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Coronavirus/COVID-19 Entertainment Update

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Guidance for Entertainment Companies

The global coronavirus (COVID-19) crisis continues to have a devastating impact across all segments of the entertainment industry. The cancellation or postponement of film and television productions, concerts, sporting events, tours, festivals and other industry events; shuttering of box offices and theater venues around the world; dramatic loss of market value and revenue streams of many studios and entertainment conglomerates; and “stay at home” mandates from state and local authorities have brought much of Hollywood to a standstill and resulted in substantially reduced near-term revenue prospects for the vast majority of companies in or servicing the industry.

Although there are well-grounded fears for the short- and long-term impacts of the crisis, there are numerous ways in which entertainment companies — large and small — are thoughtfully pivoting to navigate the storm and take advantage of opportunities presented by the downturn. While there is no single playbook, below are some topics and opportunities that many boards and management teams are considering in real time as they deal with the crisis.

‘Cut’ Has New Meaning

The severe financial impact on the industry has forced many entertainment companies to implement or consider various cost-cutting measures to conserve liquidity in the face of a precipitous fall in actual and projected revenues. In many cases, such measures include painful decisions relating to employees, including layoffs, furloughs, salary or drawdown reductions, freezes on discretionary spending, policy modifications, and adjustments to sales or other incentive plans.

To avoid becoming a cautionary tale, however, companies need to be mindful of various legal traps for the unwary, including statutory notice and other procedural requirements under federal and state labor laws that are not reasonably apparent to most lay persons or in-house counsel who are not experts in this area. In particular, the new Families First Coronavirus Response Act (FFCRA) temporarily expands the reach of leave under the Family and Medical Leave Act of 1993 and provides emergency paid sick time for various COVID-19-related circumstances between April 1 and December 31, 2020. Employers are not permitted to require employees to use other paid leave (e.g., paid sick time or vacation) prior to using the paid leave under the FFCRA. In addition, certain recently enacted exceptions in federal and state Worker Adjustment and Retraining Notification (WARN) laws may allow for shortened notice requirements. Consideration also needs

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to be given to existing anti-discrimination, immigration and paid sick leave laws, the Fair Labor Standards Act and state wage and hour laws, and the National Labor Relations Act, as well as other employer-specific laws and policies.

Failure to carefully think through the appropriate steps to ensure compliance with applicable labor laws and regulations could result in, among other things, governmental and private actions against the company and monetary penalties or awards, which could distract management time and divert company resources during this critical period. Consultation with external labor counsel may help to successfully navigate potential pitfalls and gain perspective as to what options other industry players are considering, how they are being implemented, and best internal and external communication practices.

Financial Forecast Is *Cloudy With Meatballs*

With significant hits to forecasted revenues and an uncertain timeline for industry recovery, many entertainment companies are focusing on liquidity and access to cash to ensure continuity of operations. For companies with committed revolving credit facilities, some are making the decision — based on lessons learned from the last financial crisis — to draw down on such facilities to the maximum extent permitted.

Prior to any drawdowns, both the drawing conditions and the current and projected future effect on any financial covenants should be carefully considered. In particular, drawing conditions often include representations as to the solvency and the absence of any event, change, condition or development that has had or could reasonably be expected to have a “material adverse effect,” which, as discussed more fully below, requires a factual analysis and review of the precise wording in the credit agreement.

Companies with asset-backed loan (ABL) facilities — including those with borrowing base tests that key off of assets such as film libraries — will want to ensure enough cushion to take into account declines in these asset values and the potential imposition of reserves. In some cases, increased borrowing over certain thresholds (e.g., percentage of facility drawn) could trigger financial-covenant testing, increased reporting or valuation requirements, and decreased baskets (e.g., investment and restricted payment baskets), all which need to be weighed against the need for liquidity and the availability of other sources of capital.

Even in the absence of additional drawdowns, companies should review their financial covenants in their credit agreements to ensure the current or projected impact of the business interruption does not put them in noncompliance as of March 31 or

in subsequent quarters. In some cases, companies are seeking covenant “holidays” for one or more upcoming quarters to allow time for recovery (which often requires a fee payment to the lender). In many cases, when seeking such waivers, management should be prepared to outline the company’s general and specific plans (as applicable) to address the crisis (e.g., cost-cutting measures implemented or planned) but avoid volunteering revised financial forecasts. Such forecasts are likely to be cloudy at best (and very possibly will prove wrong) as the situation is rapidly evolving and key assumptions may be mere speculation. As many entertainment companies are in a similar situation and many use the same banks, approaching lenders for waivers sooner rather than later may be a good idea to avoid being in back of a long queue.

If additional capital sources are required, companies can consider various alternative sources, including financing secured by unencumbered intellectual property, projects or other assets, second or junior lien debt, mezzanine or holdco debt, subordinated debt or preferred stock. Additionally, we’re seeing that various private equity and foreign players still have a lot of “dry powder” and are looking to make opportunistic bets in certain sectors of the industry.

Finally, new federal and/or state assistance — including SBA loans — may be available to smaller entertainment companies to help bridge payroll and operational needs under recently enacted and pending legislation. As these areas are continuing to evolve, please check [Skadden’s COVID-19 updates](#) for additional information.

The *Force Majeure* Is With You (But Not Always)

Many entertainment companies are locating and carefully reviewing their key contracts in light of the current crisis. The spotlight often is focused on so-called “*force majeure*,” “material adverse change” (MAC) and “material adverse effect” (MAE) clauses, which are routinely included in talent agreements, production and distribution agreements, licenses, acquisition agreements and other industry contracts but often regarded as “boilerplate” and not heavily negotiated in normal times. The particular wording of these provisions — including any exceptions expressly contemplated, such as changes in “general economic conditions or financial markets,” “events generally affecting the industries in which the company operates,” “national or international calamity or crisis,” “national emergencies,” and “epidemics or pandemics,” as well as exceptions for situations where harm to the company was not disproportionate to others in the industry — is now critically important for determining whether the contract remains enforceable or if the counterparty has a credible basis to rescind, delay or modify performance.

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Any *force majeure*, MAC or MAE clause must be analyzed on a fact-specific basis under the terms of the agreement and under the governing law under the contract. Companies should undertake a review of these provisions with their counsel to assess the parties' respective rights and obligations under the contract and applicable law, and formulate an appropriate offensive or defensive strategy as appropriate. Depending on the drafting of the clause and relative negotiating position, in certain cases a reasonable legal argument that these clauses should be viewed in your favor, backed by an interpretation of counsel, may give rise to an opportunity to renegotiate or terminate an agreement. Going forward, we're likely to see terms such as "pandemics," "disease outbreaks" and "widespread illness" as specific examples incorporated into future *force majeure* event clauses.

For a more in-depth review of the interpretation of *force majeure* and MAC clauses in contracts, see the Skadden client alerts "[Coronavirus/COVID-19: Implications for Commercial and Financial Contracts](#)" and "[Coronavirus/COVID-19: Implications of Event Postponement and Cancellation](#)."

The Stock Matrix: Reloaded

Certain entertainment companies are using the depressed market values of industry-focused companies as an opportunity to grant new equity or equity-like interests to key employees for reasons such as to establish an employee retention mechanism (e.g., via equity grants and vesting over time and/or based on performance criteria), to make up for lost salary and/or bonus opportunities arising from the market downturn or cost-cutting measures, or to migrate the company to a more appropriate long-term equity capitalization. In some cases, issuing these interests may soften the blow of forced salary reductions and serve to align incentives to increase company value during and post-crisis.

In order to be tax-free on grant to the employee, often times these grants are structured as "profits interests" (for limited liability companies) or stock options (for C-corporations), which typically need to be issued with a baseline value (for LLC units) or strike price (for stock options) at "fair market value." Given the current crisis, some companies (and their valuation experts) have reason to put a very low "fair market value" on these securities, allowing for more "upside" to the employees (due to lower baseline or option strike price) than was possible before the crisis. So if there is capacity under a management equity pool, for example, now may be a good time to consider using the pool to make grants to key employees.

If your company is considering employee equity issuances, counsel should be consulted in preparing state-of-the-art equity plans and grant agreements, as well as for related structuring and tax advice.

Take 2

If an entertainment company fears it may not outlast the current industry crisis, there are various restructuring alternatives to consider. Faced with an unprecedented downturn, even companies that had fundamentally sound business plans and appropriately leveraged capital structures may find themselves in need of a "breathing spell" to allow them to maintain continuity of operations and defend against creditor actions.

Fortunately, second chances are a core pillar of the U.S. bankruptcy laws. Among other things, bankruptcy law is designed to preserve and maximize value, including by providing valuable protections that may afford the company the leverage it needs to negotiate solutions to liquidity problems and position itself to emerge from the crisis with a stronger balance sheet and better prospects for long-term success. Some benefits include:

- no requirement that the company prove it is insolvent;
- management and board remain in control;
- business continues to operate in the ordinary course; and
- imposition of the "automatic stay" halts all creditor enforcement actions.

The current crisis is likely to drive many board and management teams also to consider other restructuring options as well. Although entertainment companies have been reluctant to consider some of these options in the past for reputation and other reasons, given the "new normal" it's likely that a number of entertainment companies will need to take advantage of some form of restructuring to survive, particularly if the crisis lasts for many months.

Counsel with experience in entertainment company restructurings should be consulted to explain, among other things, the pros and cons, timelines, resources and communications strategies available under the circumstances, including nuances that are relevant to entertainment, an industry that often requires a delicate balancing of interests and relationships. Additionally, boards should carefully consider fiduciary duties in consultation with their counsel if insolvency is a reasonable possibility. In most cases, well-advised companies are working hand-in-hand with their counsel and other advisers to consider *all* options, so they are not caught flat-footed or second-guessed for not taking appropriate and timely actions to protect the company.

Vanilla Sky

On the brighter side, some domestic and international entertainment companies and investors in the sector may find strategic opportunities in the chaotic market or position themselves to capitalize on opportunities as the post-crisis landscape comes into focus.

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For years before the start of the crisis, the continuing proliferation of streaming services contributed to a high demand for new and existing content and productions, driving up prices and competition for film and television libraries, content production vehicles, and other entertainment-related assets and services. This trend is likely to continue once the market settles, productions come back online and we see a continued demand for fresh content. In fact, given the large consumption of available streaming content during the mandated “stay at home” requirements in many cities around the world, there is an argument that demand for fresh content will come back stronger than ever when the crisis subsides.

During this challenging period, there will be a softening of asset prices as revenues and multiples decline and some competition for such assets is pushed to the sidelines. Those who are prepared to make opportunistic bets may be able to acquire, partner with,

or otherwise collaborate with other industry players in ways that were not possible — or on better terms — than could be effected just a short time ago. In addition, market disruption is likely to present opportunities to sign new talent and clients and forge new business relationships among industry players.

A Hollywood Ending

Although many articles continue to emphasize doom and gloom, there is no doubt that this industry — which includes many of the most creative, talented and inspiring people in the world — will recover and ultimately write a Hollywood ending. While there is no single playbook for entertainment companies, many are grappling with a number of similar issues as they find their own innovative ways to pivot and manage through the current market disruption in close coordination with their counsel and other advisers.