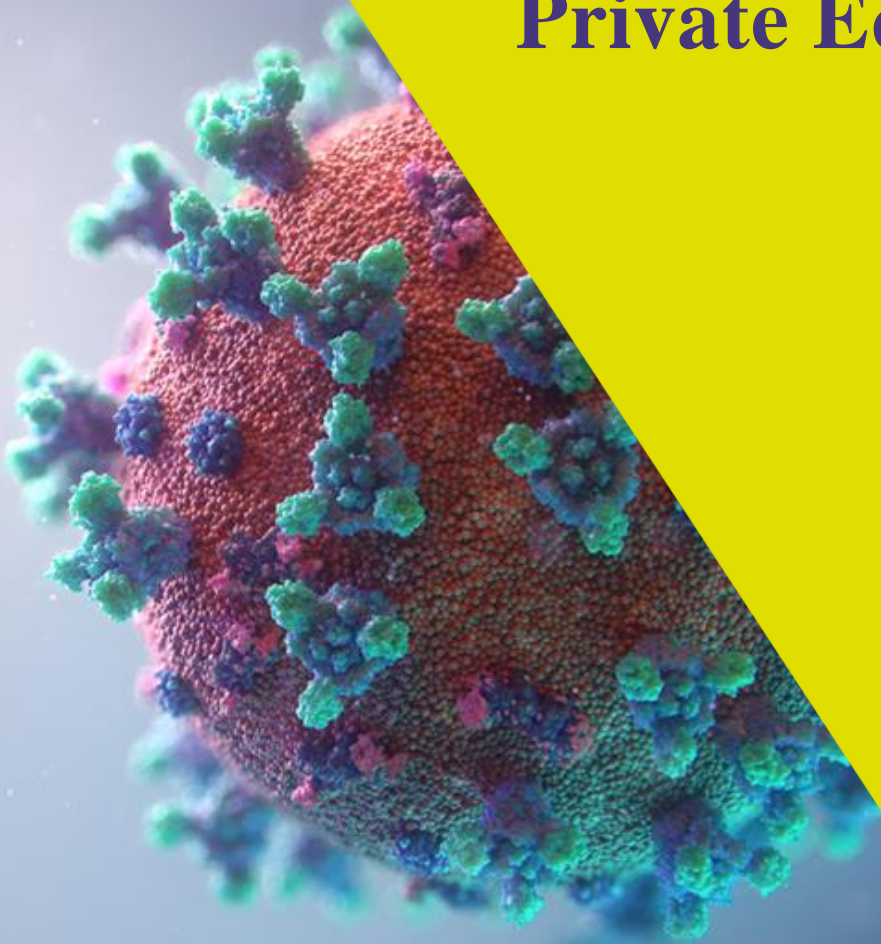


 Burness Paull

COVID-19:

A Guide for Private Equity Firms



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Executive Summary

The Coronavirus pandemic has raised new and complex challenges for businesses worldwide. Governments of many countries have sought to shore up their economies by supporting businesses through various means.

To a large extent private equity-backed businesses will be affected in much the same way as any other - the focus for almost all businesses is currently cash management, i.e. limiting outgoings – rent, wages, suppliers, VAT etc – on one side of the equation and ensuring access to sufficient cash – e.g. through loans and governmental schemes – on the other.

The specific features of private equity businesses also give rise to some particular considerations, for example:

- How should you balance the needs and demands of different stakeholders – debt providers, equityholders, management and employees?
- Can emergency government funding be sought or is this inconsistent with the group's existing financing package?
- How can investor directors' duties to different companies within a group structure be balanced in difficult times?

We have set out further commentary on each of these areas below. We have also included further information on some of the main factors affecting many businesses, including in relation to commercial contracts and property.

Investor Directors and Portfolio Companies

What are your duties?

Investor directors will be well aware of their duties under the Companies Act 2006 to act in the best interests of the Company on whose board they sit, namely:

- Duty to act within their powers, in accordance with the company's constitution, and to only exercise powers for the purposes for which they were conferred.
- Duty to promote the success of the company for the benefit of its members as a whole.
- Duty to exercise independent judgment.
- Duty to exercise reasonable care, skill and diligence.
- Duty to avoid conflicts of interest.
- Duty not to accept benefits from third parties.
- Duty to declare an interest in a proposed transaction or arrangement.

These duties apply to all directors, whether executive or non-executive, and including the chairperson. Investor directors will also be familiar with the considerations around ensuring compliance with their duties to a portfolio company, and the potential conflicts that can arise in connection with their position within the private equity manager and its duties to investors.

These duties will of course persist during difficult times, but a few particular considerations may come more sharply into focus:

DIRECTORSHIPS WITHIN A GROUP STRUCTURE

Where a director sits on numerous boards within a triple or quadruple newco structure, possibly as well as the trading companies, those interests will often be aligned under normal circumstances. However, when trading difficulties arise, these interests may conflict – does additional lending need to be taken on? Can intra-group guarantees be justified in these circumstances? Is there existing intra-group lending that needs to be factored in?

A director's statutory duties are owed to a company itself, and they are required to act in way that the director considers would be most likely to promote the success of the company for the benefit

of its members. The success of a company is likely to be interdependent with the success of other companies in the group and often with its ultimate shareholders. Where these interests do compete however, as is more likely to be the case in difficult times, additional care needs to be taken to ensure that a director does not find themselves inadvertently in breach.

INSOLVENCY CONSIDERATIONS

Once a company is at risk of insolvency, the scope and nature of the duties of its directors shift significantly. In particular, their primary duty changes so that they must act in the best interests of the company's creditors. If the directors continue to trade when they knew or ought to have known that there was no reasonable prospect that the company would avoid entering insolvent administration or liquidation, they run the risk of being held personally liable to the extent that losses to the creditors increase as a result of trading beyond the point of no return. The government has indicated its intention to revise these obligations, as a direct response to the COVID-19 situation. It is not yet clear exactly what these changes will entail, and we are monitoring developments in this respect - you can read up-to-date analysis from our insolvency team [here](#).

In any case, the key considerations that apply in any period of financial difficulty will continue to apply:

- closely monitor the business and ensure any changes are properly considered, and existing steps revised if necessary;
- comply with good corporate governance and keep proper records of decision making;
- engage with creditors and stakeholders at an early stage;
- seek professional advice where there is any doubt as to the appropriate steps to be taken. Although advice will involve an additional cost, it is often vital in protecting the position of the board and creditors alike, and is a relevant element in the defence to wrongful trading and other proceedings typically brought against directors.

Managing Stakeholders

DEBT PROVIDERS

The majority of private equity portfolio companies will sit within a security group for the purposes of their financing arrangements. While the government's emergency loan schemes and availability of financial assistance for companies in difficulty have attracted much attention (see further below), these must be considered in the context of the arrangements that the group already has in place.

– Events of default

If the group is facing financial and/or trading difficulties, it is important to consider whether any event of default may have been triggered under existing finance arrangements. There may be notification requirements if so.

Whether or not a formal notification is required, it is advisable to engage proactively with debt providers at an early stage. In a pan-market event such as the current COVID-19 related situation, many businesses are facing similar issues. Lenders are generally keen to help ensure that problems do not become insurmountable, and it is often possible to renegotiate finance terms – e.g. by resetting covenants for “new normal”, agreeing interest holidays and/or rescheduling repayment profiles and cash sweep obligations.

We are not aware of any lender having called a Material Adverse Effect, or using it as a draw stop. That said, the longer the crisis continues the more likely it is that lenders will raise MAE concerns.

– Additional borrowing

If additional borrowing is required by the business, the main options available are to (i) extend borrowing from current lenders; or (ii) take advantage of government support:

- (i) Borrowing extensions: consider precautionary drawings under existing arrangements – this is likely to become more challenging as lenders will inevitably look to restrict as the crisis endures.
- (ii) Government support: while all government support is welcomed, timing needs to be considered. As lenders are still required to apply their own credit analysis of the lending request and consideration is still being given to ranking of debt, availability of the funding is neither certain nor quick. Early engagement is therefore essential.

Access to any additional loan funding is likely to require support from the private equity sponsor either in the form of equity or fund guarantees. Loan applications are currently

being reviewed in the normal way, with the Coronavirus Business Interruption Scheme only making a difference in certain marginal cases. It is not yet the game changer people hoped for when first announced, and in a private equity context, if funding is needed quickly, it is more likely that the fund itself will need to be called upon.

EQUITY HOLDERS

An event of default arising in a portfolio company's debt documents could give rise to a cross-default in the applicable investment agreement. It could also trigger step-in rights or enhanced voting rights at board and/or shareholder level, or a right for investors to invest emergency funding with a corresponding catch-up right for management after the event.

Further, some relatively drastic action could be required in order to enable a business to deal with the COVID-19 situation. For example it may be inadvisable or even illegal for the business to continue to trade. Cessation of trade, even temporarily, is likely to be a consent right under the investment agreement.

It is important to review the applicable investment documents to determine exactly what the implications of the current situation are. Whether or not an investor wishes to enforce its rights, there may be steps which it may wish to take to preserve these rights in case of a further change in circumstances.

Many investors find themselves in these circumstances and are currently considering their rights carefully. While a variety of rights may be triggered, determining whether they wish to use them is a judgment call. This is not a normal default scenario, and injection of capital will of course not have the effect of returning the business to the ordinary course, nor will stepping in to take the reins necessarily do anything to improve the position, particularly where a number of investee companies are in the same boat. The relationship with management should also be considered – generally, it is likely to be seen as preferable for management and investors to work together in a collaborative fashion rather than to have to formally exercise rights.

In weighing up the competing demands and rights of debtholders and equityholders, some tension is inevitable. Communication is key in ensuring business continuity or indeed that the business can be temporarily halted with as little adverse effect as possible. As noted above, banks are likely to be flexible and early discussions should be held with them to attempt to put in place a revised arrangement that will ease the pressure on the business. We are also seeing equityholders take a relatively relaxed approach to their formal investment rights, but at the same time consideration must be had to any knock-on effects of this.

Some key considerations investors are needing to give thought to are:

- How does any additional funding (debt or equity) interact with that which is already in place?
- If additional equity is to be injected, how is this priced?

- How will any steps that the investor takes affect its relationship with management?
- Does the fund life or investment period need to be extended?
- Do any notifications need to be made or rights reserved at an early stage?

EMPLOYEES

Employees are central to any business continuity or emergency plan. Recognising this, the government has included employee support measures in its response to the crisis.

The coronavirus job retention scheme enables eligible employers to apply to HMRC for a grant of up to 80 per cent of furloughed workers' pay. The concept of a furloughed worker is not something that has, until now, had any formal status under UK employment law. It appears that the Government intends furloughed workers to be individuals who are doing no work at all for their employer and are on an agreed period of absence. The furloughing in this context is being done to avoid redundancies and unpaid leave.

The clear intention of the scheme is to save jobs and protect workers' pay during this crisis. In turn, relieving businesses of a large proportion of their payroll costs will clearly allow a number of businesses to continue trading when they may otherwise not have been able to do so in the current economic situation. Furloughed workers would then, it is assumed, be brought back into the workplace on their previous terms and conditions once the crisis is over.

The Scheme will be operated by HMRC and it is hoped that the first payments will be processed within a matter of weeks. We have been told the current system is not set up to make payments to employers, so this will take time. Businesses who cannot afford to wait until then are being urged to consider the other business support measures introduced by the Government such as business interruption loans and other tax relief options (see further below).

The scheme is unprecedented and will need to be implemented in a manner consistent with existing employment law, so businesses will need to take care on the finer details to make sure they qualify for the funding.

For further information, please see our [Guidance note for employers – Coronavirus Job Retention Scheme](#).

If the business does not fall within one of the categories which is listed in the government's shutdown orders and there is a wish to continue to operate, employees should work from home where possible. If this is not possible, employees may be asked to travel in to work, however this should also be carefully considered. Any business would of course have to ensure compliance with their health and safety obligations in the workplace which are heightened and very particular to COVID-19 at the moment. Care needs to be taken not to take too harsh an approach to employees

who say they are worried about attending work due to health and safety concerns and advice should be sought before disciplining or reducing pay for non attendance.

Commercial Contracts

Businesses may wish to review their commercial contracts to determine whether any action may be taken to improve their position. The position will vary according to the nature of the business and the relationships in place, however some common themes are whether or not force majeure or frustration may be argued, and the possibility of insurance claims arising. Some further analysis of these areas can be found at the following links:

- Force majeure and frustration: [Coronavirus and force majeure - keeping your contracts safe](#)
- Supply chain contracts: [The impact of coronavirus on supply chain contracts](#)
- Insurance: [Coronavirus related losses – are you insured?](#)
- Payment terms: [Ten tips to make sure you get paid by your customers and debtors during the coronavirus pandemic](#)

Property

Many private equity owned businesses will occupy leased premises. It may be possible to request or negotiate variation to rent payment and/or other lease terms with your landlord to help ease the financial pressure and ensure that the business can continue to be viable. See our analysis of the options available here: [Coronavirus and payment obligations under commercial leases](#).

Regulated Firms

Businesses which carry on a regulated activity will have particular considerations to bear in mind. While it is important to ensure that emergency action being taken does not fall foul of regulations, regulators are considering amendments or relaxations to the rules to enable firms to continue to operate during the COVID-19 pandemic in a compliant manner. For example, see the FCA's current guidance [here](#).

Governmental Assistance

The government has announced a series of temporary emergency measures designed to support people, businesses and public services during the crisis. The measures, comprising a mix of economic and fiscal initiatives, are designed to preserve liquidity in the economy while providing crucial financial support to workers and industries impacted by a pandemic-driven demand shock.

The main economic and fiscal measures that have been announced to date are as follows:

ECONOMIC POLICIES

- Coronavirus Business Interruption Loan Scheme – A new Government-backed scheme to guarantee up to 80% of short-to-medium term funding provided to a UK SME (<£45m turnover) by any major UK bank.
- COVID-19 Corporate Financing Facility Fund – A new scheme launched by the Bank of England to provide liquidity for larger, non-financial UK companies by purchasing their short term debt.
- Statutory Sick Pay – All UK based SME's will be refunded up to 2 weeks of Statutory Sick Pay paid for any employee that falls ill due to COVID-19. Any employing SME with fewer than 250 employees (as at 28 February 2020) will be eligible for this initiative.
- Coronavirus Job Retention Scheme – See *Employees* section above.

TAX POLICIES

- Time-To-Pay Scheme – All UK businesses and self-employed persons struggling financially who have outstanding tax liabilities (including PAYE and VAT) may be eligible to receive HMRC's support through this scheme.

- VAT Deferral – The upcoming VAT quarter (from 20 March until 30 June) will be deferred and any VAT liability during this period will be paid during the last quarter of the 2020-2021 financial year.
- Self-Employed Income Tax Deferral – Income tax due by all self-employed persons by 31 July 2020 under the Self-Assessment system will now be deferred to 31 January 2021.
- Business Rates Relief (England) / Non-Domestic Rates Relief (Scotland): These schemes provide companies in the retail, hospitality, and leisure sector with relief on applicable rates.
- One off grants: Available to businesses in the retail, hospitality, and leisure sectors and to certain SMEs.
- Statutory Residence Status – Relaxation of the statutory criteria for determining tax residence in the UK in certain COVID-19 related situations.

For further information, please see our blog on [The Government's economic and fiscal response to the virus pandemic](#).

Key Contacts

These are unprecedented times, and the range of measures being introduced by the government is changing day-by-day. The summary in this note is intended to provide a guide to the main factors to be considered in a private-equity owned business at this time, and we would be happy to discuss this further in connection with any specific requirements and as the situation further develops.



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Across the firm, we have a team of specialists dedicated to provide up the minute advice on COVID-19. For more details, [click here](#).

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