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COVID-19: Supply Chain and Counterparty Risk for Private Equity Portfolios

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The spread of the Coronavirus has already had a profound impact on the global economy. However, ongoing uncertainty and a fragmented response from national governments pose challenging questions to GPs as to how they can manage risk across their portfolios' contract spectrum. Those who are prepared to take a more proactive approach are likely to see their assets weather the storm more effectively than those who are reactive. In this briefing, we assess the disruptions which may arise in a portfolio asset's supply chain and how such disruption can be managed. We also assess what we consider to be the most likely rights (from an English law perspective) which a party may invoke if it is unable to perform a contractual obligation: force majeure, frustration, and material adverse change.

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Supply Chain Risk Analysis

I. Existing Contractual Relationships

A. Counterparty Risk

GPs should be working with senior management at their portcos to identify key suppliers who are likely to be disrupted by the spread of the Coronavirus. Manufacturing (particularly where businesses are based in Asia) is an obvious risk, but consider whether suppliers will effectively be able to fulfil their obligations punctually if their workforce has been sent home or quarantined. Management should proactively reach out to counterparties to identify contingencies and, where



relevant, consider substitution and diversification. Issues will turn on the portco's profile, but some key points to consider may be:

- Governing law of the key contracts and how this impacts available remedies.
- Which contracts should be prioritized and whether partial performance is relevant.
- Increased costs of supply—can the portco pass any margin onto its customers? Conversely, can a supplier pass increased costs onto the portco?
- Reviewing standard terms and conditions to identify areas of risk and considering amending for future transactions.
- If a business is regulated, does a chink in the supply chain prevent it from complying with regulatory obligations?
- Long term relationship planning and reputational risk, at the expense of circumstantial expediency.

Management should also assess whether the portco will be able to perform its contractual obligations punctually, and if there could be a knock-on effect from a counterparty failing to perform its obligations.

B. Insurance

Certain losses (or contingencies which may result in losses) may be covered by a portco's insurance policies. If the portco's business is international, it may be relevant to assess the relevant government's response to the Coronavirus and the legal classification of the spread (e.g., the U.S. has declared a state of emergency) and whether this triggers a right of the insured under the policy. It is crucial that management identify any notification requirements and comply with any obligations to disclose all relevant information to the insurer.

II. Non-performance of Obligations

A. Force Majeure

Many commercial contracts contain a force majeure provision as of rote: a catch-all to discharge (or delay) the performing party's obligations if it is prevented from doing so by disruption to its business. The application of the clause will hinge on its drafting and whether circumstances constitute a trigger event. Portcos should review their key contracts to: (i) identify whether counterparties could walk away from their obligations by invoking a force majeure provision; and (ii) ascertain whether the portco may need to invoke such a provision itself.

1. What is the scope of the provision?

Common formulations refer to events "beyond the parties' control" (or similar), but may also include an indicative list of trigger events (such as meteorological events or acts of war). If the clause refers to a "pandemic" (or similar) this may be significant in light of the WHO categorizing COVID-19 as a "Public Health Emergency of International Concern," as well as any state of emergency or restrictive positions imposed by national governments. If a trigger event is satisfied, most clauses prescribe how obligations may be discharged; this may take a variety of forms—e.g., many provisions delineate between "excusable and non-excusable delay."

2. Invoking the provision

A party seeking to rely on a force majeure provision will need to establish that the trigger event was within the contemplation of the parties at the time the contract was concluded, by reference



to the scope of the drafting. The effect of COVID-19 has been pluralistic and the party invoking a force majeure will need to establish a link between the consequence of COVID-19 and its inability to perform its obligation(s). The COVID-19 outbreak has evolved so quickly that, even if the parties had contemplated the outbreak when concluding a contract in January 2020 (for example), they may not have foreseen the wider economic impact. The invoking party may be under an obligation to mitigate the impact of COVID-19; for example a provision may only bite if the invoking party has implemented a reasonable business continuity and disaster recovery plan.

3. Do COVID-19 and its consequences render performance legally or physically impossible?

In assessing the link, it would be necessary to take account of the rapidly changing picture, having regard to the obligation which is to be performed. Examples may include: a government has introduced measures which affect the legality of a contract's performance; or the contract depends on a source of supply which is no longer available. Force majeure provisions customarily refer to excusing performance which is prevented, which does not include where performance is simply more expensive (although this principle may be tested by COVID-19).

B. Frustration

Frustration is an English law rule of contract which applies alongside express terms. Its effect is to end the contract immediately and discharge the parties from all further liability in circumstances where an event or change of circumstances has meant that performance of the contract would be "radically different" from what was envisaged when the contract was signed.

Frustration is much more likely to be relevant if the contract does not contain a force majeure provision, as express provisions will take precedence and the test for frustration under English law imposes a high standard. It is unlikely that frustration will become an issue at this stage in the COVID-19 outbreak, but if a contract requires performance at a specific time or place, it would be worth exploring if it applies further down the line. Bearing in mind how the current crisis is developing, we could see the doctrine playing a much wider role, not only where contracts do not contain a force majeure provision, but also where such provisions are not broad enough to cover COVID-19 and its consequences.

C. Material Adverse Change

MAC provisions come in many shapes and sizes. Their applicability turns on the breadth of their scope and the trigger events covered by the drafting. As commonly used, a MAC provision will excuse a party of performing its obligations if the counterparty undergoes a material adverse change. It is common for a provision to include a financial metric to measure that change. For example, financing contracts frequently refer to a fall below a threshold EBITDA. Such provisions are common in debt financing agreements, but are rarely seen in M&A sale contracts in the European market.

III. Practical Concerns

- Prior to a portco initiating any action under a force majeure or MAC provision or for frustration, ensure all portco employees maintain a detailed record of the practicalities of performing contractual obligations. Be aware that such records may subsequently be scrutinized by a court or arbitrator.
- If a portco expects to invoke force majeure, MAC, or frustration, ensure that the notice provisions in the contract are checked carefully to avoid technical or administrative non-compliance.



- If a counterparty seeks to invoke force majeure or frustration, identify the precise reason preventing non-performance and consider if this links to the fallout from the COVID-19 outbreak.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers. Using contract review AI software, Paul Hastings can assist identifying the issues described above in your portfolio.

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