Milbank

Litigation & Arbitration Group

Client Alert

COVID-19 Legal Issues: Frequently Asked Questions

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In managing the volatility and uncertainty caused by the global COVID-19 pandemic, many industries are grappling with complex legal and commercial challenges, from manufacturing shutdowns, interrupted supply chains and quarantines, to dislocated labor markets and restrictions on trade and movement, including the practical shutdown, or near shutdown, of substantial portions of the world economy. Moreover, governments have intervened to provide liquidity and emergency relief to credit markets and vulnerable industries and to preserve payrolls.

Nonetheless, economic uncertainty has forced many companies, lenders and investors to seek guidance on their rights with respect to contractual obligations, especially in these key areas:

- **force majeure provisions**
- **material adverse effects provisions**
- **ordinary course of business covenants**
- **the doctrines of impossibility and impracticability**
- **the frustration of purpose doctrine**
- **EBITDA maintenance covenants**

The analysis of any particular contract, transaction or dispute is always fact-specific and depends on, among other things, the specific contract language and conduct of the parties in each instance, as well as the relevant law applicable to that contract, transaction or dispute. Additionally, current market norms continue to evolve and legal rules cannot be interpreted in a vacuum. Regulatory and judicial interpretations of particular contract provisions, duties and applicable law may take those evolving norms into account, especially when determining concepts of materiality, reasonableness, excuse, and ordinary course operations.

As ever, maintaining collaborative commercial relationships and clear communications channels is paramount, beyond the technical interpretation of applicable contract clauses. In these challenging times, parties may receive warnings, force majeure notices, or requests for assurance from their contractual counterparties as the COVID-19 public health crisis and market conditions worsen. In such cases, in addition to conducting a contract- and fact-specific analysis, we recommend taking proactive steps, including:

- Briefing personnel who are the primary relationship managers for those counterparties, many of whom will not be lawyers, on the relevant contract doctrines—including those identified below.
- Providing standard documentation and processes to achieve consistent outcomes across large and diverse customer and supplier bases.
- Responding to each communication, particularly those where the counterparty is warning of actual or potential disruption in performance of its obligations. While it is appropriate to acknowledge the existence of COVID-19 and the need for business continuity measures, take care not to waive rights or to diverge from the terms of the underlying contracts without full analysis and proper documentation.

- Proactively contacting critical suppliers and service providers to ask those counterparties to provide information about the business continuity plans that they are executing to maintain continuity of performance.

Even though each situation is unique, the general legal principles that apply when contractual performance is stressed by external shocks are well developed.

I. Force Majeure

The concept of *force majeure* seeks to protect parties to a contract from being held to performance obligations which, due to events outside of their own control and expectation, they cannot fulfill. An assessment of a party's right to invoke a *force majeure* clause requires a review of the contract at issue. *See* RICHARD A. LORD, 30 Williston on Contract § 77:31 (4th Ed.) ("What types of events constitute *force majeure* depend on the specific language of the clause itself."). However, *force majeure* clauses are interpreted narrowly and often are difficult to invoke.

Courts generally assess the following criteria when assessing a party's reliance on *force majeure*: (i) whether the event is *force majeure* under the contract; (ii) whether nonperformance was foreseeable and could be mitigated; and (iii) whether performance is impossible. Courts narrowly apply *force majeure* to the events enumerated in the contract. *Force majeure* clauses often list the specific events (*e.g.*, floods, fires, and earthquakes) and/or categories of events (*e.g.*, natural disasters, terrorism, and government actions) that can potentially excuse performance under the contract.

Even if the event giving rise to nonperformance is within the scope of the *force majeure* clause, a party generally must also demonstrate that (i) the event was unforeseeable, and nonperformance could not be mitigated, and (ii) performance is impossible, not simply economically challenging.

- *What counts as force majeure?*

  As with all contractual disputes, courts generally begin their analysis of *force majeure* clauses by looking at the terms of the agreement and the intent of the drafting parties. Courts construe *force majeure* clauses narrowly and will generally only excuse a party's nonperformance if the event that caused the party's nonperformance is specifically enumerated. When an event is not specifically enumerated in the *force majeure* clause, but there is a general catchall provision in the clause, the catchall provision is "not to be given expansive meaning." Instead, it is "confined to those things of the same kind or nature as the particular matters mentioned." *See Kel Kim Corp. v. Cent. Markets, Inc.* 519 N.E.2d 295, 297 (N.Y. 1987) (*citing* 18 Williston, Contracts § 1968 (3d ed. 1978)).

  Generally, courts also require that the event must be unforeseeable. *See Goldstein v. Orsensanz Events LLC*, 146 A.D. 3d 492, 493 (N.Y. App. Div. 2017) ("Thus, the clause must be interpreted as if it included an express requirement of unforseeability or lack of control."). Even if an event in question fits within the delineated events that could potentially excuse performance under the *force majeure* clause, ***the nonperforming party still must establish that the event in question actually prevented, hindered and/or delayed its performance under the contract***. *Force majeure* clauses often contain provisions requiring parties to exercise reasonable diligence to avoid or overcome the *force majeure* event and its consequences, failing which performance will not be excused under the *force majeure* clause. But even in the absence of such provisions, New York courts appear to still require parties to make such a showing. Other jurisdictions, including Texas, have held that such a showing need only be made when expressly required by the *force majeure* clause.

- *Is COVID-19 within the scope of force majeure?*

  Whether COVID-19 or the governmental actions taken to contain COVID-19 are within the scope of a *force majeure* clause will depend on whether those events are listed or are of the same type of events listed in the clause. Courts construe *force majeure* clauses

narrowly and will generally only excuse a party's nonperformance if the event that caused the party's nonperformance is specifically enumerated. When an event is not specifically enumerated in the *force majeure* clause, but there is a general catch-all provision in the clause, the catch-all provision is "not to be given expansive meaning." Instead, it is "confined to those things of the same kind or nature as the particular matters mentioned." *See Kel Kim Corp. v. Cent. Markets, Inc.* 519 N.E.2d 295, 297 (N.Y. 1987) (*citing* 18 Williston, Contracts § 1968 (3d ed. 1978)).

For example, a *force majeure* clause listing floods, fires, and earthquakes likely would not include COVID-19 because disease and government action are not expressly listed. However, a *force majeure* clause listing natural disasters, terrorism, and government actions may include the government action taken to contain COVID-19, but likely would not include COVID-19 itself.

- *What if a contract lacks a force majeure clause?*

  Courts are likely to refuse a party's *force majeure* claim if the underlying contract does not include a *force majeure* clause. *See Gen. Elec. Co. v. Metals Res. Grp. Ltd.*, 293 A.D.2d 417 (1st Dep't 2002) ("The parties' integrated agreement contained no force majeure provision, much less one specifying the occurrence the defendant would now have treated as force majeure, and, accordingly, there is no basis for a force majeure defense."). In such a circumstance, a party may look to common law tools to excuse nonperformance, such as the doctrines of impossibility and, where available, impracticability.

- *Does economic hardship provide enough basis to exercise force majeure?*

  Generally, no. Absent express contractual provisions to the contrary, economic factors or financial hardships generally do not constitute *force majeure* events that excuse performance under a contract. *See* LORD, 77:31 ("Nonperformance dictated by economic hardship is not enough to fall within a *force majeure* provision."). However, the specific terms of the contract at issue and jurisdiction governing their interpretation may provide a basis for considering economic hardship when exercising *force majeure*. *See, e.g., Facto v. Pantagis*, 390 N.J. Super. 227, 231 (2007) ("A *force majeure* clause, such as contained in the . . . contract, provides a means by which the parties may anticipate in advance a condition that will make performance impracticable.").

- *Is a party able to overcome a foreseeability requirement to exercise a force majeure clause in a contract executed after the discovery of COVID-19?*

  A party exercising a *force majeure* claim generally must establish that the event giving rise to nonperformance was unforeseeable, depending on jurisdiction. If COVID-19 is the event giving rise to nonperformance, a party likely will face difficulty in excusing performance pursuant to a *force majeure* clause if the contract was executed after the World Health Organization declared COVID-19 a pandemic because COVID-19 would be deemed a foreseeable risk. On the other hand, because the COVID-19 situation is developing rapidly, as is the response of different national, state, and local governments, a party may be able to argue that the particular consequence of these responses was not foreseeable.

II. Material Adverse Effects

Complex contracts often contain a provision allowing termination of the contract, or relief from certain obligations, in the event of a "material adverse effect" or "material adverse change" ("MAE") on the business of one of the parties. Generally speaking, MAE provisions protect a party to a contract from performance when there has been an effect, change, event, or occurrence that, individually or in the aggregate, has had or would reasonably be expected to have a materially adverse effect on the other party. Exact formulations of the provision will differ from contract to contract and across contract types (*e.g.*, MAEs in merger agreements may be different than in credit agreements).

An assessment of a party's rights to invoke the MAE clause requires a close review of the context of a contract—*i.e.*, is the contract for an M&A deal, financing, *etc*.—as well as the contractual language at issue.

MAE clauses typically do not define "material," with parties instead preferring to negotiate exceptions (and exclusions from exceptions) that allocate categories of MAE risk. As a result, courts look to duration, magnitude, and foreseeability of the adverse event in determining materiality. What is durationally significant depends on the context of the contract. The length of durationally significant events for potential acquisitions can differ significantly from the length of a durationally significant event for a short-term loan. Finally, absent a specific provision to the contrary, it is generally understood that a party to a contract cannot terminate the contract based on an adverse fact that it knew about at the time it entered into the contract.

MAE clauses typically contemplate four general categories of risk: systematic or market-wide risks, indicator risks, agreement risks, and business risks. *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, at *49 (Del. Ch. Oct. 1, 2018). In the M&A context, the typical MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller. COVID-19 most likely should be considered an industry-wide risk.

- *What counts as an MAE?*

  What counts as an MAE is a product of the particular contract at issue. An MAE is generally understood as an unforeseen, durationally significant change that substantially threatens the overall financial performance of a party to the contract.

  What is a durationally significant period depends based on type of contract. In the M&A context, courts consider a change material when the change to a company's earnings power is measured in years rather than months. Whether the change is "durationally significant" differs in other contexts such as a financing—where the lender is looking at a borrower's short-term ability to make payments on the loan—or a licensing. *See Mrs. Fields Brand, Inc. v. Interbake Foods LLC*, 2017 WL 2729860, at *23 (Del. Ch. June 26, 2017) (finding that a shorter period would qualify as a "durationally significant" period for a licensee with a five-year contract as distinct from a potential acquirer in an M&A transaction).

  Most courts that have considered decreases in profits in the 40% or higher range found a material adverse effect to have occurred, but there is no bright-line rule. *Contra In re IBP, Inc. Shareholders Litig.*, 789 A.2d 14 (Del. Ch. 2001) (finding a 64% earnings drop was not sufficient to invoke an MAE clause). In industries where earnings are affected by seasonality, courts generally compare year-over-year periods rather than the prior quarter.

- *Is COVID-19 an MAE?*

  Whether COVID-19 or the governmental action taken to contain COVID-19 are within the scope of an MAE clause will depend on two primary factors: whether those events are listed in or carved out from the clause (or are events of the same type as events listed in or carved out from the clause); and the duration and scope of the pandemic and resulting governmental restrictions, including stay-at-home orders.

  Commonly, MAE provisions start with a general statement of what constitutes an MAE, and then move on to carve out certain types of events that otherwise could give rise to an MAE. For example, in a recent Delaware Chancery case, the parties specifically stated that "pandemics, . . . force majeure events or other comparable events" could not trigger the MAE clause, *Akorn, Inc.*, 2018 WL 4719347, at *51.

  Additionally, we do not yet know the duration of the pandemic or the resulting government restrictions and stay-at-home orders. Some jurisdictions have cancelled or relaxed previously pending stay-at-home orders only to reinstitute them. By the time a party's reliance on an MAE clause to nullify performance is fully litigated, a court may have the benefit of hindsight to determine whether COVID-19 is an MAE.

- *Does economic hardship provide enough basis to exercise an MAE clause?*

  Unexpected economic hardship is the basis of MAE clauses, subject to specifically negotiated carve-outs and assignment of risk in a contract. However, the economic hardship must be both durationally significant and of significant magnitude. One important question is whether, and to what extent, the at-issue MAE clause contains any forward-looking language like "would", "could", or "prospects of the party". *See, e.g.*, *Frontier Oil v. Holly Corp.*, 2005 WL 1039027, at *33 (Del. Ch. Apr. 29, 2005) (finding that a MAE clause referencing the "prospects of a party" emphasizes the need for forward-looking analysis). Forward-looking language in an MAE clause could allow a party to more readily invoke the clause based on future, expected losses from the COVID 19-related downturn, not just the already-realized losses that are properly booked now per the applicable accounting standards.

  COVID-19 and the downstream economic consequences are a rapidly evolving situation and forward-looking estimates of performance are volatile. The context of a party's business, the contract, and the ever-evolving context of the health risks and governmental restrictions will help define whether a party's economic hardship due to COVID-19 qualifies as durationally significant and of a material magnitude to qualify as an MAE.

- *Is a party able to exercise an MAE clause in a contract executed after the discovery of COVID-19?*

  This, like other MAE questions, is a highly factual question that may depend on when and where the contract was executed. COVID-19 was first reported in Wuhan, China in December 2019, and information regarding spread of the disease, health risks, and downstream economic consequences has been rapidly evolving ever since. Whether the parties to a contract were able to foresee the downstream economic consequences of COVID-19 likely depends on time of contract execution, place of performance, and location of a party's business operations. Parties that executed contracts to be performed in the United States or Europe in January 2019 would be able to put forth a more compelling lack-of-foreseeability argument than parties to a contract in China in January 2019 or parties executing a contract in New York now.

III. Ordinary Course of Business

Many contracts typically contain a covenant that requires parties to operate their and their subsidiaries' businesses in the "ordinary course of business" during the term of the contract. Absent the relevant contract defining ordinary course of business, the key inquiry in whether a company is operating in the ordinary course of business is whether a disputed practice is consistent with the company's past practices that pre-date the merger or acquisition. If a disputed practice was in place prior to the execution of the "ordinary course" covenant, courts generally find that the practice is within the ordinary course of business.

- *Are actions taken in response to COVID-19 potential breaches of this covenant?*

  While the contractual language is likely to govern, ordinary course of business covenants may be flexible considering the COVID-19 crisis. Some ordinary course covenants will provide that parties are required to undertake to comply with the covenant with "best efforts," "reasonable efforts," "commercially reasonable efforts," "good faith efforts," or another standard of conduct. If included, standard of conduct language in connection with the ordinary course covenant will shed some light on what a business is required to do. That said, some jurisdictions may find little difference among various standards of conduct. *See Williams Companies v. Energy Transfer Equity, L.P.*, 159 A.3d 264, 272 (Del. 2017) (referring to both "commercially reasonable efforts" and "reasonable best efforts" provisions, the court stated that "covenants like the ones involved here impose obligations to take all reasonable steps to solve problems and consummate the transaction" without stating any differences in the standards of conduct).

Absent standard-of-conduct language in the ordinary course covenant, courts still may allow parties flexibility when considering whether they acted in the ordinary course of business. Depending on the jurisdiction, non-routine business operations are not *per se* outside the ordinary course of business if there are compelling business reasons for such a non-routine operation. For example, one court found that a party did not breach its "ordinary course" covenant when enacting cost-cutting measures and certain lay-offs, when dictated by business circumstances. *Phoenix Techs., Inc. v. TRW, Inc.*, 840 F. Supp. 1055, 1066 n.6 (E.D. Pa.) (applying Ohio law). Parties will be safest if they can analogize current practices that are responsive to the COVID-19 crisis to past practices taken in the ordinary course.

IV. Doctrines of Impossibility and Impracticability

A party may invoke the common law doctrine of impossibility to avoid performance of a contract in cases of the "destruction of the means of performance by an act of God, vis major, or by law." *407 East 61st Garage, Inc. v. Savoy Fifth Ave. Corp*., 23 N.Y.2d 275, 281-82 (1968); *Sher v. Allstate Ins. Co*., 947 F. Supp. 2d 370, 383 (S.D.N.Y. 2013). The destruction must have been caused "by an unanticipated event that could not have been foreseen or guarded against in the contract." *Kolodin v. Valenti*, 115 A.D.3d 197, 200 (N.Y. App. Div. 2014). As discussed further below, courts construe impossibility narrowly and generally disfavor it as a basis to excuse nonperformance.

The doctrine of impracticability (codified in Section 2–615 of the Uniform Commercial Code, which governs contracts for the sale of goods) is a variant of impossibility in which a change in commercial conditions has rendered performance not impossible but rather economically unsound or wasteful. However, outside of the UCC, not all courts distinguish impracticability from impossibility or consider it a basis to excuse nonperformance. As such, any assessment of the viability of relying on impracticability must be jurisdiction-specific. Moreover, courts are unlikely to excuse as impracticable a party's nonperformance due to mere economic difficulty or adverse market conditions.

Delaware has extended the UCC's commercial impracticability doctrine beyond contracts under the UCC. Delaware courts excuse performance when: "(1) an event occurs that the parties assumed would not happen; (2) continued performance is not commercially practicable; and (3) the party asserting the defense . . . did not expressly or impliedly agree to performance in spite of impracticability." *CRS Proppants LLC v. Preferred Resin Holding Co*., LLC, 2016 Del. Super. LEXIS 520, at *17-18 (Super. Ct. Sep. 27, 2016). "The non-occurrence of that event, however, must have been a fundamental assumption on which both parties made the contract." *Freidco of Wilmington, Ltd. v. Farmers Bank of Delaware*, 529 F. Supp. 822, 825 (D. Del. 1981). "The continuation of existing market conditions and the financial situation of the parties are ordinarily not such assumptions, so that mere market shifts or financial inability do not usually effect discharge . . .." *Id.* (citing Second Restatement of Contracts, § 261, Comment b).

In contrast, New York courts (outside of the UCC) do not differentiate impracticability from impossibility. *See Clarex Ltd. v. Natixis Sec. Ams. LLC*, 2014 US Dist. LEXIS 121335, at *31-32 (S.D.N.Y. Aug. 29, 2014) ("New York courts do not appear to recognize commercial impracticability as a separate defense to the doctrine of impossibility; rather, impracticability is treated as a type of impossibility and construed in the same restricted manner.").

- *What constitutes "destruction" of the means of performance?*

  "New York courts have construed the impossibility defense very narrowly." *Clarex Ltd. v. Natixis Sec. Americas LLC*, 988 F. Supp. 2d 381, 394 (S.D.N.Y. 2013) (citation omitted). Severe difficulty of performance is insufficient: "impossibility excuses a party's performance only when the destruction of the subject matter of the contract or the means of performance makes performance *objectively impossible*." *Id.* at 394. In certain circumstances, extreme breakdowns in the supply chain—due to contingencies such as embargos, crop failures, and shutdown of major sources of supplies—may give rise to an impossibility defense. *See Rochester Gas & Elec. Corp. v. Delta Star, Inc.*, 2009 WL 368508, at *9 (W.D.N.Y. Feb. 13, 2009) (quoting N.Y.U.C.C. § 2–615 Comment 4). For example, a party may have an impossibility defense to the extent its business has been deemed non-essential and

therefore cannot operate during the pendency of a stay-at-home order. However, if that party could rely on business operations in another jurisdiction not subject to a stay-at-home order, then it likely could not rely on an impossibility defense. Similar scenarios could come up in the context of the supply chain: if a party can obtain necessary supplies to perform from another source—despite that doing so may be at an increased cost—it likely could not rely on an impossibility defense.

- *Does financial difficulty caused by the economic impact of COVID-19 excuse performance by impossibility?*

  Generally, no. "Financial difficulties growing out of a general business slowdown or recession may cause personal inability to perform but do not usually constitute an excuse by impossibility of performance." 14 Corbin on Contracts § 74.7 (2019); *see also UBS Real Estate Sec. v. Gramercy Park Land LLC*, 2009 NY Slip. Op. 33464, ¶¶ 11-12 (Sup. Ct.) (in New York, "[w]here the impossibility of performance is caused *only by financial difficulty or economic hardship*, even to the point of bankruptcy or insolvency, contractual performance is not excused") (emphasis added).

- *Could a state or federal executive order to close non-essential businesses excuse performance by impossibility?*

  Possibly. When a contract is "originally legal, but because of a change in purpose of the parties or a change in the law, performance of the acts prescribed in the contract by one of the parties has become illegal, any subsequent performance of such acts is against public policy and the party who has undertaken to perform them is excused from doing so." 8 Williston on Contracts § 19:36 (4th ed.). As such, a party potentially could invoke the impossibility doctrine to avoid performance if it were forced to suspend operations pursuant to a stay-at-home order, directing non-essential businesses to cease in-office operations.

  However, if such an executive order were temporary, it might not render performance legally impossible unless the time of performance was an essential element of the contract. *See Bush v. Protravel Int'l, Inc.*, 746 N.Y.S.2d 790, 797 (N.Y. Civ. Ct. 2002) ("[W]here a supervening act creates a temporary impossibility, particularly of brief duration, the impossibility may be viewed as merely excusing performance until it subsequently becomes possible to perform rather than excusing performance altogether.").

- *Can a party invoke impossibility or impracticability of another's performance—for example, a key supplier's—to avoid its own?*

  Generally, no, unless the third party's performance was an essential element of the first contract, or if the loss of supply was severe and widespread or the result of government intervention beyond the supplier's assumption of the risk. The party would likely be required to obtain substitute supplies, even at significant, unanticipated extra cost. *See Rochester Gas & Elec. Corp. v. Delta Star, Inc.*, 2009 WL 368508, at *9 (W.D.N.Y. Feb. 13, 2009) (collecting cases).

V. Frustration of Purpose

The doctrine of frustration of purpose excuses a party's nonperformance where performance has been rendered moot or valueless by the destruction of an essential element of the bargain. A "typical scenario" is where "the party is perfectly capable of performing (*e.g.*, paying money to rent a building), but the party's reason for doing so longer exists." 14 Corbin on Contracts § 77.1 (2019). "[T]he frustrated purpose must be so completely the basis of the contract that, as both parties understood, without it, the transaction would [make] little sense." *PPF Safeguard, LLC v. BCR Safeguard Holding, LLC*, 85 A.D.3d 506, 508 (N.Y. App. Div. 2011) (citations omitted). Courts apply the doctrine narrowly.

The doctrine of frustration of purpose is construed differently depending on the jurisdiction and thus any assessment will require a jurisdiction-specific analysis. For example, "[u]nder New York law, the

doctrine of frustration of purpose discharges a party's duties to perform under a contract where an unforeseen event has occurred, which, in the context of the entire transaction, destroys the underlying reasons for performing the contract, even though performance is possible." *Gander Mt. Co. v. Islip U-Slip LLC*, 923 F. Supp. 2d 351, 359-60 (N.D.N.Y. 2013) (internal citations, quotation marks and alterations omitted). Interpreted slightly differently in Delaware, "[a] frustration of purpose defense is available when: (1) there is substantial frustration of the principal purpose of the contract; (2) the parties assumed that the frustrating event would not occur; and (3) the Defendant is not at fault." *CRS Proppants LLC v. Preferred Resin Holding Co., LLC*, 2016 Del. Super. LEXIS 520, at *18 (Super. Ct. Sep. 27, 2016). Performance is excused even if possible when it "would make little sense to continue where the object frustrated was the basis of the contract." *Id.* (internal quotation marks omitted).

- *What might a typical frustration of purpose scenario be in the COVID-19 context?*

  A party might assert frustration of purpose as a defense for its nonperformance if COVID-19 were to destroy an essential element of its bargain—for example, a concert organizer might assert the defense against an event insurer in order to avoid paying premiums on its policy if state-mandated social distancing measures forced the cancellation of a summer music festival.

- *What kind of event is required for a frustration of purpose defense to prevail?*

  As with impossibility and impracticability, courts apply the doctrine narrowly. "Discharge under the frustration of purpose doctrine has been limited to instances where a virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party . . . . [T]he doctrine is a narrow one which does not apply unless the frustration is substantial." *A + E Television Networks, LLC v. Wish Factory Inc.*, 2016 WL 8136110, at *12 (S.D.N.Y. Mar. 11, 2016) (internal citations and punctuation omitted).

- *Can a party assert frustration of purpose where unforeseen events have made performance more financially burdensome?*

  Generally, no. The fact that a transaction has become less profitable or will even cause a party to sustain a loss will not give rise to a frustration of purpose defense.

VI. Maintenance of EBITDA Covenants

Generally, borrowers must comply with maintenance covenants that test net debt to EBITDA or adjusted EBITDA. COVID-19 may affect a borrower's compliance with those covenants either due to reduced revenue or increased expenses related to pivoting to complying with stay-at-home orders or other government-imposed restrictions. Maintenance covenants that test for net debt to adjusted EBITDA often allow for add-backs along the lines of "*any items classified by the company as extraordinary, one-off, one time, exceptional, unusual or non-recurring*." COVID-19 may constitute a one-off, exceptional, non-recurring event. Certain COVID 19-related expenses likely can be added back, but the extent to which a borrower may do so likely will be litigated in the near-future, and it is unclear how these add-backs will be construed. Construction of maintenance covenants will be highly dependent on the nuances of each contract's covenants.

- *What expenses can be added back to adjusted EBITDA as "one-time" expenses?*

  Some COVID-19 expenses likely may be added back, but the scope of what can be added back likely will be the subject of negotiations or litigation. For example, a borrower may have a good argument to add-back expenses associated with deep cleaning of offices and lost deposits on conference centre bookings but may face more difficult challenges in adding back general revenue losses from COVID-19 because those losses are hard to quantify.

  Going forward, it will be important to have precise language concerning COVID-19 in new financing transactions. Some parties have suggested including new language with broad

grants for addbacks that would cover all COVID 19-related losses, further indicating that general revenue losses likely cannot be added back under the typical expense add-back language. In drafting new financing arrangements, lenders should be careful to limit COVID 19-related add-backs to actual costs incurred or to negotiate a cap on general revenue loss add-backs.

- *How will courts and regulatory authorities interpret existing maintenance covenants?*

  Courts may resist harshly interpreting or applying maintenance covenants—despite clear contractual language—given the scope of the COVID-19 public health crisis. For example, United Kingdom banking regulators issued a release on March 26, 2020, indicating lenders should tend toward lenience for COVID 19-related disruptions: "[R]isk management takes into account fully the differences between 'normal' covenant breaches and some of the breaches that might occur because of the Covid-19 pandemic." As such, lenders should be careful in enforcing maintenance covenants strictly and should resolve issues through negotiation with the borrower if possible.

- *How should lenders approach enforcement of maintenance covenants?*

  Maintenance covenants are designed as an early warning sign for lenders and do not necessarily require enforcement of the covenant. However, COVID-19 itself serves as the early warning sign in this instance rather than in other deals where the underperformance is due to less clear reasons. Lenders should assess whether covenant breaches are connected short-term disruptions that businesses will recover from, particularly when a borrower's management team would prefer to mitigate the disruption rather than spending additional time negotiating with lenders. Lenders should also consider their placement within the borrower's capital structure (either as super senior on collateral, or closer to the assets) and whether that will allow for added patience through the more difficult period for the borrower.

- *How should borrowers handle "springing" covenants?*

  "Springing" covenants are maintenance covenants that are only tested when the drawing threshold is met. One option is that borrowers can manage cashflows to only draw upon a facility after the covenant testing date, which will defer covenant testing for a full quarter. This is a risky approach, especially if the COVID-19 pandemic and stay-at-home orders end up worse than currently expected, but this approach could allow for additional liquidity at a time when the company has a more immediate requirement.

The above areas are complicated, integrated issues that may evolve as we receive updates about the spread of COVID-19 and the governmental response. Milbank is continuing to monitor developments in real-time from courts, regulators, and the business world. Clients are encouraged to contact Milbank with any questions about the above or any other COVID-related issues.

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