, (Apr. 3, 2020). https://home.treasury.gov/system/files/136/Affiliation%20rules%20overview%20(for%20public).pdf. Seeing whether you qualify is not a simple matter of taking a headcount of the people working in your office. On April 3, 2020, the Treasury released a narrower definition of affiliation for the PPP program. In summary, first, under the SBA's affiliation regulations, any time another entity holds 50% or more of the small business's voting equity, the companies are deemed to be affiliated, and the SBA counts the total employees or aggregate revenue of all their affiliated companies. For private equity clients with majority investments, this results in all of their portfolio companies being included in the employee census or revenue calculation, which almost always results in

- **Affiliation Exceptions:** The CARES Act waives the affiliation rules for the following types of borrowers: (i) certain hospitality businesses (specifically, those assigned a NAICS 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 ("SBIC") (such a company, an SBIC, and such exception, the SBIC Exception).[54] Indeed, the SBIC Exception presents a gray area for portfolio companies[55] and it might be fruitful to look into the SBIC financing eligibility affiliation rules.[56]
- **Expanded Waivers**: Since the enactment of the CARES Act, the SBA affiliation rules faced intense public scrutiny, with venture capital and private equity trade associations and multiple members of Congress lobbying Treasury Secretary Mnuchin and SBA Administrator Carranza to relax affiliation rules for PPP Loan purposes. House Minority Leader McCarthy has expressed confidence that venture-capital backed portfolio companies will ultimately be eligible for PPP Loans.[57]

ii. **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"[58] (measured over the one-year period

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the size standard being exceeded. As a result, most of the time portfolio companies are not eligible for SBA programs. Second, even minority interests can result in a finding of affiliation, which is very fact specific. The SBA will deem a minority shareholder to be in control if that individual or entity has the ability, under the concern's charter, bylaws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors. The SBA also can find affiliation based on: (i) common management; (ii) under stock options, convertible securities, and agreements to merge; or (iii) based on identity of interest between close relatives.

[54] *See* U.S. Small Business Administration, Size Eligibility and Affiliation Under the CARES Act, (Apr. 4 2020), https://nvca.org/wp-content/uploads/2020/04/April-4-SBA-Guidance-on-Affiliation.pdf

[55] *See id*. Because SBIC financing eligibility is subject to different affiliation rules than the PPP Loan program, 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 SBIC5 and then applying for a PPP Loan (thereby circumventing the affiliation rule complications). However, based on current SBA guidance, it's unclear 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 also unclear whether this strategy would be practical.

[56] Generally, an entity is eligible for SBIC financing if it (i) is organized for profit; (ii) has a place of business located in the U.S.; (iii) operates primarily within the United States or makes a significant contribution to the U.S. economy through payment of taxes or use of American products, material, or labor; (iv) has at least 51% of its employees and assets located within the U.S.; (v) 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 (vi) 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).

[57] *See, e.g.*, Letter from Representatives Pelosi and Khanna to Mnuchin and Carranza (March 31, 2020), https://www.sbia.org/wp-content/uploads/2020/03/Speaker-Pelosi-and-Rep.-Khanna-Letter-3.31.2020.pdf; Letter from Representatives Gottheimer, Reed, Crow and Rodgers to Mnuchin and Carranza (March 31, 2020), https://www.sbia.org/wp-content/uploads/2020/04/Letter-to-Treasury-SBA-re-Affiliate-Rule-2020-03-31-SIGNED.pdf; Letter from Representative Waters to Mnuchin and Carranza (April 1, 2020), https://www.sbia.org/wp-content/uploads/2020/04/0422020_waters_ppp_loans_ltr_treas_sba.pdf; Axios, *Kevin McCarthy: Startups Will Be Eligible for Coronavirus Stimulus Loans* (April 2, 2020), https://www.axios.com/coronavirus-vc-startups-small-business-loans-6ae9e125-fbbb-4349-9d67-ce68d4a5ac57.html.

[58] 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

prior to the loan funding date) and (ii) the outstanding amount of any EID Loan (see discussion infra section B) made between January 31, 2020 and the date the PPP Loan is made available to such borrower.

iii. **Qualifying Uses and Loan Forgiveness:** PPP Loans are intended to cover the cost of maintaining payroll costs, rent and mortgage expenses for the eight-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.

iv. **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 two 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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of $100,000 per year paid to a given person, compensation of any employee whose principal place of residence is outside of the U.S., 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 Families First Coronavirus Response Act ("FFCRA"). U.S. Treasury Department, Paycheck Protection Program ("PPP") Information Sheet: Borrowers, (Apr. 2020), https://home.treasury.gov/system/files/136/PPP--Fact-Sheet.pdf. "

B. Economic Injury Disaster ("EID") Loan Program:

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

i. **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.

ii. **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.

iii. **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 thirty-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.

iv. **EID Grants:** Borrowers that self-certify as eligible can apply for an EID Advance—and an 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.

v. **Relationship 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 is currently 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.

C. Coronavirus Economic Stabilization Act ("CESA") (b)(4) Program:

In addition to the PPP Loan Program 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 through the Coronavirus Economic Stabilization Act ("CESA") (b)(4) Program. As this funding will not be routed through the SBA (and thus subject to the affiliation rules described above), one 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 yet establish, the precise mechanics of applying for relief under the CESA (b)(4) Program. As such, we will need to wait for additional guidance to provide further guidance.

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

ii. **Terms and 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[59]:

- Borrower may not pay dividends or other capital distributions while loan is outstanding and for twelve months thereafter;
- Borrower may not repurchase listed stock of the borrower or any parent company while a loan is outstanding and for twelve 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 twelve 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 twelve-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.

iii. **Mid-Sized Business Loan Program:** As part of the CESA (b)(4) Program, the U.S. 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

[59] These would not apply to other forms of aid, including secondary purchases, syndicated loans and other securities or capital markets transactions.

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 four months after the declared public health emergency in respect of COVID-19 is terminated;
- The borrower is domiciled in the U.S., with significant operations and employees in the U.S.;
- 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 two years after completing repayment;
- The borrower will not abrogate existing collective bargaining agreements during the term of the loan and two years after completing repayment; and
- The borrower will remain neutral in any union organizing effort for the term of the loan.

3. Other Sources of Federal Relief

A. Main Street Lending Program

On April 9, 2020, the Treasury Department and the Federal Reserve Board released the details of their previously announced Main Street Lending Program to promote liquidity in the lending market for small to medium sized businesses.[60] The Treasury Department will use $75 billion of the $454 billion in funds allocated by Congress under section 4000(b)(4) of CESA—a sub-part of the broader $2 trillion relief package contemplated by the CARES Act—and will leverage the Federal Reserve's emergency lending powers under Section 13(3) of the Federal Reserve Act to allow U.S. banks, depository institutions and savings and loan companies to make available up to $600 billion for the purchase of loans issued by lenders to small and medium sized businesses.[61]

The Main Street Lending Program consists of a combination of two separate facilities. First, the Main Street New Loan Facility provides for the purchase by the Federal Reserve from eligible lenders of new unsecured term loans made to eligible borrowers originated on or after April 8, 2020. Second, the Main Street Expanded Loan Facility provides for the purchase by the Federal Reserve from eligible lenders of upsized

[60] On March 23, 2020, the Federal Reserve stated that it "expect[ed] 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."
[61] 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.

tranches of existing loans originated before April 8, 2020. These will be secured solely to the extent the existing loans are secured and, in such instances, upsized loans will be secured on a fair basis.

In order to implement this program, the Federal Reserve will lend funds on a recourse basis to a single special purchase vehicle ("SPV") that will be capitalized by $75 billion of equity capital from the Treasury Department. The SPV will use the proceeds of the Treasury Department's equity capital and loans made from the Federal Reserve to purchase up to $600 billion of eligible loans. The loans made by the Federal Reserve to the SPV will be secured by the portfolio of present and future eligible loans held by the SPV. Notably however, and in contrast to the Federal Reserve's liquidity program for the purchase of loans under the Paycheck Protection Program ("PPP"), the Federal Reserve will only purchase 95% of the aggregate principal amount of loans made by eligible lenders, requiring eligible lenders to retain 5% of the risk of the loan on their own balance sheet.

i. **Eligible Borrowers:** Eligible borrowers under the program are businesses with up to 10,000 employees or up to $2.5 billion in 2019 annual revenues. Each eligible borrower must be a business that is created or organized in the United States or under the laws of the United States with significant operations in and a majority of its employees based in the United States.[62]

ii. **Eligible Lenders and Eligible Loans:** As discussed above, the Federal Reserve will not be making direct loans to businesses under this program. Similar to the PPP program, businesses will need to seek loans from banks that qualify as eligible lenders under the program, which are U.S.-insured depository institutions, U.S. bank holding companies, and U.S. savings and loan holding companies.[63] At this point in time, notably absent from the list of eligible lenders are non-bank lenders. Commercial lenders will be responsible for underwriting, documenting and funding loans under the Main Street Lending Program, and prospective borrowers may seek to leverage existing banking, lending and financing relationships to seek such loans. The participating lenders must retain 5% of the eligible loans and are subject to Federal Reserve oversight to ensure prudent lending practices.[64]

[62] There are several key takeaways for businesses based on the latest Federal Reserve and Treasury announcements, including (i) eligibility requirements such as solvency—the business must have been in good financial standing before the crises; (ii) the program is available to businesses in addition to loans received under the PPP program for small businesses; and (iii) all businesses up to 10,000 employees are eligible, including businesses with 500 or fewer employees. Importantly, this program may be an option for private equity or venture capital-backed businesses that may have otherwise had difficulty qualifying for the PPP program given the SBA's "affiliation" rules as to employee head count.

[63] Eligible loans under the program must meet certain (i) origination; (ii) security; (iii) amortization; (iv) interest rate; (v) minimum loan size; (v) maximum loan size; and (vi) prepayment criteria.

[64] Important for borrowers to note is that the leverage eligibility requirements set forth above for eligible loans look at the borrower's 2019 EBITDA, prior to any impact of the COVID-19 pandemic. The terms described by the Federal Reserve do not address whether a borrower's EBITDA will be determined on a basis consistent with existing credit facilities or whether the borrower would receive the benefit of non-GAAP add-backs to EBITDA in certifying as to the maximum loan amount requirement for eligible loans.

iii. Fees: There are three sets of fees, including the (i) loan participation fee;[65] (ii) the loan origination fee;[66] and the (iii) loan servicing fee.[67]

iv. Implications for Program Participants: There are six key implications for program participants:

- Borrowers that have obtained financial assistance under the PPP remain eligible for new loans and loan extensions under the Main Street Lending Program, but issues of bonds or syndicated loans under the Primary Market Corporate Credit Facility will not be eligible to borrow under the Main Street Lending Program;[68]
- Borrowers will need to carefully examine existing debt agreements to determine whether any amendments may be needed to permit incurrence of new or upsized loans and implement the required interest payment blockage terms applicable to outstanding loans prior to the repayment in full of the Main Street loans;[69]
- As the ability to incur any new debt under this program will likely require discussion with existing creditors, and lenders will not be required to pay a participation fee to sell upsize loans to the Federal Reserve, there may be a preference for borrowers with existing debt facilities to request upsized loans in the form of incremental loans from their existing lenders;[70]
- The Federal Reserve has required that both new and upsize loans bear interest at Secured Overnight Financing Rate ("SOFR") plus an applicable margin, rather than using the London Interbank Offered Rate ("LIBOR") reference rate;[71]
- The terms of the Main Street Lending Program are subject to further rulemaking and guidance from the Treasury and the Federal Reserve. Much like with guidance on the PPP, we will need to update guidance on the Main Street Lending Program as the Federal Reserve implements its standard operating procedures in the future; and
- In contrast to the requirements that borrowers of the loans set aside for air carriers provide financial protection in the form of warrants or senior debt instrument to the Treasury, the Main Street Lending Program does not require issue of any such securities as a condition to funding.

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[65] Solely with respect to a new loan made (and not an upsized loan), the lender will be required to pay to the Federal Reserve a 100 basis point fee on the principal amount of the loan purchased via participation (e.g., 95% of the par value of the loan). This fee is permitted to be passed through to the borrower.
[66] The borrower shall pay an origination fee of 100 basis points of the principal amount of the new or upsized loans.
[67] The Federal Reserve will pay a per annum fee of twenty-five basis points of the principal amount of the new or upsized loan that it has purchased via participation as consideration for the lender administering the loan.
[68] Participation in the two Main Street programs are mutually exclusive, as extensions of new loans made to borrowers under the Main Street New Loan Facility will not be considered eligible loans under the Main Street Expanded Loan Facility, and new loans will not be available to borrowers under the Main Street New Loan Facility if the borrower's loans were upsized under the Main Street Expanded Loan Facility.
[69] In particular, prospective borrowers should focus on restrictions on the incurrence of debt and any restriction on negative pledges because borrowers of Main Street loans will be prohibited from repaying debt of equal or lower priority until the Main Street loan is repaid in full. Each pre-existing lender to the borrower would need to agree to such payment subordination, making an amendment to any widely syndicated loan facility to permit the incurrence of new or upsized loans challenging.
[70] This implied preference for upsize loans may serve to prioritize further lending under existing debt facilities because documentation of incremental loans will likely not require extensive amendments to the borrower's outstanding third-party debt. Furthermore, a lesson learned from the PPP program is that given the outsized demand from businesses for the Treasury's loan programs, most banks may only provide financing to existing clients given administrative burdens and overwhelming demand from many prospective borrowers.
[71] Particularly in the context of upsize loans in the form of incremental debt, this will prove administratively difficult given that the vast majority of existing variable rate loan facilities look to LIBOR as the reference rate.

4. U.S. Tax Considerations

In addition to potential sources of federal funding described above, the FFCRA and the CARES Act also include several important tax provisions, many of which should benefit private equity firms and their portfolio companies.

A. The CARES Act and the Employee Retention Credit and Delay of Repayment of Employer Taxes

With regard to employee retention credits, eligible employers[72] are allowed a refundable payroll tax credit equal to 50% of qualified wages[73] 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.

Employers and self-employed individuals may delay 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 two 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.

Looking Ahead

The COVID-19 pandemic will inevitably present opportunities for private equity to help advance economic recovery. Distress investors have been preparing to act, tracking opportunities to acquire distressed assets, and discounted debt.

Based on industry data, private equity funds continue to sit on record levels of committed capital.[74] As was the case after the 2008 financial crisis, this capital is poised to drive much-needed liquidity into the economy. After years of unabated valuation growth, buyout funds will likely see valuations cool. A historically low interest rate environment coupled with depressed valuations could make for a rapid rebound in buyout activity, although a delayed resurgence in travel—an important component of new deal creation—could temper that pace.

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[72] 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.

[73] "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.

[74] Kate Rooney, *Private Equity's Record $1.5 Trillion Case Pile Comes With a New Set of* Challenges, CNBC (Jan. 3, 2020), https://www.cnbc.com/2020/01/03/private-equitys-record-cash-pile-comes-with-a-new-set-of-challenges.html.

It is still too soon to predict what those deal terms will look like in a post-COVID-19 economy, but there are some early predictions. Valuations, which are inherently based on trailing EBITDA, will be uncertain, and as a result, buyers may be heavily reliant on earnouts, and could demand higher rollover amounts, particularly for new platform company acquisitions. Underwater equity incentives may necessitate a greater use of transaction and retention bonus programs, which may be less tax advantageous to target executives than profits interests, by contrast. Sellers may wish to monetize tax losses in transactions, and buyers might expect to have to negotiate those points more exhaustively than in recent years, especially if sellers try to make up ground from depressed valuations.

And then there will be the residual effects of the impact on deal terms from COVID-19 itself. In a very short time, COVID-19-related issues have moved quickly into M&A agreements. References to pandemic-related impacts have already appeared in MAC definitions, representations and warranties; interim operating covenants between signing and closing; financing commitments; and related deal termination provisions. Representations and warranties insurance providers have also moved quickly to exclude coverage for COVID-19-related matters.

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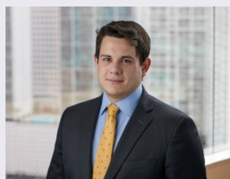

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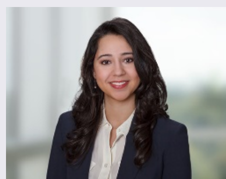

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