Private Equity Guide: COVID-19

Private Equity Firms and Portfolio Companies
April 3, 2020

TABLE OF CONTENTS

Page

The global health crisis related to the outbreak of COVID-19, and the resulting business downturn and uncertainty are creating unprecedented business, financial and legal challenges, including for private equity funds and their portfolio companies. Fund sponsors and their portfolio company management teams are facing crisis management scenarios that are far beyond those they have faced in the past. As a result, preparation is key. This Private Equity Guide (this "**Guide**") is intended to provide private equity professionals with a resource regarding many areas in which we have seen the effects of COVID-19 impact funds and portfolio companies, including issues related to labor/employment, tax matters, working remotely and related data privacy and security issues, M&A and capital raising and deployment.

The world is changing fast as a result of COVID-19. We welcome the opportunity to discuss the subjects covered in this Guide (or any other matters over which you may have concerns) with you.

For additional information concerning COVID-19 please refer to the following link: *https://www.usa.gov/coronavirus*.

1. PE Firms and Portfolio Companies - General

(a) Labor/Employment

(i) Providing a Safe Work Environment

Section 5(a)(1) of the Occupational Safety and Health Act of 1970 requires employers to provide their employees with a workplace free from recognized hazards likely to cause death or serious physical harm. Although no new legal regulations or standards have been mandated, the Occupational Safety and Health Administration has provided guidance on how to prepare the workplace, which includes steps to take to prevent risk of exposure, planning guidance based on infection prevention and industrial hygiene practices, and a discussion of engineering, administrative, and work practice controls and personal protective equipment.

(A) Generally

Employers should not rely on general guidelines. Rather, they should assess their specific work site(s), workforce, and risk factors. Employers with different workforce needs will likely implement different protocols and procedures. If possible, employers should consider issuing their own guidance to their workforce regarding infection prevention, how to handle illness or symptoms, and any requirements the employer wants to implement with respect to travel.

(B) Employees with Symptoms

If an employee (or anyone else who may come to the workplace regularly, such as contractors) has symptoms consistent with the COVID-19 virus, which include fever, cough, sore throat, muscle aches or shortness of breath:

- They should not come to the office.
- They should consider seeking immediate medical attention.
- They should not return to work until (i) they have written clearance from their healthcare provider, (ii) they satisfy local public health authorities' recommendations (where existing) regarding returning employees to work when they were kept home because they showed symptoms but did not seek medical care or were not tested by their healthcare provider for COVID-19, or (iii) where no medical clearance or local guidance exists, it has been at least seven days since the onset of symptoms and at least 72 hours since the employee's fever resolved and there has been "improvement" in respiratory symptoms.
- If their jobs permit them to work from home, they should do so according to the employer's remote work policy.

(C) Employees without Symptoms

If an employee (or anyone else who may come to the workplace regularly, such as contractors) has been in contact with an individual who is positive or presumed positive for COVID-19, and is not experiencing any symptoms:

- They will be expected to self-quarantine for 14 days from exposure.
- If their jobs permit them to work from home, they may be expected to work from home during this time, according to the employer's remote work policy.

(D) Traveling Employees without Symptoms

An employer with employees who are required to travel for essential business, either via roadways, rail, or air, should develop protocols for the employees to follow. For example, if an employee begins experiencing symptoms while traveling, they cannot enter a third-

party site and must return home, or if an employee has experienced symptoms within the last 14 days, the employee cannot travel and they must take their temperature each morning to confirm no fever, etc.

(E) Recommendations for Implementing Guidelines

- Confirm that staffing agencies, contractors, and temp agencies are following the same protocol with respect to any leased or temporary employees and notify the employer if a worker experiences symptoms.

- Consider whether an employer's paid time off ("**PTO**") and unpaid leave practices, such as requiring employees who are quarantined and unable to work remotely to use all PTO and sick leave, incentivize the desired behavior of staying away from the workplace and avoiding infection.

- Consider waiving normal eligibility requirements, such as employment for a certain period of time, for new employees to use PTO for medical or quarantine reasons.

- Determine whether any of the employer's short-term disability ("**STD**") eligibility requirements should be waived, including whether any circumstances warrant such waiver being handled on a case-by-case basis during the outbreak.

- Communicate and confirm with any insurance providers before disseminating information relating to applicable coverage and waiving eligibility requirements.

(ii) Emergency Paid Sick Leave Act ("**EPSLA**")

Part of the Families First Coronavirus Response Act ("**FFCRA**"), the EPSLA requires that employers with fewer than 500 employees must provide paid sick time to employees arising out of the COVID-19 pandemic.

(A) Permitted Reasons

An employee may use the leave for the following reasons:

- To self-isolate due to a federal, state, or local quarantine or isolation order related to COVID-19.

- To self-isolate on advice of a health care provider because of COVID-19.

- To seek a medical diagnosis due to experiencing symptoms of COVID-19.

- To care for an individual under self-isolation.

- To care for a son or daughter whose school or place of care is closed, or child care provider is unavailable, due to COVID-19 precautions.

- Due to experiencing substantially similar conditions to those specified by the Secretary of Health and Human Services, in consultation with the Secretaries of Labor and Treasury.

(B) Duration

Full-time employees are entitled to 80 hours of paid sick leave, while part-time employees are entitled to a number of hours for paid sick leave equal to the number of hours worked, on average, over a two-week period.

(C) Amount

The compensation amount is calculated based on the greater of the employee's regular rate of pay, federal minimum wage, or the state or local minimum wage rate where the employee is employed. However, paid sick leave is capped at $511 per day ($5,110 in the aggregate) when leave is taken for an employee's own illness or quarantine, and $200 per day ($2,000 in the aggregate) when leave is taken to care for others or due to school closures.

(D) Availability

Paid sick leave is available for immediate use. Emergency paid sick leave is in addition to an employer's other PTO, paid sick, and vacation benefits. Employers cannot require employees to take any other paid leave before using paid sick time under this act.

(E) Carryover

Employees may not carry over this leave after December 31, 2020, and it is not payable upon termination.

(F) Tax Credit for Qualified Sick Leave Wages

For sick leave paid to an employee under the EPSLA, an employer receives a federal income tax credit for wages paid to the employee during the first 10 days of the employee's entitlement to paid sick leave under the EPSLA. The tax credit is limited to $511 per day (or $200 per day in cases where the employee utilizes the paid sick time off to care for others or due to school closures). According to the Internal Revenue Service's ("**IRS**") News Release, guidance will be available soon regarding how eligible employers who pay qualifying sick leave will be able to retain an amount of the payroll taxes equal to the amount of qualifying sick leave that they paid, rather than deposit them with the IRS.

(iii) Emergency Family and Medical Leave Expansion Act ("**FMLA Expansion Act**")

Like the EPSLA, the FMLA Expansion Act applies to employers with fewer than 500 employees. Although the Department of Labor ("**DOL**") has issued an FAQ on application of the FFCRA, small employers are hoping that once the DOL issues regulations (expected in April 2020) employers with fewer than 50 employees may not be required to comply with all provisions of the FMLA Expansion Act.

(A) Eligibility

Normally, to be eligible for leave under the Family and Medical Leave Act ("**FMLA**") leave, an employee must work for a covered employer, and must have worked for 1,250 hours during the last 12 months. To be eligible for the FMLA Expansion Act, an employee must have been employed for 30 days.

(B) Benefits

Under the FMLA Expansion Act, employers must provide 12 weeks of leave to eligible employees for a qualifying need relating to a public health emergency. The qualifying need is that the employee is unable to work (or telework) due to a need for leave to care for their (under 18) son or daughter if their school or place of care is closed, or child care provider is unavailable due to a public health emergency.

(C) Unpaid Leave

The first 10 days may be unpaid, although an employee may elect to substitute PTO benefits during this time. The final version of the

FMLA Expansion Act is silent as to whether employers may require employees to use any such paid benefits.

(D) Paid Leave

Employers must compensate an employee for each day of leave at no less than two-thirds the employee's regular rate of pay for the number of hours the employee normally would have been scheduled to work. The required amount of pay is capped at $200 per day and $10,000 in the aggregate.

(E) Job Restoration

Employees must be restored to their position or an equivalent one upon their return to work. There is an exception to this requirement for employers with fewer than 25 employees, if the employee's position does not exist due to economic conditions or other changes in the employer's operating conditions that affect employment, which are caused by a public health emergency during the leave. In this case, the employer is required to make reasonable efforts to restore the employee to an equivalent position and reasonable efforts to contact the employee if an equivalent position becomes available.

(F) Exclusions

The Secretary of Labor has the authority to issue regulations to exclude certain health care providers and emergency responders from the definition of "eligible employee" and to exempt small businesses (defined as having fewer than 50 employees) if the leave would jeopardize the viability of the business. Employers also may exclude employees who are health care providers or emergency responders from this FMLA Expansion Act entitlement. DOL has issued Q&A that explains how businesses with fewer than 50 employees can seek exemption from the paid sick leave requirements. *https://www.dol.gov/agencies/whd/pandemic/ffcra-questions*.

(G) Tax Credit for Qualified Family Leave Wages

For leave paid to an employee under the FMLA Expansion Act, an employer receives a federal income tax credit for wages paid to the employee during the full term of an employee's additional leave as permitted under the FMLA Expansion Act. The tax credit is limited to $200 per day and $10,000 in the aggregate for each employee. The IRS has issued guidance regarding how eligible employers who pay child care leave will be able to retain an amount of the payroll

taxes equal to the amount of qualifying child care leave that they paid, rather than deposit them with the IRS. *https://www.irs.gov/newsroom/covid-19-related-tax-credits-for-required-paid-leave-provided-by-small-and-midsize-businesses-faqs*.

(H) Other

For employers with 500 or more employees, the FMLA's ordinary provisions apply.

- COVID-19 may be considered a serious health condition depending on the circumstances. Accordingly, an employee with COVID-19 or an employee who is taking care of a qualifying family member with COVID-19 may be permitted to take protected FMLA leave.

- FMLA leave consists of up to 12 weeks of unpaid, job-protected leave in a designated 12-month leave year for specified family and medical reasons, which may include the flu where complications arise that create a "serious health condition" as defined by the FMLA.

- Employees who take time off to avoid exposure to COVID-19 would not be protected under the FMLA unless an employee can show that they are taking time off due to a serious health condition (or other approved reason under the FMLA).

- The DOL's guidance asks employers to encourage employees who are ill or who are exposed to ill family members to stay home and consider flexible leave policies for employees in these circumstances.

- The FMLA does not require paid leave, but it allows employees to elect or an employer to require the substitution of paid sick leave and paid vacation or personal leave in some circumstances.

- Employers should also consider state requirements if paid leave or paid disability benefits are mandated by the state.

(iv) Considering the Implications of the Americans with Disabilities Act ("**ADA**")

Employers should carefully consider whether an employee who becomes ill with COVID-19 has a disability before providing reasonable accommodations under the ADA. "Disability" is a physical or mental impairment that substantially limits one or more major life activities of such individual, a record of such an impairment, or being regarded as having such an impairment.

(A) The ADA governs employers' disability-related inquiries and medical examinations for all applicants and employees, including those who are not "disabled."

(B) If an employer wants to conduct a medical exam, which would include checking employees' body temperatures, the exam must be job-related and consistent with business necessity, which means that the employer has a reasonable belief that an employee's ability to perform essential job functions will be impaired by a medical condition or an employee will pose a direct threat due to a medical condition.

- Whether or not a procedure is a medical exam is determined by "considering factors such as whether the test involves the use of medical equipment; whether it is invasive; whether it is designed to reveal the existence of a physical or mental impairment; and whether it is given or interpreted by a medical professional."

- A "direct threat" is "a significant risk of substantial harm to the health or safety of the individual or others that cannot be eliminated or reduced by reasonable accommodation." If an individual with a disability poses a direct threat despite reasonable accommodation, the employee is not protected by the nondiscrimination provisions of the ADA.

- As of March 19, the U.S. Equal Employment Opportunity Commission ("**EEOC**") has advised that because the Centers for Disease Control ("**CDC**"), state, and local health authorities have acknowledged the community spread of COVID-19 and issued attendant precautions, employers may measure employees' body temperature. However, employers should be aware that some people with COVID-19 do not have a fever and should not disclose employees' temperature readings unless otherwise required by law, as the employee

names and readings should be kept confidential as required by the ADA.

(C) In summary, employers must keep in mind that the ADA prohibits employers from excluding employees with disabilities from the workplace for health or safety reasons unless they pose a "direct threat," which is defined as a significant risk of substantial harm even with reasonable accommodation. However, this applies to employees who fall under the definition of disability, which is why it is important to carefully consider whether an employee with COVID-19 falls within the definition.

(v) Understanding the Policies and Procedures that Are Acceptable under the EEOC's Pandemic Preparedness in the Workplace and the ADA Guidance

(A) Employers may send employees home if they display COVID-19 symptoms.

(B) Employers may ask employees if they are experiencing COVID-19 symptoms, such as fever or chills and a cough. Employers must maintain all information about employee illness as a confidential medical record in compliance with the ADA.

(C) Employers can mandate that employees report on their recent travels to assess exposure risks. Employers can encourage employees not to travel during this time and cancel business travel to high risk destinations. Employers should be sensitive to employee requests to avoid travel, particularly to high risk countries. When an employee returns from travel to a country or region with an active COVID-19 outbreak, employers do not have to wait until the employee develops symptoms to ask questions about exposure during the trip, even if the travel is personal.

(D) If employees voluntarily disclose (without a disability-related inquiry) that a specific medical condition or disability puts them at increased risk of COVID-19 complications, the employer must keep this information confidential. The employer may ask these employees to describe whether any assistance will be needed (e.g., telework or leave for a medical appointment).

(E) Employers may encourage telework as an infection control strategy and as a reasonable accommodation.

(F) Employers may require employees to adopt infection-control practices, such as regular hand washing, at the workplace.

(G) Employers may still ask employees why they have been absent from work if the employer suspects it is for a medical reason.

(H) Employers may require employees who have been away from the workplace during the pandemic to provide a healthcare provider's note certifying fitness to return to work. However, this may change, as advised by the CDC, if healthcare providers are too busy during and immediately after a pandemic outbreak to provide fitness-for-duty documentation. Therefore, new approaches may be necessary to permit the employee to return to work during the wait for certification. In addition, employers must consider state law and local ordinances with respect to medical certification and return to work requirements.

(vi) Government Financial Incentives to Retain Employees

(A) Both the FFCRA and the recently enacted the Coronavirus Aid, Relief, and Economic Security Act (the "**CARES Act**"), which became law on March 27, 2020, provide enterprises with financial incentives to retain employees. Please see the following articles previously published by Baker Botts on these topics:

1) CARES Act: *https://www.bakerbotts.com/insights/publications/2020/march/congress-passes-$2-trillion-stimulus-bill-in-response-to-coronavirus-pandemic*

2) Treasury Department Cares Act Guidance: *https://www.bakerbotts.com/insights/publications/2020/march/treasury-issues-anticipated-guidance-on-cares-acts-paycheck-protection-program*

3) FFCRA: *https://www.bakerbotts.com/insights/publications/2020/march/president-trump-signs-into-law-families-first-coronavirus-response-act*

(vii) Furloughs and Laying Off Employees

(A) Furlough

Rather than institute a layoff, employers may consider furloughing employees or reducing wages instead. However, a furlough that is part of a week, or an overall reduction in hours and/or pay, can have pitfalls for employers, particularly with respect to exempt employees.

- If an employer wants to reduce a salaried exempt employee's pay due to economic circumstances, then the weekly salary must remain at least $684 per week (or otherwise as provided by the regulations) if the employer wants to maintain the exempt status of the employee.

- A reduction in a salaried exempt employee's pay should not correspond with a reduction in hours, or the employer runs the risk of losing the exempt status.

- Furloughs are complicated because employers must pay exempt employees their full salary amount in ***any*** week that the employee performs ***any*** work without regard to the number of days or hours worked (subject to certain deductions). For instance, if an employer furloughs employees two of five days in a workweek, the employer cannot deduct for the two furlough days because they were caused by the employer or its operating requirements. If the employee is ready, willing, and able to work, deductions may not be made for time when work is not available.

- An employee's weekly salary is not required to be paid if the employee performs no work for an entire workweek. That is easier said than done, however, when employees have phones and laptops, and are constantly connected with the workplace.

- Furloughs and salary reductions should be carried out after careful consideration of the regulations and guidance regarding the exemption issues.

(B) <u>WARN Act and Mini-WARN Law Implications</u>

- The Worker Adjustment Retraining Notification Act ("**WARN Act**") requires employers who are planning a plant closing or a mass layoff to give affected employees at least 60 days' notice of such an employment action. Damages and civil penalties can be assessed against employers who violate the WARN Act.

    - An "employer" is any business enterprise that employs 100 or more employees, excluding part-time employees.

    - A "plant closing" is a temporary or permanent shutdown of a single site of employment resulting in

termination or layoff exceeding six months for 50 or more employees (excluding part-time employees) in any 30-day period.

- A "mass layoff" is a reduction in force of at least 50 employees (excluding part-time employees) at a single site of employment, where at least 33% of the active employees are terminated or laid off for more than six months.

- The regulations allow for reduced notice to employees where the plant closing or mass layoff is caused by business circumstances that were "not reasonably foreseeable as of the time that notice would have been required." However, employers must give as much notice as practicable and must state why the notice period was reduced.

- The "unforeseen business circumstances" exception requires fact-specific analysis and there are no clear guidelines as to when it applies. This provision could apply to the COVID-19 outbreak, depending on the effect it has on an employer.

- In any event, the WARN Act requires notices with specific information included for employees, government units, and unions, if applicable. Further, a number of states (including California, Illinois, New Jersey, and New York) have mini-WARN Acts with lower thresholds that trigger notice requirements, although they may have relaxed standards during the pandemic. It is important to be aware of state law on this topic.

(C) Assessing Unemployment Insurance and Workers' Compensation Coverage

- Employees subject to furlough due to a temporary shutdown of the employer's operations may be eligible for unemployment insurance ("**UI**"). Depending on the size and length of any temporary shutdown, an employer may be required to notify the applicable state unemployment department.

- Employers may also be eligible for UI work-sharing programs as an alternative to layoffs, where the employer reduces an employee's hours and wages, which are partially offset with UI benefits.

- Workers' compensation ("**WC**") policies generally extend insurance benefits to employees for work-related injuries. Employees who are unable to perform their regular duties because of contracting COVID-19 and who can show they contracted the virus on the job could potentially be eligible for WC benefits.

    - As part of the WC claim, an employee must show that they contracted the virus at work, and such contraction was "peculiar" to their employment.

    - The analysis is very fact-specific and must be analyzed under state law, but is more likely to be successful in the case of a health care worker or first responder, as these workers may be more likely to benefit from a presumption that they contracted the virus in the course of their job.

(viii) Wage and Hour Issues

Employers are required to pay employees who are absent from work, who are being quarantined, who are self-monitoring at home, or who are otherwise ill with COVID-19 or caring for a family member, if they have accrued PTO pursuant to any paid safe/sick leave law. See Sections 1(a)(ii) and 1(a)(iii) above.

(A) Employees may be entitled to paid leave benefits under state or local leave laws if they are caring for qualifying family members with COVID-19 or to federal paid leave if they are caring for children under age 18 whose schools or child care arrangements are closed.

(B) After any paid safe/sick leave is exhausted, the obligation to pay employees depends on whether they are classified as exempt or non-exempt, and whether they are required to be absent from work.

- Non-exempt employees are only paid for actual hours worked. Therefore, if they are unable to return to work after exhausting any paid leave entitlement, they are not required to be paid.

- Exempt employees must be paid their full weekly salary if they perform any work during a work week (subject to a number of permitted deductions). Further, if an employer requires exempt employees to be absent from work, such as to self-monitor for COVID-19 symptoms at home, the employer must pay these employees their full weekly salary.

- If exempt employees are diagnosed with COVID-19 and are unable to work due to their medical condition, then the employer likely would not have to pay them after the exhaustion of any paid leave entitlement.

(C) Employers should review and extend any state- or employer-provided disability benefits to eligible employees who are absent from work due to COVID-19.

(ix) Shelter in Place Orders and Definitions of "Essential Businesses"

Employers must determine whether they meet a "Stay at Home" Order's definition of "Essential Business" based on each jurisdiction's order, whether it is a state, county, or city order. Most of such orders permit residents to leave their homes in order to work at Essential Businesses such as healthcare, government, retail, providing basic necessities, services necessary to maintain other essential businesses, and critical infrastructure. With respect to "essential critical infrastructure," most orders refer to the 16 critical infrastructure sectors identified by the National Cybersecurity and Infrastructure Agency, which include chemical; commercial facilities; communications; critical manufacturing; dams; defense industrial base; emergency services; energy; financial services; food and agriculture; government facilities; healthcare and public health; information technology; nuclear reactors, materials and waste; transportation systems; and waste and wastewater systems.

There is considerable variation among the states, counties, and cities that have issued guidance thus far. However, it is important to recognize that this is not solely a legal question. The question should also be assessed from a political and ethical standpoint. Employers should weigh the risk that, if they continue operations and there is a COVID-19 outbreak linked to those operations, politicians and media who were once pleased to support the jobs and the economic contribution created by the project may quickly shift to finger pointing and blame. Employers also need to balance the economic harm of ceasing operations against the potential public health harm, the potential risk to their employees and personnel of continuing operations, and the potential for future litigation should an outbreak occur linked to those operations.

(x) COVID-19 Considerations Relating to Employer Health Plans

An employer should anticipate the possibility of receiving an increased number of questions relating to its health plans and coverage relating to COVID-19 and ensure that its plans adequately protect its employees.

(A) Under the FFCRA, group health plans and health insurance issuers offering group or individual health insurance coverage, including "grandfathered" plans for purposes of the Patient Protection and Affordable Care Act, must provide without any cost-sharing (deductibles, co-pays, or co-insurance) or other prior authorization requirements federally-approved forms of testing for COVID-19, and without any charges for office, urgent care or emergency room visits related to the testing during the period of the declared national emergency.

(B) IRS guidance provides that a high deductible health plan ("**HDHP**") under Section 223(c)(2)(A) of the Internal Revenue Code ("**Code**") may provide health benefits associated with testing for and treatment of COVID-19 without a deductible or with a deductible below the minimum deductible (self only or family) for an HDHP without jeopardizing the plan's status as an HDHP. As a result, an employee who uses his or her HDHP to cover such costs will not be disqualified from being an "eligible individual" under Section 223(c)(1) of the Code who may make tax-favored contributions to a health savings account ("**HSA**").

(C) Under the CARES Act, HSAs are permitted to cover telehealth services prior to a participant reaching the required deductible and allows participants to use funds in their HSAs and flexible spending accounts for the purchase of over-the-counter medical products, including those needed in quarantine and social distancing, without a prescription from a physician.

(D) Some state insurance departments, such as California, New York and Washington, are requiring no-charge for COVID-19 testing for insurance policies subject to state insurance laws.

(xi) <u>COVID-19 Considerations Relating to 401(k) Plans</u>

(A) <u>Employer Contributions</u>

Under the current circumstances, employers may wish to reduce, suspend or eliminate employer matching and other non-discretionary employer contributions to their 401(k) plans. Typically, such actions can be undertaken on a prospective basis by plan amendment, but specific rules apply for safe-harbor 401(k) plans which can limit, or even prevent, this from occurring by plan amendment (i.e., absent a full termination of the plan). For instance, if the 401(k) plan's most recent safe harbor notice contains language that the employer retains the right to reduce or suspend its safe harbor contribution, then the reduction or suspension can occur

during 2020 for any reason. If the plan's most recent safe harbor notice is missing this language, a reduction or suspension of the safe harbor contribution will only be permitted if the employer can demonstrate that it is operating at an "economic loss" (which has not been clearly defined, but probably means that the employer's expenses are clearly in excess of its income for the relevant year). In either case, the reduction or suspension of the safe harbor contribution cannot become effective until at least 30 days after a supplemental safe harbor notice is sent to employees.

(B) Early Distributions

Employees may want to access funds in their 401(k) accounts to help with various expenses that may be related to COVID-19. Special 401(k) plan distribution opportunities are now available under the CARES Act. A 401(k) plan participant may request a "coronavirus-related distribution" ("**CRD**") of up to $100,000 from the plan during 2020. Certain requirements apply in order to be eligible for a CRD, including the plan participant being diagnosed, or having a spouse or dependent being diagnosed, with the COVID-19 virus. Alternatively, CRDs may be permitted as a result of the participant's experiencing adverse financial consequences as a result of a quarantine related to COVID-19, including furlough, lay-off, reduction in hours, need to provide child care, etc. While a CRD is a taxable distribution, notably, the 10% early distribution penalty that normally applies for in-service withdrawals for individuals under age 59½ and mandatory 20% tax withholding requirement are waived. At this time, it is not entirely clear whether CRDs are optional or mandatory 401(k) plan features.

In addition, there are several other 401(k) distribution options that are available under pre-existing law (i.e., outside of the CARES Act). For instance, regular in-service distributions for employees who are age 59½ or older remain available to assist employees with expenses arising in connection with COVID-19. Also, a 401(k) plan may allow the employee to request a hardship withdrawal for an immediate and heavy financial need. The amount of the hardship withdrawal is limited to the amount necessary to satisfy the immediate and heavy financial need requirement and the employee cannot reasonably obtain the needed amount from other sources. However, unlike the CRD, a hardship withdrawal by a participant who has not reached age 59½ is subject to the 10% early distribution penalty tax.

- Safe Harbor Hardship Withdrawal:

  Under IRS regulations, an employee is deemed to meet the immediate and heavy financial need requirement for certain events, including (1) for medical expenses and certain tuition and related education expenses for the employee, the employee's spouse, dependents or beneficiary, (2) if necessary, to prevent eviction from, or foreclosure on, the employee's principal residence, and (3) for expenses and losses (including loss of income) incurred due to a disaster declared by the Federal Emergency Management Agency (FEMA). In our experience, most 401(k) plans rely on the safe harbor approach for hardship distributions. Medical expenses related to the treatment of COVID-19 that are not covered by medical insurance should be eligible for a hardship distribution. Also, to date, FEMA has declared a major disaster area for California, Iowa, Louisiana, New York, Washington, Texas, Florida, North Carolina, New Jersey, Illinois, Maryland, South Carolina, Massachusetts, Missouri, Michigan, Puerto Rico and Guam which should allow for hardship withdrawals for employees who reside in those states and territories. Finally, withdrawals to pay the employee's mortgage or tuition expenses may also qualify for hardship withdrawal for an employee placed on unpaid leave.

- Non-Safe Harbor Hardship Withdrawal:

  For those 401(k) plans that do not limit hardship withdrawals to safe harbor events, depending on the facts and circumstances, the plan may conclude that there is an immediate and heavy financial need for some limited COVID-19-related expenses that would not qualify for the safe harbor, in addition to amounts that would otherwise fall under one of the safe harbors.

(C) Plan Loans

Additional relief under the CARES Act applies for plan loans made under a 401(k) plan. The maximum loan amount now available under a 401(k) plan is increased to $100,000 and 100% of the participant's vested account balance from $50,000 or 50% of the participant's vested account balance. The increased limits apply for plan loans made during the 180-day period following March 27, 2020. In addition, for pre-existing 401(k) loans (as well as new

loans), loan repayments due for the remainder of 2020 may be delayed for one year.

(D) Late Distributions

Existing rules require that a 401(k) participant begin receiving required minimum distributions ("**RMDs**") from the participant's tax-qualified retirement plan once the participant reaches a certain age (70½ or 72) or, if later, retires. Pursuant to the CARES Act, RMDs for 2020 are waived for 401(k) plans. Thus, if a 401(k) participant would prefer to leave 2020 RMD amounts in his or her 401(k) account and give them a chance to recover in value from the recent losses in the stock market, the participant can leave those RMD amounts in the plan and take advantage of this opportunity. The 2020 waivers of RMDs does not apply to a defined benefit (pension) plan.

(E) Partial Plan Terminations

Recent layoffs and downsizing can result in 401(k) plans experiencing a partial plan termination. If such a partial termination has occurred, the affected employees (i.e., those whose employment terminates in connection with the partial termination) must be entitled to 100% vesting of their 401(k) accounts, regardless of their years of service. IRS guidance indicates that a partial termination is presumed whenever more than 20% of the 401(k) plan's active participants are terminated in a year, but there is no bright-line rule for determining whether or not a layoff or downsizing event triggers such a partial termination.

(xii) COVID-19 Considerations Relating to Executive Compensation Arrangements

Employers that are currently implementing performance-based plans or considering new executive arrangements should consider the impact of those decisions in light of COVID-19.

(A) Incentive Plans

Creating incentive plans and establishing performance goals that will create meaningful and appropriate incentives in a volatile market can be challenging. However, these circumstances provide an opportunity for companies to revisit their ordinary course performance goals and forms of incentive awards.

When establishing new performance-based compensation programs, in consultation with the company's accounting and finance departments, consider:

- Delaying the establishment of any long-term performance criteria;
- Anticipating the need to allow discretion to adjust future performance measurements (or requiring that future performance measurements be adjusted) to neutralize the impact of COVID-19;
- To the extent public companies can serve as meaningful performance peers, using relative performance measures;
- Creating new short-term performance goals aimed at incentivizing desired behavior (such as cash flow maximization or cost savings); or
- Considering any potential cash flow limitations when structuring incentive plans, while being mindful of long-term incentive and retention goals.

(B) Contractual Obligations

A company should be aware of any contractual obligations (such as under employment agreements or severance policies) before making changes to salaries, bonus opportunities, or benefit offerings to ensure the company does not inadvertently breach a contractual obligation or trigger an employee's right to resign (e.g., for "good reason") and receive severance.

Under the Coronavirus Economic Stabilization Act (the "**CESA**"), which forms a part of the CARES Act, the Secretary of the Treasury has the authority to make loans, loan guarantees and other investments in U.S. eligible businesses, including air carriers and other U.S. businesses not afforded adequate relief under the CARES Act, in an aggregate amount up to $500 billion. Note that CESA includes different conditions and restrictions on the borrower than other programs under the CARES Act including the Paycheck Protection Program. As a condition to receiving assistance under CESA, companies must comply with certain obligations, including workforce retention requirements and other restrictions on capital distributions. For more detailed information, please see the CESA portion of the following article previously published by Baker Botts on the CARES Act:

https://www.bakerbotts.com/insights/publications/2020/march/congress-passes-$2-trillion-stimulus-bill-in-response-to-coronavirus-pandemic. An eligible business that receives this assistance must also impose restrictions on future payments of executive compensation and severance amounts to certain officers or employees whose 2019 total compensation exceeded certain thresholds. Thus, it would be important for a business to understand any contractual obligations with which it could not comply, and obtain any necessary waivers or consents or make any necessary amendments, before entering into any such loan, loan guarantee or investment arrangements. For instance, under CESA, any such officer or employee whose total compensation exceeded $425,000 in calendar year 2019 cannot receive total compensation during any 12-month period that exceeds the officer's or employee's 2019 total compensation or severance benefits that exceed twice the officer's or employee's 2019 maximum total compensation. Additional limits apply for any such officer or employee whose total compensation exceeded $3 million in calendar year 2019, such that they cannot receive total compensation during any 12-month period that exceeds the sum of $3 million plus 50% of the officer's or employee's 2019 total compensation that exceeded $3 million. These limitations generally apply until March 24, 2022 for air carriers who receive financial assistance. For companies who receive loans and loan guarantees, these limitations remain in effect until 12-months after the loans are repaid and the loan guarantees are no longer in effect. The duration of the limitation period that applies to companies that receive relief in the form of an investment is not entirely clear.

When entering into new employment agreements, a company should consider including, as an exception to clauses that provide good reasonable protection in the case of salary or bonus opportunity reductions, reductions that are made in connection with management-wide or company-wide reductions. It may also be prudent to include a general provision that would specifically allow the company to comply with any applicable requirements that are imposed as a result of accepting loans, loan guarantees or investments under the CARES Act.

(b) U.S. Government Financial Assistance Initiatives

(i) SBA Loans and the Paycheck Protection Program

In particular, the CARES Act expands the Small Business Administration ("**SBA**") loan programs including the creation of the Paycheck Protection Program (the "**PPP**") which provides up to $10 million per company in

fully-forgivable loans. In order to qualify for any SBA program, including the PPP or Economic Injury Disaster Loans, a business must have fewer than 500 employees or qualify as a small business under the size standards for its particular industry. However, in determining qualification for SBA programs, the SBA aggregates businesses under common control, with few exceptions. As aggregation will often result in commonly controlled portfolio companies exceeding the 500-employee threshold, many portfolio companies of private equity firms are currently excluded from these programs. Private equity sponsors should nevertheless keep the following in mind:

- On March 31, 2020, the Treasury Department issued implementation guidance which did not alter the affiliation rules. However, as of April 2, 2020, both Speaker Pelosi and members of the Congressional Republican leadership expressed their support for relaxing these standards. Additionally, members of the private equity industry and their lobbyists are engaged in intense lobbying efforts for additional relief. Accordingly, sponsors and portfolio companies should ask legal counsel to notify them if regulations ultimately allow them to apply for PPP funding.

- While there is no guaranty that regulations will alter affiliation rules for the PPP generally, the PPP already includes three exceptions to the 500 employee threshold:

    - companies with a North American Industry Classification System (NAICS) code beginning with 72 (i.e., accommodation and food services businesses) may receive funding as long as each physical location includes less than 500 employees;

    - any business operating as a franchise that is assigned a franchise identifier code by the SBA; and

    - any business that receives financial assistance from a company licensed as a small business investment company, or SBIC, under Section 301 of the Small Business Investment Act.

  Portfolio companies that meet any of these exceptions could be eligible for PPP funding. Additionally, any portfolio company that qualifies for SBIC loans may consider applying for a loan in order to qualify for PPP funding. Please see the link below for new Treasury guidance for PPP applicants.

(ii) Mid-Sized Business Program

Section 4003 of the CARES Act also tasks the Treasury Department with endeavoring to implement a lending facility through the Federal Reserve that specifically addresses needs of non-profit organizations and businesses with between 500 and 10,000 employees. If implemented, this lending facility would fall outside of the SBA lending programs and therefore would not include the same affiliation restrictions described above. However, the CARES Act includes additional restrictions including retention of 90% of the borrower's workforce, restrictions on stock buybacks and dividend payments and neutrality in any union organizing effort during the term of the loan.

(iii) Main Street Business Lending Program

On March 23, 2020, the Board of Governors of the Federal Reserve System announced six programs to support the debt markets and general corporate lending. The Main Street Business Lending Program is expected to extend the Federal Reserve's reach to small to medium-sized enterprise lending, either directly or more likely through a bank or intermediary. Unlike the other programs, details about this program have not been announced by the Federal Reserve. However, it bears the hallmarks of programs administered by the SBA, and therefore may contemplate a program centered on banks and other direct lenders as vehicles for providing financing to borrowers. Sponsors and portfolio companies should ask legal counsel to notify them if regulations ultimately permit portfolio companies to access credit under this new program.

For more detailed information, please see the following articles previously published by Baker Botts on these topics:

- CARES Act:

  https://www.bakerbotts.com/insights/publications/2020/march/congress-passes-$2-trillion-stimulus-bill-in-response-to-coronavirus-pandemic

- Treasury Department Guidance:

  https://www.bakerbotts.com/insights/publications/2020/march/treasury-issues-anticipated-guidance-on-cares-acts-paycheck-protection-program

- Federal Reserve Actions:

  https://www.bakerbotts.com/insights/publications/2020/march/federal-reserve-announces-programs-to-support-markets-and-businesses

(c) U.S. Taxes

(i) U.S. Tax Relief, Issues, and Considerations

The COVID-19 stimulus packages passed by Congress contain certain U.S. federal tax relief measures and implicate certain material U.S. federal, state, and local tax issues that might be important for private equity firms and their portfolio companies, which are summarized below.

(A) U.S. Federal Tax Filings and Payment Deferrals

- CARES Act:

  The CARES Act provides for a deferral of the employer's share of the U.S. federal social security payroll taxes (6.2%) on wages paid as of the date of the enactment of the CARES Act through December 31, 2020. Half of the deferred amount of such payroll taxes will be due December 31, 2021, with the remaining half due December 31, 2022. However, employers who receive small business interruption loans pursuant to the CARES Act are not eligible for this payroll tax deferral.

- U.S. Federal Income Tax Filing and Payment Deferrals:

  The due date for filing U.S. federal income tax returns and making U.S. federal income tax payments (without interest or penalty) has been extended from April 15, 2020, until July 15, 2020. The postponement is applicable with respect to all U.S. federal income taxes (including payments of tax on self-employment income) due on April 15, 2020, including income tax payments due in respect of the 2019 taxable year and estimated income tax payments due on April 15, 2020. There is no limitation on the amount of the U.S. federal income tax liability payment which may be deferred.

(B) Employer Payroll Tax Credits

- FFCRA:

  In order to provide financial assistance to employers with fewer than 500 employees who are generally required to provide short-term paid sick leave and longer-term paid family leave to employees while away from work due to COVID-19 related events, the FFCRA provides a refundable tax credit for qualified wages paid by such employers.

  This tax credit is allowed to offset the employer's quarterly U.S. federal payroll taxes. If the amount of the tax credit exceeds the payroll taxes, the excess credit is refundable to the employer, and employers will be able to request accelerated payment of such refunds from the IRS. Amendments provided in the CARES Act will also allow employers to seek advance refunds of this tax credit using forms and instructions to be provided by the IRS, and the IRS has been instructed to waive any penalties payable by employers for failure to deposit payroll taxes if the failure were due to this anticipated payroll tax credit.

  The amount of this tax credit is generally determined as follows:

  - For sick leave paid to an employee under EPSLA under the FFCRA, an employer receives the U.S. federal payroll tax credit for wages (including properly allocable qualified health plan expenses) paid to the employee during the first 10 days of the employee's entitlement to paid sick leave under the EPSLA, and the tax credit is limited to $511 per day and $5,111 in the aggregate (or $200 per day and $2,000 in the aggregate in cases where the employee utilizes the paid sick time off to care for others or due to school closures); and

  - For leave paid to an employee under the FMLA Expansion Act under the FFCRA, an employer receives the U.S. federal payroll tax credit for wages (including properly allocable qualified health plan expenses) paid to the employee during the full term of an employee's additional leave up to the 12 weeks permitted under the FMLA Expansion Act, and the

tax credit is limited to $200 per day and $10,000 in the aggregate for each employee.

- CARES Act:

  In order to provide relief to employers due to the economic impact of retaining employees during the COVID-19 outbreak, the CARES Act provides a refundable payroll tax credit for certain qualified employers with respect to certain wages paid after March 12, 2020, and before January 1, 2021.

  The amount of this tax credit is equal to 50% of up to $10,000 in qualified wages (including properly allocable qualified health plan expenses) paid per employee during the COVID-19 crisis by qualified employers, which results in a maximum credit of $5,000 per employee. The employers that generally qualify for this tax credit are employers (A) whose operations were fully or partially suspended, due to governmental shut-down orders related to COVID-19 or gross receipts declined by more than 50% when compared to the same quarter in the prior year (up until their gross receipts exceed 80% of their gross receipts for the same calendar quarter in the prior year), and (B) who do not receive small business interruption loans pursuant to the CARES Act.

  The wages paid by qualified employers that will generally qualify for this tax credit are:

  - In the case of qualified employers with greater than 100 full-time employees, wages paid to employees when they are not providing services for the period that the employer is a qualified employer; and

  - In the case of employers with 100 or fewer full-time employees, the wages paid to all employees, whether the employee is providing services or not, for the period that the employer is a qualified employer.

(C) Other Business Tax Relief Measures in the CARES Act

- Removes Net Operating Losses ("**NOLs**") Limitations:

  The 2017 Tax Cuts and Jobs Act generally eliminated the ability to carryback NOLs arising after 2017 and subjected

the carryforward of such NOLs to an 80% taxable income limitation. The CARES Act temporarily removes both of these limitations. The CARES Act allows for a five-year carryback for NOLs arising in 2018, 2019, and 2020 and removes the 80% taxable income limitation for NOLs until tax years beginning in 2021.

- Suspends Excess Business Loss limitation for Non-Corporate Taxpayers:

  The CARES Act also temporarily suspends the "excess business loss" limitation for non-corporate taxpayers that was imposed by the 2017 Tax Cuts and Jobs Act, which limits current losses attributable to trades or businesses for non-corporate taxpayers to $250,000 ($500,000 in the case of joint filers). Any such limited losses would then create an NOL and be subject to any applicable NOL limitations. The CARES Act has retroactively postponed the implementation of this "excess business loss limitation" so that such limitation does not apply until tax years beginning in 2021.

- Increase in the Business Interest Expense Limitation:

  The 2017 Tax Cuts and Jobs Act limited the deduction for business interest expense to 30% of "adjusted taxable income." Except as otherwise provided below with respect to entities classified as partnerships for U.S. federal income tax purposes, the CARES Act increases the limitation to 50% for 2019 and 2020 and provides an election to allow taxpayers to use 2019 "adjusted taxable income" for purposes of calculating the 2020 limitation.

  The CARES Act provides special rules with respect to entities classified as partnerships for U.S. federal income tax purposes. With respect to partnerships, the increase in limitation to 50% of "adjusted taxable income" applies only in 2020. However, 50% of the business interest of a partner that is accrued and limited in 2019 will be deemed to accrue in 2020 and not be subject to any limitation in 2020.

- Bonus Depreciation for Non-Residential Building Improvements:

  Due to a mistake in the 2017 Tax Cuts and Jobs Act, improvements to the interior of non-residential buildings were not eligible for bonus depreciation (which depreciation

is equal to 100% for property placed in service from 2018 through 2022). The CARES Act fixes this mistake retroactively to 2018 and on a going forward basis so that such property is eligible for bonus depreciation.

(D) General U.S. Federal Income Tax Issues and Considerations

- Debt Restructuring:

  The economic downturn may result in a need for private equity firms and their portfolio companies to evaluate and consider altering, modifying, cancelling, or otherwise restructuring outstanding debt. Any actions taken with respect to outstanding debt, even a single alteration or modification (such as a maturity date extension, forbearance, or an interest rate change), can potentially result in material U.S. federal income tax issues and consequences.

  Such material U.S. issues and consequences can include deemed debt exchanges, cancellation of debt (COD) income or other similar gain recognition by the borrower (and in the case of entity classified as a partnership, its direct or indirect partners), gain or loss recognition by the lender, disallowance or deferral of interest deductions on a going forward basis as a result of the application of the "applicable high yield debt obligation" rules or other interest deduction limitations (including the business interest expense limitation, which as discussed above was implemented by the 2017 Tax Cuts and Jobs Act and modified by the CARES Act), and deemed equity issuances or debt for equity exchanges (and potential Section 382 limitations arising therefrom).

  Due to the potential U.S. federal income tax issues and consequences that could arise, private equity firms and their portfolio companies should analyze and consider the various U.S. federal income tax issues and consequences prior to altering, modifying, cancelling, or otherwise restructuring outstanding debt.

- Business Interest Expense Limitation:

  As discussed above, the CARES Act increased the business interest limitation and allows taxpayers to use 2019 "adjusted taxable income" for purposes of calculating the 2020 limitation. While such changes will help many private

equity firms and their portfolio companies that experience declines in business activity in 2020 due to COVID-19, private equity firms and their portfolio companies that did not have significant "adjusted taxable income" in 2019 and will not have significant "adjusted taxable income" in 2020 could still be materially impacted by the deferral of business interest deductions due to the business interest expense limitation. As a result, private equity firms and their portfolio companies may still to need monitor and consider the impacts that the business interest expense limitation, as modified by the CARES Act, will have from a U.S. federal income tax perspective.

- NOLs:

  The CARES Act suspends the 80% taxable income limitation for carried forward NOLs until tax years beginning in 2021. Thus, any significant NOLs created during 2018, 2019, or 2020 that are unable to be used through the five year carry back or a carry forward during such period will then be subject to the 80% taxable income limitation beginning in 2021. Additionally, Section 382 limitations, which can significantly limit the ability to use NOLs, are a potential problem if there are equity issuances or ownership changes in connection with debt or other restructurings.

  Accordingly, private equity firms and their portfolio companies need to evaluate and consider their NOL positions and potential Section 382 limitations as they analyze and evaluate restructurings and other transactions and could also consider exploring whether to engage in taxable restructuring or other transactions in order to recognize gain in a current period and, therefore, reduce the amount of losses in the current period and the amount of NOLs that will then be carried forward to tax years beginning in 2021 and thereafter.

(ii) State and Local Tax Issues

(A) Tax Filing and Payment Deferrals

Many states and localities have postponed tax return and payment due dates, and/or provided relief from penalties and interest for late filings and payments.

- Income Tax:

  As of April 15, 2020, most of the 45 states with corporate income tax have delayed filing and payment deadlines. Many extended deadlines to July 15, 2020 in conformity with the federal extension. However, Massachusetts, Minnesota, and New Hampshire retained original April 15 filing deadlines. Florida, Montana, Ohio and Virginia retained May filing deadlines, although Virginia extended its payment deadline to June.

  Most states with individual income tax extended filing and payment deadlines to July 15, except for Idaho which extended to June 15 and Mississippi which extended to May 15. New Hampshire and Virginia retained original filing deadlines (April 15 and May 1, respectively), but Virginia extended the payment deadline to June 1.

  Many states also extended deadlines for pass-through entities required to file composite income tax returns and to remit payment on behalf of non-resident members, including California, Ohio, and Alabama.

- Indirect Tax:

  States have been less willing to grant extensions for indirect taxes. As of April 15, 2020, twenty states granted some type of relief for sales and use tax obligations, either in the form of extended deadlines or waiver of penalty and interest. Some of these states only grant sales tax relief for small businesses.

  Six states extended deadlines to pay property taxes and at least ten more issued guidance authorizing counties or municipalities to waive penalty and interest or extend local deadlines.

  Colorado extended the deadline to pay its severance tax to May 15, but other states, such as Alaska, have specifically excluded oil and gas severance taxes from tax relief measures.

(B) State Income Tax Conformity to Federal Income Tax Changes

Most states use the federal income tax base as a starting point for computing state income tax, but the extent to which states will

incorporate the federal CARES Act income tax relief discussed above will vary depending on each state's conformity to the Internal Revenue Code ("**Code**"). About half the states are "rolling" conformity states, meaning they will automatically incorporate federal income tax changes, while other states must take affirmative legislative action to do so. Disjoint between state and federal filing obligations may result in increased complexity for taxpayers navigating state tax regimes, depending on whether the state conforms to federal tax relief in the Code and particularly if the state requires separate or combined filing. State conformity to federal tax relief is further complicated due to various state income tax regimes which conform to the Code in some areas but may "decouple" or depart from the federal income tax treatment of NOLs, interest expense limitations, and bonus depreciation. Taxpayers should take care to track legislative developments and state revenue department guidance for ongoing tweaks to state conformity with the federal Code.

New York was the first state to address state income tax conformity to federal tax relief. New York conforms to the Code on a rolling basis passed legislation on April 3, 2020 specifically decoupling from the federal corporate income tax relief under the CARES Act. New York's deductions for business interest expenses will continue to be limited to 30 percent "adjusted taxable income" plus business interest income and floor plan financing interest, consistent with the Tax Cuts and Jobs Act. And New York taxpayers must still calculate NOLs using a state-specific NOL carryforward. Wisconsin passed legislation on April 15, 2020 to bring the state's tax code into conformity with several features of the CARES Act, including exempting certain retirement account distributions from tax and permitting loan forgiveness on a tax-free basis under the federal SBA loan programs. However, Wisconsin had decoupled from the business interest expense limitation on deduction under the 2017 Tax Cuts and Jobs Act and did not address conformity to the increased limit under the CARES Act. Guidance was also released in April from Pennsylvania and New Jersey conforming to the CARES Act business interest expense limitation and requiring separate and combined reporting, respectively.

(C) Remote Workforce Nexus Liability

Remote working status of employees should trigger a nexus analysis to identify new or changed state and local tax liability.

- State Income Tax:

A state's authority to tax the business income of private equity firms and their portfolio companies may change when employees move from a central office to a home office in new different taxing jurisdictions. If an employee or independent contractor's presence in a new state or local jurisdiction meets the threshold for "business activity," taxpayers may face new business income tax exposure. Some states may change an entity's income tax liability if a remote worker's payroll is sourced into a new taxing jurisdiction. And a temporary home office may create a new taxable connection to states where a business was previously untaxed. As of April 15, 2020, Indiana, New Jersey, Mississippi, Pennsylvania, and D.C. have released guidance that they will not assert nexus to impose tax obligations on previously untaxed businesses if an employee is only working from home due to health and safety reasons or a stay-home order.

Additionally, some states require withholding on payments to "nonresident" employees. And an employee's new, even temporary, presence in a state may trigger state income tax withholding obligations. Employees may need guidance on if or how to report whether their withholding status has changed.

- Sales and Use Tax:

  The presence of employees in new states may change a company's relationship with a state from a "remote seller" status to "doing business in the state," which could change how income from sales transactions is taxed and sourced for purposes of remitting local sales tax due.

  States vary on the taxation of service-based revenue. Some state and local jurisdictions require sales tax collected for an employee's services to be remitted to the jurisdiction of an employee's home office. Other taxing jurisdictions use market-based sourcing for service-based revenue, and a customer's "market" may depend on the location of its employees (for example, Louisiana sources certain sales to the state where the customer principally manages the service contract).

(D) Other Considerations

- State Delays and Budget Shortfalls:

Many state tax departments are requiring tax agency employees to telecommute from home, which potentially may impact tax department responses and field audit visits. State court tax litigation and administrative hearings are also likely to be delayed, and some states are planning for telephone or videoconference options. In addition, states or localities may seek to cover the economic shortfall from lost income tax, sales and use tax, and property tax revenues by pressing for new taxes, increasing tax rates, or with more aggressive enforcement.

- Disaster Declarations:

  At least 48 states have declared a state of emergency in response to the coronavirus, several following the federal declaration issued March 13. Many state tax laws include alternative rates, caps, or implementation procedures in the event of a formally declared disaster. For example, under some emergency conditions, Texas provides options for certain taxing units to override normal voter approval requirements for increasing property tax rates. Disaster declarations may also increase a governor's authority to influence state and local tax. California's governor has used this emergency authority to extend income tax filing deadlines and other due dates. Taxpayers should review tax legal authority for emergency provisions and carefully track governors' orders during a declared disaster.

(d) Working Remotely

(i) Generally

Allowing employees to work remotely can be a lifesaver in a situation where an entire office must close due to an outbreak. However, employers that normally do not permit remote work or do not have remote work policies should consider implementing one and whether it is more desirable for any such policy to be limited to specific emergency situations. Employers should consider that many employees with disabilities request telecommuting as an accommodation. If all jobs move to remote work in case of an emergency, an employer may lose its argument that a certain job cannot be performed remotely. Consider including language in a policy that employees are permitted to work remotely in the emergency or crisis situation and acknowledge specifically that not all of the employees' essential job functions can be performed remotely.

Items that may be included in a remote work policy:

- Technology requirements, e.g., internet;
- Security requirements;
- Equipment provided by employer;
- Hours of work;
- Expectation that employee will take PTO appropriately;
- Safety requirements (workplace injury notification requirements);
- Availability for calls, online meetings;
- Job expectations;
- Temporary nature;
- At-will nature of employment is unchanged;
- Expenses reimbursed – pay attention to state requirements here;
- Acknowledge in an emergency that there will be some juggling of work and personal responsibilities;
- Non-exempt employees – recording all hours worked accurately;
- Tax consequences are employee's responsibility;
- Acknowledgment that arrangement is temporary and on an emergency basis; and
- If an employer already has a Bring Your Own Device ("**BYOD**") policy in place, it may be helpful to extend that policy if employees will be doing work on their own equipment instead of using an employer laptop.

Additionally, we anticipate a number of unique, sizeable data privacy and cybersecurity challenges with remote working that are not commonly encountered with in-office work arrangements. We have summarized below key considerations to ensure the security of networks, systems, and data during this time.

(ii) Data Privacy Issues

Despite the need for businesses to quickly adapt to a remote working environment, we recommend doing so in a manner that minimizes data privacy related risks. Various regulatory agencies have issued recent guidance indicating that enforcement of data privacy laws remains in effect. For example, the California Attorney General's Office is going forward with the enforcement of the California Consumer Privacy Act ("**CCPA**") on July 1, 2020 despite logistical issues caused by COVID-19 and remote working. Similarly, the Information Commissioner's Office ("**ICO**") stated the General Data Protection Regulation ("**GDPR**") is not a barrier to increased remote working, but businesses need to consider the same kinds of data security measures for remote working that would be used in normal circumstances.

The ICO has clarified data protection law will not stop organizations from being able to work together to stop the COVID-19 pandemic. Particularly, it is not direct marketing for the government, the NHS and other health professionals to send public health messages to people, either by phone, text, or email, or to use the latest technology to facilitate consultations and diagnoses. Additionally, public bodies may require additional collection and sharing of personal data to protect against serious threats to public health.

The Data Protection Commission ("**DPC**"), the Irish supervisory authority for the GDPR, advised timelines for responding to requests from individuals under GDPR cannot be changed, but unavoidable delays may arise as a direct result of the impacts of COVID-19. Organizations that cannot respond to a request in full or in part within statutory timelines remain under an obligation to do so and should ensure the request is actioned as soon as possible. It is pertinent for such organizations to document the reasons for not complying with the timelines and clearly communicate any extension for responding and the reason for such extension to the affected individuals.

Complying with data privacy legislation during the COVID-19 pandemic is important to avoid future enforcement action. Areas of focus would include:

- Whether your business interacts with European consumers or California consumers or not, implementing internal controls and policies for handling personal information is essential.

- Consider undertaking a series of data mapping exercises to acquire an updated, in-depth understanding of how your business processes personal information.

- Regularly revise internal privacy policies and external privacy notices to align with the GDPR, CCPA and other data privacy laws.

- If possible, benchmark your standards against similar companies in your industry, obtain a third-party assessment of your IT security.

- Stay vigilant and remain attentive to the latest developments, amendments, copycat legislation from other jurisdictions, and other similar items that will affect your business's data security obligations.

(iii) Cybersecurity

Working from home creates an opportunistic situation for hackers and phishers. Cybersecurity incidents have increased since jurisdictions have enacted "stay at home," "shelter in place" and other similar orders, and such incidents are expected to increase further as more people are working remotely. Current cybersecurity attacks include malicious phishing emails leveraging the uncertainty of the crisis, posing as the CDC in attempts to obtain financial information, and using interactive COVID-19 statistics to plant malware on devices.

Telework and remote work technologies often need additional protection since these technologies have higher exposure to external threats compared to those in the office. Remote working devices are portable, making the devices likely to be lost or stolen, which places the data or device at an increased risk of compromise. Additionally, remote working devices use unsecured networks and provide external access to internal-only resources that can expose the device to new threats, and which significantly increase the likelihood the device will be compromised.

To protect against cybersecurity risks that accompany remote working, the following best practices should be considered:

- Alert employees to an expected increase in phishing attempts; consider new trainings on phishing and social engineering.

- Develop a telework security policy that defines telework, remote access, and BYOD requirements.

- Review incident response plans and update, if necessary, for remote working.

- Require multi-factor authentication.

- Update VPNs, network infrastructure devices, and devices being used for remote working with the latest software patches and security configurations.

- Ensure IT security personnel are prepared to ramp up the following remote access cybersecurity tasks: log review, attack detection, and incident response and recovery.

- Implement MFA on all VPN connections to increase security. If MFA is not implemented, require teleworkers to use strong passwords.

- Ensure IT security personnel test VPN limitations to prepare for mass usage and, if possible, implement modifications—such as rate limiting—to prioritize users that will require higher bandwidths.

2. **Private Equity Firms**

(a) Pending Transactions

We have summarized below certain select considerations parties to pending M&A transactions should keep in mind as they move ahead with deals during the disruptions caused by COVID-19.

(i) Extending Bidding Deadlines

As more jurisdictions impose limitations on movement and travel becomes more challenging, it will be increasingly difficult for principals and other deal participants to gather in a single location for management Q&A sessions and in-person discussions. To a certain degree, meetings that might have been conducted in person could be conducted remotely via the use of teleconferencing or videoconferencing technologies. However, as discussed in more detail below, the limitations on travel could have a significant impact on the due diligence process and timing. Accordingly, targets may have to reconsider their auction timelines and adjust them accordingly to accommodate a longer auction process.

(ii) LOI Phase (Renegotiating/Repricing)

Parties who agreed on enterprise value before the impact of COVID-19 was understood could find themselves in a situation where the buyer's and target's expectations are no longer in sync. For instance, historic financial data may no longer be reliable in light of extraordinary events affecting the target's business (i.e., extended time periods to pay payables or collect receivables, inventory levels that are not consistent with the target's historic practices, supply chain disruptions, low demand for the target's products or

services, and the effect of commodity prices on the target's business). Additionally, the target's financial projections may no longer be reliable in light of COVID-19's near-term and long-term impact to the target's business. As a result, deal valuations may need to be revisited. While certain mechanisms, such as earn-outs, might be utilized to bridge the valuation gap, we anticipate situations in which parties will not be able to reach a mutually acceptable agreement on valuation.

It is customary for parties to agree in the LOI that the buyer will be given somewhere between 30 and 90 days of exclusivity for purposes of conducting its due diligence investigation. In light of logistical challenges likely to affect the due diligence process (as discussed below), agreed upon exclusivity periods may no longer be adequate and buyers may seek to extend the agreed exclusivity period to accommodate a longer due diligence timeline. We have already seen some buyers request automatic extensions for a set period of time if the social distancing guidelines have not been lifted by the original expiration date.

(iii) Diligence Implications

Much of the due diligence process can be conducted through virtual data rooms, and we anticipate minimal disruption to that process as a result of COVID-19. On the other hand, limitations on travel and in-person meetings will present a challenge in transactions where in-person diligence is a crucial component of the buyer's investigation (i.e., site/equipment inspections, inventory counts, title diligence at courthouses, and environmental site assessments). Buyers should therefore plan their acquisition and pre-signing diligence timelines accordingly to account for delays resulting from in-person diligence. Alternatively, parties may agree to shift the in-person diligence to the post-signing/pre-closing period, coupled with a due diligence condition to closing or termination right, in the hopes that by pushing the in-person diligence to a later time such diligence can be conducted with less disruption to the overall transaction timeline. This, however, would require targets to accept closing risk they may not be willing or prepared to accept.

Assessing the impact of COVID-19 on the target's business condition will be important for buyers and a difficult exercise. Areas of focus would include:

- Force majeure provisions and other contractual rights that might excuse non-performance or trigger termination rights under the material contracts of the target.

- The target's ability to perform under its material contracts.

- The impact of COVID-19 on the target's workforce and operations (supply chain, inventory, invoicing, collections, etc.).

- Insurance coverage for interruptions to the target's business as a result of COVID-19.

- Whether the target's emergency and business continuity measures and procedures are adequate to respond to COVID-19 contingencies.

- The target's IT systems and the extent to which the target can enable work-from-home arrangements for its employees.

- For a target with operations across multiple jurisdictions (domestically or internationally), the extent to which the target operates in jurisdictions with worsening conditions as a result of COVID-19.

Most of all, because COVID-19 is a historic event that is affecting industries on a global scale in a manner that is unique even when compared to other recent crises, buyers will be faced with the challenge of predicting the potential near-term and long-term impact to the target's business without the benefit of seeing how the target has navigated similar circumstances in the past.

(iv) Impact on Representations and Warranties

The representations and warranties in the acquisition agreement may be used as a mechanism to address COVID-19 risk and liability. For example:

- Should the "no undisclosed liabilities" representations cover liabilities relating to COVID-19 or should that category of liabilities be deemed to be known and therefore excluded (shifting the risk to the buyer)?

- Customary inventory representations should be scrutinized. The adequacy of current inventory levels may have been adversely affected due to COVID-19-related changes in supply and demand.

- Representations regarding the collectability of accounts receivable and payments of accounts payable may no longer be accurate and may require additional qualifications or disclosure.

- Representations and warranties concerning key customer and vendor relationships often address whether the target knows or has reason to know a customer or vendor relationship is not likely to

continue on the same terms through the closing. Should parties address the COVID-19 impact and uncertainty as it might pertain to these representations?

- Buyers may request representations and warranties that are particularly focused on the target's emergency and contingency planning and measures as they relate to COVID-19.

- The representations and warranties regarding absence of changes since the date of the last audited financial statements (or another agreed peg date) need to be drafted and negotiated with the impacts of COVID-19 in mind, given that many businesses have taken extraordinary measures in recent months to comply with governmental orders and otherwise manage through the crisis.

- The representations and warranties concerning worker health and safety may incorporate COVID-19-specific statements about the target's measures to protect the workplace from contamination and employees from contracting the virus in the workplace.

Many representations and warranties are qualified by the target's "ordinary course of business" (sometimes with the additional qualifier of "consistent with past practice"). What this means, including whether it is an appropriate qualifier for certain representations and warranties, is something that will need to be considered by the parties as they negotiate the scope of the representations and warranties.

Targets, on the other hand, may seek to limit their exposure by making any COVID-19 representations and warranties self-contained and excluding the impacts of COVID-19 from other general representations and warranties. Targets should also scrutinize non-reliance provisions to confirm that buyers are unable to rely on forecasts and projections.

We also anticipate disclosures concerning COVID-19 in the target disclosure schedules to be heavily negotiated. Targets may attempt to make general disclosures given all the uncertainty surrounding the impact of the pandemic to the target's business, which are likely to be resisted by buyers.

(v) Impact on Representations and Warranties Insurance ("**RWI**")

In addition to the other matters discussed in this Guide with respect to M&A in the COVID-19 environment, COVID-19 is forcing M&A practitioners to assess appropriate risk allocation mechanisms to address the impact of COVID-19 on global business operations, including RWI. While the full impact of COVID-19 on RWI continues to develop in real time, there are several things to consider when utilizing RWI as an effective risk allocation

tool. For example, RWI insurers are assessing the impact of the virus on M&A targets, with some insurers proposing exclusions related to COVID-19 that can vary in scope.

As discussed in Section 2(a)(vi) below, we anticipate COVID-19 will impact "Material Adverse Effect" ("**MAE**") clauses, interim period operating covenants, and the ability to satisfy closing conditions. Parties obtaining RWI should expect increased underwriter diligence around COVID-19's impact, particularly with respect to workforce and supply chain disruption, in particular in transactions with longer interim periods. Buyers should consult with counsel in undertaking pre- and post-signing diligence regarding COVID-19, as a buyer's "knowledge" usually results in an exclusion under the RWI policy.

In terms of ability to make claims, RWI covers unknown, historical, disclosure-related issues that result in losses to the policyholder. However, if a counterparty simply doesn't perform after closing of the M&A transaction due to a change in the economic environment, that is a business risk that typically would not be covered. If either the seller or the buyer is seeking to obtain RWI as a source of post-closing indemnity on a deal, they will need to focus on how exclusions and limitations will apply to the impact of COVID-19. Because COVID-19 is a known risk, RWI insurers are likely to specifically exclude coronavirus-related losses from their policy coverage. In sum, parties should prepare for the likelihood that RWI insurers will not cover losses stemming from COVID-19, whether in part or in whole.

(vi) Post-Signing/Pre-Closing Phase

(A) MAE, Other Closing Conditions and Bringdowns

MAE. Arguably, a historic event like COVID-19 should be the type of disruptive event that would qualify as an MAE under most acquisition agreements. However, buyers are cautioned not to rely on MAE as a way to exit a transaction for the following reasons:

- A recent key Delaware case (*Akorn, Inc. v. Fresenius Kabi AG, et at.*) reiterated that a buyer who seeks to rely on MAE to terminate a transaction bears a high burden. Specifically, the court stated that the inquiry is whether there has been an adverse change in the target's business that is consequential to the company's *long-term earnings power* over a commercially reasonable period, *which one would expect to be measured in years rather than months*. At this time, it is difficult to determine the duration of the impact of the COVID-19 outbreak, or the severity of its impact on

particular industries or companies. Thus, the court's focus on an extended durational impact, and measurement in terms of years rather than months, makes it unclear (and perhaps unlikely) that the impact of COVID-19 would fit within the standard articulated by the *Akorn* court.

- There is no standard MAE definition under the law. Rather, MAE is a specifically negotiated defined term in acquisition agreements. It is customary for MAE definitions to include negotiated exceptions to what can constitute a MAE, including "*general economic or political conditions*," "*conditions generally affecting the industries in which the target operates*," "*any changes in financial, banking or securities markets*," "*any natural or man-made disasters or acts of God*" and "*any changes in applicable laws*." In certain instances, MAE definitions specifically exclude "*epidemics*" and "*pandemics*." We have already seen recent transactions that specifically exclude COVID-19 from what is a MAE, and we can expect that trend to continue. As a result, buyers can expect MAE definitions to directly or indirectly exclude the effects of COVID-19 from what can constitute a MAE.

  It is customary for parties to agree that the buyer only assumes the risk of the negotiated MAE exceptions as long as the adverse impact on the target's business is not disproportionate as compared to other participants in the target's industry. Therefore, even if COVID-19 is specifically excluded from the MAE definition, it could constitute a MAE if the target's business is affected in a manner that is different from its other industry participants.

We anticipate COVID-19 will result in increased focus on how parties choose to define MAE going forward and, much like terrorism after the September 11, 2001 terrorist attacks, the effects of pandemics and epidemics to become a negotiated point within the exclusions to what constitutes a MAE.

Rather than relying on the MAE concept, as an alternative mechanism parties may consider specifically defining if and how the COVID-19-related impacts to the business would result in a remedy to the buyer, whether that is an adjustment to the transaction consideration or a condition that would allow the buyer not to close the transaction.

Closing Conditions. As parties attempt to allocate closing risk in the COVID-19 environment, we anticipate closing conditions to be crafted to specifically address the risk. Below are a few examples of conditions to closing we anticipate may become more common in acquisition agreements:

- Conditions to closing intended to address the absence of specifically identified COVID-19 effects on the target's business. For example:
    - A condition that the target's facilities have not been ordered closed as a result of a government-ordered shutdown
    - A condition tied to the target's revenues exceeding an agreed threshold as of the closing date
    - A condition that the target's supply chain not be materially disrupted as a result of COVID-19-related closures or other actions since the date of the acquisition agreement
    - A condition that material counterparties of the target not have exercised rights under force majeure or similar contractual provisions
- A condition to closing that the buyer has completed in-person due diligence to its satisfaction, to the extent the parties have elected to defer diligence to the post-signing/pre-closing phase (see the discussion above).
- A condition that the buyer has obtained financing to consummate the transaction (see the discussion regarding reverse breakup fees below).

Bringdowns. The representations and warranties bringdown condition to closing addresses the extent to which the target's representations and warranties must be accurate in order for the buyer to be required to close.

The first component is temporal – it is customary for the condition to specify the representations and warranties must be correct as of the signing date of the acquisition agreement and as of the closing date, though in some cases this is negotiated to be limited to only the closing date.

The second component is the extent to which the representations and warranties must be accurate. One formulation is that the representations and warranties must be accurate in all material respects, except that representations and warranties that are themselves qualified by materiality must be accurate in all respects. This formulation tends to be more buyer favorable in that it only allows for immaterial inaccuracies in the representations and warranties. Another formulation is that the representations and warranties must be accurate except for inaccuracies that would not result in a MAE, and for this purpose all materiality qualifiers in the representations and warranties are disregarded. This formulation is more target favorable in that it ultimately refers to the MAE standard, which is a more difficult standard to satisfy from the buyer's standpoint (refer to the discussion of MAE above). A hybrid approach we have seen in transactions is to make "fundamental" representations and warranties subject to the lower "in all material respects" standard and the other non-fundamental representations and warranties subject to the higher MAE standard.

We anticipate targets will strongly argue for the higher MAE standard in order to mitigate their closing risk. Whether that is acceptable to a buyer will of course depend on how the parties have agreed to draft the MAE definition.

(B) Interim Operating Covenants

Parties will need to address the extent to which the target will be permitted to take extraordinary steps in the interim period between signing of the acquisition agreement and closing to respond to the outbreak and the impact on the target's business. For example, should the target be permitted to furlough employees or institute layoffs (or other cost reduction measures) without the buyer's consent? To what extent should the target be permitted to seek financing if necessary to continue operating during the interim period, and if the buyer has a right of consent to what extent should the buyer be obligated to provide bridge financing if the buyer objects to other sources of financing?

Interim operating covenants often allow for the target to take actions required to comply with laws, which in the context of COVID-19 can have unknown and unintended consequences given the pace at which national, state and local governments are reacting to address the crisis. Buyers may seek to more specifically define the scope of such an exception.

(C) Financing Commitments

We anticipate lenders will continue to honor their existing financing commitments in the near-term. However, buyers should analyze their legal remedies under their debt commitment papers in preparation for situations where lenders start to back away from such commitments. This will be particularly relevant for a buyer who has agreed to a reverse breakup fee, as discussed below.

In addition, buyers will want to ensure their commitment papers allow sufficient time to close in light of delays in the acquisition process resulting from COVID-19.

(D) Reverse Breakup Fees

In the most recent pre-COVID-19 M&A environment, it has been increasingly rare for buyers' obligations to purchase businesses to be conditioned upon financing and increasingly common for buyers to agree to pay reverse termination fees if all conditions to closing have been satisfied and buyer fails to close the deal (i.e., due to the absence of financing). Even though lenders are indicating their intentions to honor the financing commitments, because of the severity of the economic disruptions caused by COVID-19, buyers should have contingency plans in place in case they are unable to complete acquisition financings.

(E) Third Party Consents and Regulatory Approvals

Timelines in the purchase agreement may need to be extended to account for potential delays in obtaining third party consents and governmental approvals. For example, acquisition agreements typically include a "drop dead" date after which the acquisition agreement may be terminated if conditions are not satisfied. If the COVID-19 situation materially worsens in the United States, we anticipate staffing shortages and other disruptions could result in longer than customary timelines for obtaining third party consents and governmental approvals, and as a result parties may need to contemplate longer than customary drop dead dates in their acquisition agreements. See, for example, the discussion below of modifications to U.S. and international antitrust M&A approval processes in response to COVID-19.

(b) New Investments

Many private equity sponsors will be focused on their existing portfolio companies during this time of economic distress, ensuring prior investments have the balance sheets to weather the storm. However, there are still opportunities for new investments, including in public equities or in the form of growth equity

investments rather than full blown leveraged buyouts. The current dislocation in public and private markets may present compelling buy-side opportunities for private equity investors. The private equity industry is sitting on record amounts of dry powder, with some estimates placing the figure at $2 trillion or more.

Until this crisis passes and due to the difficulty of using no MAE conditions to avoid closing transactions, buyers may (as they have in past down cycles) begin insisting upon financing outs or other conditions that take into account the changing market conditions resulting from COVID-19.

(i) Investment Limitations

In evaluating such opportunities, fund sponsors should consider any relevant investment limitations contained in their fund partnership agreements, including the following:

- concentration limitations (acquiring indebtedness of a portfolio company usually must be included in this calculation);
- restrictions on investments in particular types of securities (e.g., equity, debt, convertible instruments, options, etc.);
- leverage, bridge financing, and guarantee limitations;
- geographic restrictions or limitations;
- industry-specific limitations;
- restrictions on investments in funds-of-funds or other blind pool strategies;
- restrictions on investments in derivative instruments or hedging transactions; and
- restrictions on investments in publicly-traded securities.

Some of the foregoing limitations and restrictions may be waived with the consent of the advisory committee, while others may require limited partner approval. Sponsors should confirm the necessary approval thresholds in the applicable fund documents before going too far down the road on a particular strategy. Depending on the registration status of the fund's investment adviser, certain investment limitations may also implicate certain registration exemptions under the U.S. Investment Advisers Act (the "**Advisers Act**"). Sponsors should consult with fund counsel early in the

process to confirm whether a proposed investment could raise any such regulatory issues.

In addition to the contractual limitations set forth in the fund governing documents, sponsors should also confirm that proposed investments are consistent with the strategies and risk factors contained in disclosure documents disseminated to limited partners. A shift in fund strategy may require amendments to the fund documents, many of which can be difficult to obtain, especially when advisory committee members' and limited partners' attentions may lay elsewhere given the impact of COVID-19. Additionally, shifts in investment strategy or focus that are permitted under fund documents have the potential to ruffle feathers with investors.

Sponsors should maintain frequent communication with their limited partners and advisory committees to ensure the fund is best positioned to quickly take actions, including actions that may require the consent of the limited partners or the advisory committee. It may be prudent to begin the process of amending fund documents as soon as possible if any such amendments appear necessary.

(A) Public Securities

As noted in a recent PitchBook article titled *COVID-19's Influence on the US PE Market*[1], private equity sponsors are likely to turn to more private investments in public equities in the near term. However, fund documents may limit the percentage of the fund's committed capital that can invested in publicly-traded securities. As of the time of publication of this Guide, public markets have retracted by upwards of 30% while private markets may remain relatively inelastic, making public securities potentially attractive. Funds with strict limits on the ability to invest in public securities may not be able to capitalize on attractive opportunities involving public companies without (1) advisory committee approval, (2) limited partner approval, and/or (3) amendments to fund documents (which generally will require limited partner approval). Restrictions on investments in publicly-traded securities can differ from fund to fund, and sponsors should consult with fund counsel to determine whether specific carve-outs or baskets apply to a particular investment or strategy.

(B) Investing in Distressed Companies / Concentration Limitations

1 https://files.pitchbook.com/website/files/pdf/PitchBook_Q1_2020_Analyst_Note_COVID_19s_Influence_on_the_US_PE_Market.pdf

Fund documents may also limit or prohibit investments in distressed companies and usually restrict allocating more than a specific portion of fund commitments to a particular investment. Many of the best opportunities in markets such as those existing today may involve distressed companies, including "fallen angels" (companies whose debt was downgraded below investment grade) or companies with bonds trading significantly below par. In addition, a fund may want to deploy more capital to an existing portfolio company facing a liquidity crunch or that the fund believes is significantly undervalued but may not be able to do so as a result of concentration limitations or specific limitations on follow-on investments. Careful attention should be given to the fund's governing documents, as well as its specific strategy and mandate, to ensure that sponsors do not run afoul of these provisions.

(C) Recycling Capital / Follow-on Investments

For funds that permit "recycling" (whereby the general partner is permitted to re-call previously contributed capital, or retain a portion of current distributions representing a return of capital, that was previously invested in an investment that is exited within a defined—usually less than 24 months—period of time), fund documents often contain specific limitations on the extent to which capital can be recycled.

Further, as mentioned above, fund documents will often contain specific limitations on making follow-on investments in existing portfolio companies. During a time in which portfolio companies may be in need of capital, the fund documents may not permit the fund to make additional contributions. If there is no follow-on investment capacity, or if follow-on capacity may be constrained down the road, sponsors may want to consider if other means of credit support are available. In addition, some fund documents may permit follow-on investment restrictions to be waived or modified with advisory committee or limited partner approval.

(ii) Access to Capital

The turmoil in the markets and the related tightening of credit markets may restrict sponsors from satisfying underlying leverage limitations. Fund sponsors should note any limitations in their fund documents that could restrict the fund's ability to satisfy its leverage limitations. Funds will likely need to be creative in accessing additional capital for their portfolio companies, including by structuring transactions using preferred or mezzanine equity securities or using swaps, margin loans or alternative forms of financing. However, sponsors should be mindful of provisions in

their fund documents that may restrict the use of such capital, including any provisions that require certain equity-like securities to be treated instead as long-term debt. For example, with respect to portfolio companies in the energy industry, the use of a popular financing tool referred to as a "Drillco" may sometimes be required to be classified as debt.

Sponsors may need to be creative in accessing capital beyond the existing commitments and any subscription line facilities, and they should be in close contact with limited partners, the advisory committee and any potential sources of capital to ensure they can move quickly should the need (or opportunity) arise. Further, as mentioned above, additional considerations may come into play for certain investment advisers relying on exemptions from registration under the Advisers Act.

(c) Antitrust

(i) Potential Delays Under HSR and International Reviews

(A) U.S.

On Friday, March 13, 2020, the Federal Trade Commission ("**FTC**") and U.S. Department of Justice ("**DOJ**") announced a temporary filing procedure for all filings required under the Hart-Scott-Rodino Act ("**HSR Act**"), effective Tuesday, March 17, 2020.

Under the new procedures, parties required to file under the HSR Act will no longer be permitted to submit filings in hard copy or by DVD. As of March 17, 2020, all filing parties must notify the FTC of their intent to file by email and the FTC will provide a link to follow for uploading the form. After receiving the link, the HSR filing and all attachments will be uploaded to the cloud and distributed electronically to the FTC and DOJ Premerger Notification Offices.

In addition to adding procedural steps, the March 13 announcement stated that the agencies would not be granting early termination of the HSR waiting period until further notice. On March 27 the FTC announced that will resume processing requests for early termination, effective March 30. However, in its announcement the FTC emphasized that parties are not entitled to early termination and that early terminations "will be granted in fewer cases, and more slowly, than under normal circumstances." The agencies also requested that parties not contact the agencies to request accelerated action and noted that the agencies may return to a temporary policy of no early termination as circumstances develop.

(B) International

On March 16, 2020, the European Commission ("**Commission**") issued an unprecedented request to companies encouraging them to delay merger notifications under the EU Merger Regulation ("**EUMR**") that they may have been planning until further notice. The Commission's announcement does not represent a moratorium on the review of new EUMR notifications as the Commission will continue to review new notifications that it receives. The request from the Commission does, however, reflect concern that the Commission could experience difficulty in receiving input from third parties in respect of their merger reviews, and also concerns in respect of potential limitations on remote working case handlers' ability to access the necessary information and databases to carry out their investigations.

The practical impact of this request is that companies who are planning to proceed with submission of a merger notification to the Commission need to be aware of various "soft" tools that the Commission has at its disposal to extend review periods, including declaring notifications incomplete, issuing stop-the-clock decisions putting the review timetable on hold (normally only used in complex, Phase II cases), or informally requesting the parties withdraw a filing and re-file at a later point. Acquisitions by private equity buyers can often fall into the category of "no issues" deals, being suitable for notification under the Commission's "simplified" procedure. These are the sorts of cases where the Commission has less need to consult exhaustively with third parties, potentially reducing the risk of the Commission delaying their review of such cases. In practice, private equity buyers can expect to receive an informal indication from the Commission during pre-notification engagement as to whether the Commission would prefer the parties to hold off on submission of a merger notification. If notifications are submitted, the Commission has departed from normal practice and requested that notifying parties submit notifications electronically only.

National competition authorities, including the German, French, Spanish and UK authorities, are all encouraging merging parties to delay submission of merger notifications in the immediate term, if possible. This trend is reflected more broadly, with antitrust agencies in jurisdictions such as China, India, South Africa and Brazil issuing similar guidance.

(ii) Coordination with Competitors on HSE and Lobbying Activities

(A) U.S.

On March 24, 2020, the FTC and DOJ Antitrust Division issued a joint statement detailing an expedited antitrust review procedure and providing guidance to businesses looking to cooperate in the fight against COVID-19. The expedited review is limited to requests for approvals for temporary collaborations in response to the pandemic and does not apply to mergers, however.

The statement recognizes that businesses may need to temporarily combine production, distribution, or service networks to facilitate production and distribution of COVID-19-related supplies. Under the expedited procedure, the agencies will aim to respond to COVID-19-related requests within seven calendar days of receiving all necessary information. This expedited procedure offers a significantly quicker review than the existing procedures for evaluation of proposed conduct under the Division's Business Review Process or the FTC's Advisory Opinion Process, which typically take several months.

The agencies also announced that they will work to expeditiously process filings under the National Cooperative Research and Production Act for flexible treatment of certain standard development organizations and joint ventures which "may be necessary for businesses to bring goods to communities in need, to expand existing capacity, or to develop new products or services." The joint statement also reminds businesses that there are many ways that firms, including competitors, can engage in procompetitive collaboration that does not violate the antitrust laws. For example, the Federal Trade Commission & U.S. Department of Justice, Antitrust Guidelines for Collaborations Among Competitors (2000) and Statement of Antitrust Enforcement Policy in Health Care (1996) provide guidance as to how the agencies analyze cooperation and collaboration between competitors.

While the agencies recognize that certain joint efforts among competitors may be needed to respond to health and safety matters during this extraordinary time, the agencies have warned that they will continue to pursue vigorously any antitrust violations, whether civil (including agreements to restrain competition through increased prices, lower wages, decreased output, or reduced quality as well as efforts by monopolists to use their market power to engage in exclusionary conduct) or criminal (including agreements to fix prices or wages, rig bids, or allocate markets).

(B) International

A number of antitrust agencies in Europe have cautioned businesses against engaging in conduct that could run afoul of EU antitrust rules despite or especially in the current circumstances. These warnings have focused on pricing practices, in particular excessive pricing practices related to essential products that are currently in high demand, such as hygiene products or protective medical equipment. There have been some calls for greater flexibility in the application of EU antitrust rules in the current situation, in particular in relation to cooperation between supermarkets with a view to ensuring supplies and deliveries. The UK government has temporarily relaxed the competition laws to allow supermarkets to work together on their contingency plans and share resources. For the moment, no comprehensive guidance has been issued by major antitrust agencies on exactly what additional steps international agencies may take in order to provide assurance to businesses in relation to permissible forms of cooperation. In the meantime, agencies continue to underline their willingness to continue strong enforcement, with the European Competition Commissioner, Margrethe Vestager, warning explicitly on March 27 that the COVID-19 crisis should not be seen as companies as "a shield against competition enforcement."

(d) Capital Calls

(i) Management Fees

For funds that are outside their investment periods and are calculating management fees on the basis of invested capital, write-offs and permanent write-downs of portfolio investments may affect the amount of invested capital on which management fees are calculated, depending on the terms of the fund's partnership agreement. Valuation determinations, including write-off and write-down determinations may be expressly addressed in the fund's partnership agreement, and such provisions should be confirmed and followed. In other cases, the advisory committee may be required to approve certain valuation determinations that affect management fee calculations.

(ii) Liquidity Reserves

As the COVID-19 pandemic continues, funds may face increasing uncertainties, and portfolio realizations and income may not generate significant cash flow at the fund level. Further, many funds do not provide broad latitude for the general partner to reserve large amounts of capital for indefinite periods. However, in many cases, fund partnership agreements allow the general partner to call capital from limited partners, or to reserve

from amounts otherwise distributable to the partners, to establish reserves for anticipated fund expenses.

(iii) Limited Partner Defaults

The market disruption caused by COVID-19 may result in an increased likelihood of limited partner capital commitment defaults. Most fund partnership agreements grant the general partner discretion to enforce default remedies, which may include some or all of the following:

- forfeiture of all or a portion of fund partnership interest;
- forced withdrawal from the fund;
- suspension of voting/approval rights;
- forfeiture of advisory committee representation;
- specific performance;
- suspension of rights to receive distributions; and
- recovery of damages.

In light of these unprecedented circumstances, the general partner may decide to defer or refrain from enforcing default remedies to the extent it would under ordinary conditions. If the general partner elects to enforce available remedies, it should generally do so in an even-handed manner among the defaulting partners, absent objective reasons why disparate enforcement is in the best interest of the fund or the partners.

(iv) No-Fault Terminations of Investment Period

Many fund partnership agreements permit the limited partners, usually by a supermajority vote (e.g., 75% in interest), to require a no-fault early termination of the investment period. Such an action would restrict the fund from calling additional capital to fund new investments (typically with certain exceptions for investments that are in the process of being concluded at the time of termination and for limited follow-on investments in existing portfolio companies).

(v) Investor Relations

Limited partners will generally expect open and frequent communication from fund sponsors during the COVID-19 crisis. Sponsors should leverage their relationships with their advisory committees and limited partners and

deliver thoughtful, organized, and timely information to all investors, even (and perhaps especially) if the information is negative. Proactive, comprehensive, and concise messaging can build and maintain trust among investors. Selective, sporadic, or incomplete communication can erode that trust at a time when it is most important for the fund.

(e) Investor and Regulatory Reporting

(i) Review Valuations for Impairment Issues

Sponsors should consider any COVID-related impacts on portfolio valuations. Valuation determinations, including write-off and write-down determinations, are often addressed in fund partnership agreements and or investment adviser compliance manuals. Given the unprecedented circumstances presented by COVID-19, sponsors should consider consulting with their fund advisory boards and external service providers in preparing updated valuations and considering any COVID-related impairments.

As described above, valuation changes may impact the calculation of management fees. In addition, sponsors should consider the effect of any valuation changes on distribution waterfalls, GP clawbacks, and fee waivers.

(ii) Investor Disclosures

For funds that are expecting closings before financials are available for Q1 2020, sponsors should include appropriate disclosure in offering memoranda and/or supplements regarding the impact that COVID-19 and current market turmoil have had or could have on investment performance and valuations. While many sponsors already include general risk factor disclosure related to epidemics in their fund offering materials, sponsors should consider including specific disclosure and risk factors in offering materials related to COVID-19 and/or supplement existing disclosures and risk factors to capture the impact of COVID-19. Sponsors that are conducting offerings should also consider proactively supplementing due diligence questionnaires in anticipation of investor questions and concerns over the impact of COVID-19 on fund performance and portfolio company operations. Sponsors should coordinate such responses with portfolio company management to ensure consistency between investor messaging at the fund level and practical responses at the portfolio company level.

(iii) Regulatory Reporting and Deadlines

Investment advisers should include specific disclosure regarding the impact of COVID-19 in their Form ADVs.

In response to COVID-19, the Securities and Exchange Commission ("**SEC**") issued an initial order on March 13, 2020 (the "**Initial Order**") that extended deadlines for registered investment advisers ("**RIAs**") and exempt reporting advisers ("**ERAs**") with respect to Form ADV and Form PF filing and delivery requirements falling between March 13, 2020 and April 30, 2020. The Initial Order required an RIA or ERA to provide a statement (an "**Explanatory Statement**") to the SEC and investors (1) to the effect that the investment adviser is relying on the extension, (2) explaining the reasons why the investment adviser is unable to meet the applicable filing or delivery deadline, and (3) providing the date by which the investment adviser estimates it will satisfy the applicable filing or delivery requirement. The SEC subsequently superseded the Initial Order by issuing an amended order on March 25, 2020 (the "**Amended Order**"), which eliminated the Explanatory Statement requirement and extended filing and delivery requirement relief to Form ADV and Form PF filing and delivery requirements falling between March 13, 2020 and June 30, 2020. Under the Amended Order, an RIA or ERA will need to notify (A) the SEC by electronic mail, and (B) with respect Form ADV filing and delivery requirements only, investors by website disclosure (or direct disclosure to investors) that it is taking advantage of the filing and delivery relief. The Amended Order requires that an RIA or ERA make required Form ADV or Form PF filings or deliveries "as soon as practicable, but not later than 45 days after the original due date."

Under Rule 206(4)-2 of the Advisers Act (the "**Custody Rule**"), RIAs are prohibited from having custody of client funds or securities, unless the adviser takes certain required steps to protect the assets. Many investment advisers rely on the "Audit Exemption" to the Custody Rule, which, permits RIAs to have custody of client funds and securities as long as (1) such client funds and securities are maintained with a "qualified custodian," and (2) the RIA obtains an annual audit of the relevant fund's financial statements by an independent public accounting firm that is registered with (and is subject to regular inspection by) the PCAOB and distributes the financial statements prepared in accordance with GAAP to each investor in the fund within 120 days of the fund's fiscal year end (180 days for funds of funds).

To date, the SEC has not extended the audited financial statement delivery deadline under the Audit Exemption to the Custody Rule in response to COVID-19. However, prior SEC guidance indicates that the SEC would not recommend enforcement for a Custody Rule violation arising as a result of the failure by an RIA that reasonably believed that the fund's audited financial statements would be distributed within the Audit Exemption deadline but failed to have them distributed in time under "certain unforeseeable circumstances." *See "Staff responses to Questions About the*

Custody Rule – Question VI.9" at https:/www.sec.gov/divisions/investment/custody_faq_030510.htm.

(iv) Financial Reports to Investors

Fund partnership agreements usually require general partners to prepare and deliver periodic internally-prepared financial reports and to deliver annual audited financial reports to investors. Delivery requirements vary among funds, but it is common for there to be a deadline for delivery of these financial reports (e.g., 120 days after the end of the fund's fiscal year for audited financials). In many cases, the general partner is required to use its "commercially reasonable efforts" to satisfy these delivery requirements before the applicable deadlines or "as soon as reasonably practicable" thereafter. Sponsors should review their fund partnership agreements carefully to determine what, if any, flexibility is afforded the general partner in terms of satisfying fast-approaching delivery deadlines, as COVID-19-related delays are likely foreseeable with audit season in full swing and accounting firms being forced to work remotely. Delays in portfolio company financial reporting should also be expected and factored in when messaging expectations in communications with investors.

(f) Investor Meeting Requirements (Virtual Meetings)

In response to travel and physical proximity limitations arising as a result of COVID-19, fund sponsors may be required to cancel or postpone scheduled investor meetings or to host such meetings over webcast. Sponsors with scheduled in-person investor meetings during the next weeks and months should consult their fund governing documents and develop contingency plans to host such meeting virtually via webcast or to postpone such meetings, to the extent permitted.

(g) GP and Investment Adviser Duties

Fund general partners have the express duties, obligations, rights, and authority set forth in the fund's partnership agreement, which will typically grant the general partner broad authority and discretion to conduct the fund's investment and other activities, subject to the enumerated limitations therein. Further, Delaware fund partnership agreements will typically modify and/or supersede default fiduciary duties of general partners arising under Delaware law (although standards of conduct and duties may be further modified with respect to certain investors by side letter). It should also be noted that, although a general partner's fiduciary duties may be modified or eliminated, Delaware law does not permit the elimination of the general partner's implied covenant of good faith and fair dealing with respect

to the fund and its investors.[2] Circumstances arising in connection with COVID-19 will generally not relax a general partner's contractual duties and obligations under the fund partnership agreement or investor side letters, nor will they eliminate the implied covenant of good faith and fair dealing.

In addition to the foregoing, sponsors should keep in mind that their fund investment advisers, which generally operate in a contractual investment advisory capacity on behalf of the sponsor's managed funds, have duties that must continue to be observed. As fiduciaries, investment advisers (including both RIAs and ERAs) are required to act in the best interest of their clients and not place their own interests ahead of their clients' interests. An investment adviser's fiduciary obligation to act in the best interest of its managed funds is not relaxed or suspended during times of financial turmoil, including those arising as a result of COVID-19. Investment advisers should keep their fiduciary responsibilities in mind when taking any decisions on behalf of their managed funds, including (in particular, but without limitation) the following:

- pursuing any new or different investment strategy (in particular, as a fiduciary, the investment adviser must have the requisite expertise);
- making (or electing not to make) valuation impairment determinations, as such decisions may impact management fee calculations, clawback determinations, and distribution limitations;
- disclosure requirements in connection with financial reporting as well as advertising or offering activities; and
- investment activities generally, including timing and valuation determinations related to both acquisitions and dispositions.

(h) Credit Funds

(i) General

Public debt markets have been effectively closed since the onset of the COVID-19 pandemic, meaning that private credit funds may be approached

[2] Under Delaware law, the implied covenant of good faith and fair dealing is a gap-filler that is applied when the partnership agreement is not explicit with respect to standards of conduct and is not intended to do more than protect "the spirit of what was actually bargained and negotiated for." *See Fisk Ventures, LLC v. Segal* (Del. Ch. May 7, 2008).

by firms that traditionally tap the public markets. In markets such as this, opportunities abound.

All lenders should be assessing their exposure in view of the markets and should develop liquidity measures, including through back-up options, in light of the rapid and evolving changes in market conditions. Lenders can expect to be approached by borrowers seeking additional liquidity or covenant relief. Lenders should evaluate loan documentation and collateral to consider whether to seek improvements in their rights, collateral, or other economic matters in connection with any waiver or amendment process.

(ii) Acquiring Debt of Portfolio Companies

Rumors are already swirling of private equity funds acquiring the distressed debt of their own portfolio companies. The current state of the credit markets makes it more likely that fund sponsors will want to invest in more senior levels of a portfolio company's capital structure, in particular when it involves purchases of distressed debt or rescue financings. Doing so may create fiduciary issues for fund sponsors, as they may be seen favoring one or the other of the investors in credit funds with those in equity funds. Sponsors should pay very close attention to their fund's policies and documents related to conflicts and any fiduciary duties set forth therein or created by applicable law.

(i) Intellectual Property

(i) Practical Considerations

Given the current climate, several Universities and research labs are currently closed. These labs would typically develop technology and medicines that would ultimately seek private equity investment. Due to their inability to proceed with this research, opportunities for private equity investors may become limited in the near term. As to existing research projects and prospects, patent filings and protection of the technology may be delayed due to a lack of information or research data available to continue. Private equity firms should be mindful of these issues in developing frameworks for investing and expectations for evaluating research investments.

(ii) Patent litigation

Patent litigation is practiced in District Courts. Each of the District Courts that have significant patent cases have issued orders regarding procedures for Court operation during this pandemic. All in-person hearings and conferences in District Courts have been modified to allow for telephonic appearances. However, jury trials have been postponed through the end of

April. For specific Court-by-Court guidance, Baker Botts has the most recent orders available for each Court here.

3. **Portfolio Companies**

(a) Credit Facilities

The worldwide business disruptions caused by COVID-19 are severely impacting the credit markets and have, or will result in, material implications under the debt documentation of many portfolio companies.

(i) Updating Forecasts

Borrowers' cash flow and operations forecasts, and worst-case liquidity needs, should be updated promptly and reassessed on a regular basis – this will help identify potential future defaults and also upcoming liquidity needs that should continue to be monitored closely to ensure the timely availability of funds.

(ii) Revolver Drawdowns

Many borrowers are drawing down as much as possible under their revolvers, rather than waiting for an immediate need for the funds. Since all credit agreement borrowings require a bringdown of representations and a certification that no default exists or would result from the borrowing (and, in some cases, include a certification regarding the absence of a MAE since a particular time in the past), this can avoid revolving borrowings being unavailable at the relevant time in the future due to the existence of a default at that time. In asset-based facilities, be prepared for lenders to closely scrutinize borrowing base determinations. Consider whether there are any springing financial covenants, increased reporting requirements or cash dominion provisions triggered upon drawing down a revolving facility. Commonly in leveraged finance credit agreements, some or all of the financial covenants do not get tested until a certain percentage (often 35-40%) of the revolving facility is drawn. Ongoing liquidity concerns may arise for a number of reasons. For example, borrowers are receiving or can expect to receive requests from customers to extend payment terms. Receivables and the concentration of receivables may increase, and the solvency of many customers may be in jeopardy. Demand for product may be significantly lower than normal and inventory delivery schedules may be disrupted, resulting in increases in slow-moving inventory and inventory in transit. These issues and other factors will need to be considered in assessing future liquidity needs and, where relevant, borrowing base calculations. In considering a full or partial draw down on a revolving credit facility, borrowers should be mindful of the timing of the borrowing in relation to its financial covenant test dates, the impact of the additional debt on its

financial covenant compliance, the increase in interest expense resulting from the additional borrowings and how such borrowing may affect its relationship with its lenders. If the borrower suspects that an event of default may be looming in the future, it should also understand the rights available to its lenders after the event default occurs, including the ability to sweep or block access to deposit accounts.

(iii) Business Interruption Insurance

Is there business interruption insurance that will cover losses incurred as a result of COVID-19? Property insurance policies may cover business interruption, but such coverage may require a direct physical loss, which may not occur. If there is business interruption insurance, can the proceeds be added to EDITDA for purposes of determining financial covenant compliance?

(iv) Bringdown of Representations and Warranties

Since representations must be accurate at the time of each borrowing under a credit facility, contingency plans should be developed if there are concerns about maintaining the accuracy of any credit agreement representations as of anticipated drawdown dates. Examples of representations that may be adversely impacted by the current disruptions and that should be closely examined include those relating to the absence of a default under the credit facility, absence of defaults under agreements with third parties (e.g., material supplier and customer contracts), borrower's solvency, the absence of proceedings or litigation, and no MAE. While many representations are qualified by MAE (which is typically negotiated and defined in respect of each credit facility), there is no bright-line test in the applicable case law to analyze whether the facts will meet the defined MAE standard. Therefore, lenders typically are reluctant to rely solely on an MAE for asserting a default or refusing to fund and instead prefer to rely on an event of default that is less open to interpretation. However, COVID-19 is an unprecedented event that could be expected to have a substantial and prolonged effect on certain industries, so in connection with any borrowing, a close review of the contract language and all the relevant facts and circumstances will be necessary.

(v) Clean-Downs

While not common in US credit facilities in recent years, portfolio company (and project finance) credit agreements sometimes include "clean-down" provisions. These are requirements to periodically pay down a revolver to a specified amount for a specified short period of time. The business disruptions caused by COVID-19 may result in borrowers having difficulty meeting their clean-down requirements, resulting in waiver requirements

and/or additional capital needs, or, particularly in a project finance context, leading to a distribution blocker (if cash might otherwise be, or have been, available for distribution).

(vi) Financial Covenant Compliance

If a borrower expects covenant compliance issues, it is usually advisable to engage with lenders early to discuss waivers or modifications in advance of a default. Since many financial covenants are tested on a trailing 12-month basis, the results of prior periods may temporarily cushion the impact of COVID-19 on financial covenant compliance. On the other hand, reduced EBITDA in the first two fiscal quarters of 2020 could have financial covenant implications until mid-2021. Waivers are commonly available for covenant breaches that are expected to be one-time events, although lenders may expect a fee for approving the waiver and further constrained credit markets and a prevalence of borrowers requesting covenant relief could make waivers more difficult to obtain than in the past few years. Consider whether an equity cure is available and may be preferable to seeking a waiver for a covenant breach (see further below). Where covenant issues are expected to be recurring, which may be anticipated due to the significance and prolonged nature of the economic impact expected from COVID-19, borrowers should seek to reset their covenant levels in line with expected reductions in EBITDA over the period that will be impacted. Usually, financial covenants are set with a percentage cushion to the borrower's expected covenant level each quarter, although in resetting covenant levels as a result of COVID-19, lenders may be less willing to provide the typical level of cushion. Clear updated business plans and financial projections will assist in assessing the required covenant levels and appropriate cushion, although these may require more time for completion, meaning a one-time waiver may be necessary initially. Further, following a request by a borrower to reset covenant levels, lenders may seek to renegotiate other terms and will require time to understand the borrower's updated plans and financial model.

(vii) EBITDA Add-Backs

Closely scrutinize available EBITDA add-backs or adjustments to understand what is available to the borrower to assist in satisfying covenant compliance determinations. For example, determine whether COVID-19 related expenses or write-offs qualify as one-time or non-recurring expenses that can be added back to EBITDA. How are business interruption insurance proceeds treated (see above)?

(viii) Sale-Leaseback Transactions

Review baskets and other credit agreement provisions to determine if there is capacity for a sale-leaseback of assets to generate cash for short-term liquidity requirements or prepayments of debt. Identify assets that could be sold and leased back (e.g., owned real estate and certain capital equipment).

(ix) Negative Covenants

While the negative covenants may not be directly impacted by the economic impacts of COVID-19, they include many exceptions to create flexibility for borrowers to operate their business in a way that promotes growth, such as by acquiring assets, incurring debt and granting liens. Often the utilization of certain covenant exceptions is contingent upon the borrower satisfying a pro forma leverage ratio, debt service coverage ratio incurrence test or other financial ratio test, and certain covenant exceptions can include baskets that grow as EBITDA increases. Therefore, a borrower's ability to utilize certain negative covenant exceptions may be restricted by a reduction in EBITDA. Similarly, in asset-based facilities, certain covenant exceptions may be subject to a pro forma availability test, and therefore covenant flexibility may be limited if availability under the facility falls below the required threshold.

(x) Prepayments

Examine each borrower's credit facility to determine whether an anticipated covenant breach can be avoided with a voluntary prepayment from cash on hand. A well-timed prepayment can reduce leverage prior to the applicable covenant testing date and potentially may provide a buffer in the debt service coverage ratio the next three quarters. If a credit facility allows the borrower to direct the application of voluntary or mandatory prepayments to amortizing debt, it may be possible to use proceeds from asset dispositions to reduce upcoming debt service, in addition to leverage. Borrowers should note however, that often leverage ratios and/or financial covenants are based on a "net debt" concept, meaning that for the purposes of such leverage calculations, if available cash is used to prepay debt, it may not be fully effective in improving the ratio calculation.

(xi) Infusions of Additional Capital/Equity Cures

If additional capital will be injected into the borrower, consideration should be given to whether it should be in the form of equity or subordinated debt. Each credit facility should be examined to determine if an equity or subordinated debt injection can be subsequently designated as a "cure amount," if the borrower is unsuccessful in obtaining a financial covenant waiver or refinancing the credit facility. Equity cure rights usually can be exercised within 10 to 20 business days after the compliance certificate delivery deadline and generally apply to all financial covenants, but credit

facilities should be examined to determine the parameters around exercising an equity cure, the limitations on the number and timing of permitted cures, permissibility of over-cures, and the application of cures to successive quarters. In addition, borrowers should determine whether the entirety of cure payments must be used to prepay debt, or whether a portion of the cure payment may be kept on its balance sheet or used for other purposes.

Private equity sponsors will sometimes make equity cure payments in advance of borrower's delivery of its compliance certificate in order to avoid a default. This may be important to preserve the borrower's ability to draw on its revolver during the 10-20 business day period before the equity cure is made. However, private equity sponsors must weigh this benefit against the implications of perhaps unnecessarily calling capital from investors.

(xii) Financial Reporting and Information Rights

Credit agreements include requirements to deliver financial statements and other reports, compliance certificates, notifications of defaults and events of default and often, a catch-all provision allowing lenders to make reasonable requests for other requested information. Consider whether any waiver is likely to be needed to meet the timing of delivery requirements and/or to revise budgets or forecasts. As a general matter in the current environment, it may be advisable for borrowers and their private equity sponsors to keep lenders informed about developments in a borrower's business and the expected impacts of developments resulting from COVID-19 ahead of reporting deadlines. Surprising lenders with information about unanticipated issues that a borrower has known about for some time is unlikely to establish a constructive tone for further conversations about potential waivers or amendments. Private equity sponsors and portfolio company management should designate individuals to conduct discussions with lenders and communicate regularly about developments affecting the borrower, the information to be provided to lenders, and the content and timing of disclosures to lenders. Further, in considering what information to disclose to lenders, those individuals should consider the relationship dynamic with their existing lenders, including whether it will set an expectation for similar disclosure in the future. Selective voluntary disclosure by a portfolio company or its private equity sponsor to certain lenders and not other lenders of the same company could also give rise to issues.

(xiii) Events of Default

Borrowers should consider the relevant grace periods (if any) for different events of default to understand the time period permitted for curing a default. A "Default" under a credit agreement (that is not yet an event of

default) will have various implications, including the inability to drawdown new funds under the credit agreement and the requirement to provide notice to lenders identifying the nature of the default and the steps being taken the remedy the default.

(A) Failure to Pay Required Interest or Principal Payments

Many recent credit facilities include a three to five business day cure period for a failure to pay interest or fees under a credit agreement, but there is typically no grace period for failure to make principal repayments.

(B) Qualified Audit

Many borrowers are in the middle of their annual financial statement audits. Going concern qualifications in audit reports usually result in a covenant breach. In most cases, auditors' reports include only an "emphasis of matter" and not an audit qualification for projected financial covenant defaults. However, borrowers should discuss this distinction with their auditors and confirm this conclusion. A "going concern" qualification can arise where an auditor does not believe that a borrower will be able to satisfy its short-term debt (one year or less) without a refinancing. In addition, credit agreements should be promptly reviewed to determine other specified audit qualifications that may trigger an event of default. Given the current economic environment, borrowers may need to consider whether to seek a one-year holiday on delivering audits that do not contain a going concern qualification.

(C) Cross-Defaults

Credit facilities should be reviewed to identify cross-default provisions (including any cross-acceleration provisions). A default under any material debt of a borrower (above a specified dollar amount) will usually trigger a cross default under other material debt, including under the credit agreement.

(D) Material Contracts

Does the termination or non-performance under any material contract trigger a default or an event of default? What cure period exists, if any, to cure the default and can the relevant contract be replaced to cure any such default? Borrowers may want to do increased diligence on force majeure or termination provisions in any relevant material contracts to understand whether the third party

may validly avoid their contractual obligations and/or terminate the contract.

(E) Cessation of Business

The closing of the borrower's business (or a material portion thereof) as a result of COVID-19 will likely lead to an event of default under the credit agreement.

(F) Litigation/Material Judgments

Often the litigation default is qualified by MAE or other materiality. However, a judgement usually triggers a default if the amount of the judgment is above a specified dollar amount (often set at the same level as the cross-default threshold) and is not paid within a defined period of time.

(G) Bankruptcy/Insolvency/Creditor Proceedings

Note that the definition of "insolvency" varies by jurisdiction and can be broadly defined. In determining whether there is an issue, refer to the governing law and jurisdiction provision of a credit facility. Also, consider whether an insolvency of a foreign subsidiary could be caused by a balance sheet insolvency, and result in a bankruptcy event of default under the credit agreement.

(H) Material Adverse Effect

While unusual, certain credit facilities include an express MAE event of default. The term will be defined in each credit agreement and the negotiated exceptions in the definitions should restrict its application to very limited circumstances. As explained above, in the absence of another clear event of default, it is unlikely that a lender will seek to rely solely on a MAE event of default as a basis for taking enforcement action.

(xiv) Debt Repurchases

(A) Portfolio company borrowers, or their private equity owners (or affiliated funds), may wish to contemplate repurchasing debt, especially where the debt is trading significantly below par. A credit agreement will often have specific provisions relating to debt repurchases (particularly in a term loan B financing) and the rules are typically different depending on whether the debt repurchase is made by the borrower (or one of its subsidiaries), by affiliated funds of the borrower that are bona fide debt funds (and act independently

of the private equity business), or by an affiliated fund that indirectly controls the borrower through equity ownership and is not a bona fide debt fund. Note that usually only term loans (and not revolving loans) can be repurchased.

(B) There are various issues to consider in relation to a debt repurchase which need to be carefully analyzed on a fact specific basis. For example, the tax implications that may arise (and any solutions to mitigate tax issues) should be closely considered. Usually a repurchase of debt by the borrower itself will result in a cancellation of the debt, which can lead to a tax liability. In addition, borrowers and private equity firms should consider whether the purchaser of the debt is in possession of material non-public information and whether securities laws, anti-fraud law or general internal insider trading policies would restrict the debt repurchase. The ability to vote on any waiver or amendment with respect to any repurchased debt under a credit facility may also be limited and differ between affiliated bona fide debt funds and affiliated non-debt funds. Consideration should also be given to corporate governance matters and bankruptcy issues that may arise in relation to a debt repurchase.

Please note that each credit facility that a portfolio company has in place was likely highly negotiated. It may include provisions that were consistent with market dynamics at the time entered into and also certain terms specifically requested to take into account the needs or desires of a particular portfolio company during the term of the credit facility. While the above-mentioned provisions are contained in a broad array of credit facilities, their exact terms and their impact on a specific company or business may vary widely, and they should be closely reviewed in light of the specific circumstances affecting an entity and its business.

(b) Commercial Contracts

(i) Force Majeure/Material Adverse Effect

Recent supply-chain disruptions, event cancellations, and social distancing have led to questions about when a party may be excused from its obligations under a contract, leading corporate lawyers to focus on force majeure and MAE clauses in their commercial contracts. These clauses can be of particular importance in take-or-pay arrangements in which a party is required to accept delivery of goods or pay a specified amount. Invoking an argument to excuse performance based on force majeure or MAE should be avoided if possible, especially where the parties can mutually agree to delay payment or delivery terms until the crisis subsides.

Force Majeure. Many commercial contracts contain "force majeure" clauses which generally excuse performance because of traditional "acts of

God" (e.g., hurricanes, fires) or human events beyond control (e.g., riots, wars). In addition, related common law doctrines may excuse performance in certain cases. The application of force majeure clauses and related common-law doctrines is highly fact specific and dependent on the language of the parties' contract, the governing law of the contract, and the nature of the event that is purported to have caused non-performance.

See the following article and webinar previously published by Baker Botts for more information. The webinar includes a detailed analysis of force majeure clauses in connection with the COVID-19 epidemic but if you do not have time to watch the entire program, your Baker Botts lawyer can separately provide written materials that served as the basis for the webinar.

Article:
https://www.bakerbotts.com/insights/publications/2020/march/force-majeure-and-related-doctrines

Webinar:
https://www.bakerbotts.com/insights/publications/2020/march/force-majeure-considerations-in-light-of-energy-downturn-covid-19

Material Adverse Effect. While less common that force majeure clauses in commercial contracts, MAE (or similar term) clauses also can excuse performance based on a contractually agreed definition which can include "act of God" related events. See Section 2(a)(vi) above for information on MAE clauses generally.

(ii) Adding Pandemics to Force Majeure and MAE Definition/Exclusion

While putting forward an argument centered on force majeure and MAE should be invoked only when payment or delivery alternatives fail, parties should consider adding COVID-19 or other pandemics to newly drafted provisions going forward. Even if the current crisis abates in the short term, there could additional waves of social distancing and quarantines later in the year or beyond.

Within newly drafted force majeure clauses, parties should consider adding COVID-19 and/or pandemics to an enumerated list of triggering events (as opposed to relying on catch-all "acts of God" language). MAE clauses, on the other hand, often include a list of excluded events that do not constitute an MAE (often with a caveat that the exclusion falls away if the event disproportionally effects the party to the contract). Parties should consider whether COVID-19 and/or pandemics generally should, or should not, be excluded. Alternatively, commercial parties may insist on language that such events automatically trigger an MAE as contractually agreed between the parties.

(iii) Contract Review

In reviewing commercial contracts, parties should pay close attention to provisions that may be triggered or modified as a result of COVID-19. While representations and warranties, general covenants, force majeure, MAE, indemnification and termination provisions are obvious contenders, there are others to keep in mind. Fluctuation in currency values may have a direct effect in the contract's pricing. Parties should consider how to allocate future risk through flexible pricing or hardship clauses. Change in law provisions are triggered upon a change in law that makes performance impossible, or that results in increased costs. This is not a finite list of items that could be affected in commercial contracts and parties should consider what other provisions could be impacted by the current crisis.

(c) Leases/Landlords

Many leases will include force majeure clauses which may be broad enough to cover COVID-19, its secondary effects, or subsequent actions such as governmental orders (see the discussion regarding force majeure clauses above). While a force majeure clause may excuse a party's performance over certain lease obligations (such as obligations to operate as the intended business that executed the lease), many contractual force majeure clauses expressly except monetary obligations, including the payment of rent. Accordingly, in these leases, rent abatement is unlikely to be permitted due to current circumstances even if a company is temporarily unable to occupy the premises.

(i) Negotiated Payment/Rent Deferrals

If a company desires rent relief in the current environment, it should consider approaching the landlord to negotiate a lease modification. The modification could defer or reduce rent for a negotiated period. If the landlord insists on repayment of the rent after the crisis is over, the modification should include clear terms for the repayment. Companies should be aware that landlords are likely receiving similar requests from many tenants and negotiating these agreements may take time.

Note that the PPP under the CARES Act permits funds obtained under the program to be applied toward rent under a leasing agreement that was entered into before February 15, 2020. Subject to restrictions under the PPP, including retention of workers, funds used toward rent are fully forgivable under the PPP. As stated in the PPP discussion above, portfolio companies controlled by private equity firms are likely not eligible for PPP funding at this time if all controlled portfolio companies exceed 500 employees. However, companies should wait for additional SBA regulations to determine if affiliation rules are ultimately relaxed.

(ii) Consequences of Non-Negotiated Payment/Rent Deferrals

If a company elects not to, or is unable to, negotiate a modification with a landlord and fails to comply with the terms of its lease, whether by not paying rent or otherwise, the company may be in default of its lease (subject to any notice and curative periods therein). This will potentially subject the company to any rights and remedies available to the landlord after a tenant default. Note, however, that many states and localities have enacted eviction moratoriums which may affect the landlord's remedies in the short term.

(d) Rolled Equity Buyout and Put/Call Option Triggers

Portfolio company operating agreements and certain sponsor partnership agreements (e.g., carried interest vehicles) may include put and call provisions that allow the applicable entity to redeem the equity interests therein held by a founder with rolled equity, a member of management, or an investment professional under certain specified circumstances, usually including separation of employment. In some cases, the terminated individual may also have the right to put equity to the entity.

The consideration payable by the redeeming entity in the event of a put or call exercise is often dependent upon the auspices of the equityholder's separation from employment (e.g., termination for "Cause," termination without "Cause," resignation for "Good Reason," resignation without "Good Reason," and/or death or "Disability") and can be calculated as a percentage of the fair market value of the redeemed interest by the entity's board of directors or similar governing authority or based on an enterprise value formula (e.g., assuming a sale of the entity at some multiple of trailing EBITDA). In the case of put/call provisions that require valuation by the board, the impact of COVID-19 may result in lower redemption prices immediately, while valuation provisions that rely on trailing financial performance may not adjust to current market realities for some time.

In some cases, put/call consideration may be in the form of either cash or subordinated debt. Given the current market turmoil, subordinated debt may represent only a slightly improved capital structure position relative to equity and without the potential for upside if value impairment is resolved when market conditions normalize.

If sponsors or portfolio companies are required to impose lay-offs in the wake of COVID-19 that affect members of management or others with equity interests that are subject to put/call options, such separations will generally be treated as terminations without "Cause," which often trigger call and/or put rights at fair market value, or in some cases at a premium to fair market value. In addition, a reduction in compensation (sometimes with the exception of a proportionate reduction in connection with across-the-board pay cuts) may allow a manager to

resign for "Good Reason." As with terminations without "Cause," resignations for "Good Reason" may likewise trigger call and/or put rights at fair market value, or in some cases at a premium to fair market value.

Sponsors and portfolio company boards should carefully review the put/call provisions in their relevant operating and partnership agreements and should consult with counsel before implementing any staff reductions or compensation adjustments that could trigger any put/call options.

(e) Governance/Board Duties

When making decisions to address fund and portfolio company investment and operational issues arising as a result of COVID-19, private equity sponsors should bear in mind their duties to fund investors and co-investors in portfolio investments. If portfolio companies are struggling with liquidity issues and insolvency and bankruptcy become serious considerations, the parties to whom duties are owed may have expanded to include all stakeholders, including creditors. In such scenarios or when in doubt, we recommend contacting restructuring counsel before making material decisions in order to ensure that you understand your specific duties and the parties to whom they are owed.

(f) Insurance/Risk Mitigation

(i) Review Policies, Including Business Interruption, General Liability, and Environmental Insurance

(A) First-party Property, Pollution, and Business Interruption Insurance

- For stoppage or slowdown of business, typically due to a physical loss or damage to the covered property (but usually not available for direct person-to-person transmission). Insurers will likely argue that COVID-19 is not a physical loss or damage because the harm caused to an insured's property by COVID-19 is not tangible. Insureds may counter that COVID-19 renders its covered property unusable, either because of actual or suspected COVID-19 contamination. Whether COVID-19 is covered will depend on the specific policy language and the facts and circumstances of the claim. At least one major international broker has already alerted its client insureds that it does not believe that the COVID-19 crisis triggers typical business interruption coverage due to the absence of actual property damage to an insured's property. Loss of Attraction extensions, however, may exist under policies and usually do not have the triggering requirement of "physical damage" or, depending on the

policy language, "physical loss or damage" to insured premises.

- Property/Business Interruption policies cover, among other things: (1) the cost to clean up contaminated factories, buildings or other premises, or parts, supplies or other materials and render them safe for use; and (2) lost revenue or lost profits resulting from plant shutdowns, or customer or supply chain disruptions caused by COVID-19.

(B) Commercial General Liability (CGL) Insurance

For liability to third parties arising from bodily injury or, potentially, personal injury or property damage (including direct person-to-person transmission, as well as contamination of property).

(C) Directors & Officers (D&O), Management Liability, Errors & Omissions (E&O), and Professional Liability Insurance

For claims that management personnel failed to take appropriate measures to protect the business or third parties (including direct person-to-person transmission, contamination of property, or secondary effects such as financial losses).

(D) Workers' Compensation Insurance

Adopt protocols and procedures to help employees make a record establishing work-relatedness in submitting claims.

(E) Event Cancellation Insurance

Event Cancellation policies cover, among other things: the amount you are out of pocket, including extra costs related to refunds, vendor costs, notification costs, administrative costs, as well as the lost revenues resulting from a cancellation.

(F) Recommendations

Look for the following in your policy:

- Communicable Disease Coverage Grants – some policies contain such coverage;

- Contamination Exclusions – depending upon how they are worded, they may not preclude COVID-19 coverage; in addition, they may not apply to all coverages under the

policy, and may not apply if the policy contains a "Communicable Disease" coverage grant; and

- Various Conditions/Requirements – when notice is required; level of claim proof required and timing; loss mitigation requirements; some policies (and some court rulings) require notice to be given very soon after a claim arises (sometimes within weeks).

Consider the applicable law:

- Most policies do not have choice of law provisions; but
- The coverage provided and various conditions can be greatly affected by the law of the applicable jurisdiction.

Document your claim, including:

- The presence of coronavirus or COVID-19 at the relevant location(s) (ideally documented by an expert/vendor);
- The time frames for shutdowns, supply disputations, etc.; and
- All lost income and costs.

Review your contracts to assess whether you are obligated to provide coverage to customers/clients, joint venture partners, contractors or others for risks outlined above.

Review customer contracts to assess whether you are entitled to coverage provided by customers/clients, joint venture partners, contractors or others for risks outlined above.

If so, request copies of relevant insurance policies (not just certificates of insurance) and review them to assess potential coverage.

(ii) Add Visitor Warnings/Disclaimers

First, stay informed about your relevant jurisdiction's stay-at-home orders and policies, follow them, communicate them to your business partners, and document your decisions regarding them.

If you continue operations, take a number of steps to minimize the risk of spread.

- If you can conduct an event virtually, then consider doing so.
- Clearly instruct all employees and business partners that if they are not feeling well to stay home and require a confirmation before in-person activity begins.
- Ensure that your premises (either managed by you or a property management company) are undertaking appropriate cleaning protocols.
- Send notifications to business partners in advance of in-person meetings of the need to maintain social distancing and hand washing/sanitizing practices and require a confirmation before the in-person activity begins.

(g) ERISA – Defined Benefit Plans

(i) CARES Act Relief

The CARES Act provides some relief for single-employer defined benefit pension plans by allowing for delays for the minimum required contributions that are normally due in 2020. If a minimum required contribution is delayed pursuant to this relief, the contribution will subsequently be increased by interest during the period the contribution remains unpaid. In addition, relief is provided under CARES Act to waive the benefit restrictions under Section 436 of the Code (e.g., restrictions on lump sum distributions, amendments to improve benefits, etc.) that apply when a plan is severely underfunded. The triggering of these restrictions normally depends on the plan's current funded status, referred to as the "adjusted funding target attainment percentage" ("**AFTAP**"). Under the CARES Act, a plan may substitute its most-recent pre-2020 AFTAP as the AFTAP that will apply for calendar year 2020. This relief may help avoid situations in which the restrictions under Section 436 of the Code are triggered by a sudden drop in the asset values in the plan due to the markets.

(ii) Other Considerations for Single-Employer Defined Benefit Plans

Other regulatory considerations for single-employer defined benefit pension plans are arising as a result of recent layoffs and downsizing. This can trigger partial plan terminations that result in automatic 100% vesting for the affected employees (see above discussion regarding 401(k) plan considerations for partial termination definitional matters, etc.). In addition, employers can trigger notice and liability obligations if these actions result in what is known as a "substantial cessation of operations" (generally at least a 15% reduction of the employee population that is eligible to participate in a qualified retirement plan). While certain exemptions may

apply for small plans or well-funded plans (i.e., without regard to the CARES Act relief described above), layoffs and downsizing can trigger significant plan funding obligations as well as notice obligations to the Pension Benefit Guaranty Corporation.

(iii) Other Considerations for Single-Employer Defined Benefit Plans

Similar layoff/downsizing issues arise with respect to multiemployer defined benefit pension plans. These actions can trigger significant multiemployer plan withdrawal liabilities for an employer if such actions result in a permanent cessation of its contributions to the plan or at least a 70% reduction in its plan contribution base units (normally hours worked) for a three-year period. While layoff and downsizing normally are not considered to result in permanent cessation of contributions, the multiemployer plan itself is responsible for making these determinations as an initial matter and employers may need to contest those determinations in order to avoid withdrawal liability.

(h) Intellectual Property

(i) Intellectual Property filings, including Patents, Trademarks and Copyrights

Currently, the United States Patent and Trademark Office ("**USPTO**") and the Copyright Office ("**CO**") are closed to the public. However, the deadlines for such filings and responses currently remain unchanged. As part of the relief under the CARES Act, Congress has authorized USPTO to take action if it chooses to suspend or temporarily delay filing deadlines that are set by statute. We are monitoring any such guidance that follows and will provide that information to any interested companies. As a further note, patent examiners are continuing to work remotely on responses.

(ii) International Intellectual Property

Several international patent offices have suspended deadlines at least through March or to mid-April. We are collecting daily information regarding World-Wide Patent Office updates and can address any questions you have.

(iii) CCPA

California landmark privacy law requires companies to confirm compliance by July 2020. Several businesses have raised concerns about the ability to comply given resources devoted to managing the current pandemic. Several letters to the California Office of the Attorney General request at least a six-month extension to enforcement of the CCPA. Baker Botts will continue to

monitor these developments. If your company has specific questions regarding timetables for enforcement of the CCPA, please let us know.

If you have any questions regarding the unprecedented business, financial and legal challenges for private equity funds and their portfolio companies including labor/employment, tax matters, working remotely and related data privacy and security issues, M&A and capital raising and deployment, please visit https://bakerbotts.com/services/practice-areas/corporate/private-equity.

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