Determining EBITDA in a Time of COVID-19

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Beyond the human toll that the pandemic has had on our lives, the COVID-19 virus, as well as our and our governments' responses to it, has had a marked economic impact. Many businesses have faced challenges and it is fair to expect that in a number of cases, earnings will have been affected in a material way. As entities look to report on the past year, it's worth considering how we calculate the impact of the pandemic on earnings.

EBITDA (earnings before interest, tax, depreciation and amortization) is the most commonly used stand-in for earnings and can be found in a wide array of agreements, from the financial covenants contained in loan documents, through earn-outs in M&A agreements, employment remuneration terms and long-term incentive plan awards, to pricing formulae in options and other contingent rights.

EBITDA is oftentimes defined in agreements to exclude "one-off," "non-recurring," "unusual" or "extraordinary items" or other special circumstances ("**Adjustments**").[1] Whether, and in what form, Adjustments are contained in an agreement could have a significant impact on the EBITDA calculation and, as a result, on the economics of the bargain that the parties have made. Similarly, pandemic-related government benefits and programs could also have a significant impact on EBITDA if such benefits and programs result in an unanticipated increase in earnings and cannot be excluded as Adjustments.

Considered in context, if EBITDA, as used in an earn-out provision, can be found to exclude the impact of COVID-19, a seller may satisfy its EBITDA targets by adding back any COVID-19 losses. From the buyer's perspective, this may seem like an unfair windfall for the seller. In a credit agreement, if the Adjustments in that agreement allow for EBITDA to be calculated without taking account of the impact of COVID-19, the borrower may be able to satisfy its debt-to-EBITDA ratio by excluding the impact of COVID-19 losses when the lender may have otherwise expected COVID-19 losses to be included in the calculation.

The most commonly used language for Adjustments is some variant of the exclusion of "non-recurring, unusual or extraordinary items." The meaning of these Adjustments in the context of COVID-19's impact on EBITDA calculations has not been judicially considered so we are left to consider the impact of these words using their ordinary meaning. Taking, for example, the exclusion of "extraordinary items," the *Dictionary of Accounting* describes an "extraordinary item" as "a large item of income or expenditure entered into accounts that is unusual in nature and also occurs very infrequently."[2] *Terminology for Accountants* provides a similar definition.[3] More generally, *Black's Law Dictionary* defines "extraordinary" as "beyond what is usual, customary, regular, or common."[4] In that light, the COVID-19 pandemic is undoubtedly an extraordinary event and one that, thankfully, occurs very infrequently. The Ontario Court of Appeal has stated that it is "beyond controversy that the COVID-19 pandemic has created extraordinary circumstances."[5] The Ontario Securities Commission described the COVID-19 pandemic as "extraordinary circumstances with many consequential effects."[6] Similarly, the Ontario Superior Court of Justice stated that the COVID-19 pandemic is "a once in a lifetime event, which has had catastrophic repercussions."[7]

As a result, if faced with Adjustment language that excludes "non-recurring, unusual or extraordinary items" or a similar formulation, should the impact of the COVID-19 pandemic be excluded when calculating EBITDA? There appears, at the very least, to be an argument for such a result. However, any determination will be fact specific – are you in a jurisdiction in which a state of emergency was declared? Were you subject to non-binding government guidance or binding public health orders? Is there any evidence as to the parties' intentions? Given the impact that the interpretation of EBITDA could have on the economic outcomes under a contract, we expect that these positions will be disputed by some parties. Contracting parties should take a few minutes to consider what, if any, exposure they have to such an interpretation, whether any ambiguity exists and whether proactive steps are needed to clarify or amend the formulae in their agreements.

We expect now to see more contracts include an express statement on the impact of COVID-19 (or pandemics generally[8]) on the calculation of earnings and, to a lesser extent, the use of EBITDAC (earnings before interest, tax, depreciation, amortization and COVID-19). In the medium term, we expect a move to more explicit formulations of EBITDA; some that we have seen allow for the exclusion of only "non-recurring expenses as mutually determined by the Parties" or a more robust definition of the sorts of items that constitute "unusual" or "extraordinary items."

The COVID-19 pandemic has caused many changes to "business as usual" and businesses may need to review their existing EBITDA definitions in order to determine whether they or a counterparty may rely on "extraordinary items" or other similar wording to adjust for the impact of COVID-19. In the future, we anticipate a more granular focus on exclusions to EBITDA as a general practice and eventually for caselaw to develop around the impact of health emergencies on EBITDA exclusions.

[1] Common examples of EBITDA exclusions include: "extraordinary items"; "any items (positive or negative) of a one-off, non-recurring, extraordinary or exceptional nature"; "non-recurring, unusual or extraordinary items"; "any loss from extraordinary items"; "any other extraordinary gains (or losses)"; "any extraordinary, unusual, non-recurring or exceptional expenses or losses"; "all extraordinary, non-recurring and unusual items"; "extraordinary, non-recurring and unusual losses"; "any unusual or non-recurring charges (or losses)"; "extraordinary losses and non-recurring charges"; "any extraordinary gains or deducting any extraordinary expenses"; and "extraordinary and non-recurring losses".

[2] SMH Collin, ed, *Dictionary of Accounting*, 4th ed, (London, UK: A & C Black, 2007) *sub verbo* "extraordinary item".

[3] *Terminology for Accountants*, 4th ed, *sub verbo*, "extraordinary item".

[4] *Black's Law Dictionary*, 11th ed, *sub verbo*, "extraordinary".

[5] *4352238 Canada Inc. v SNC-Lavalin Group Inc.*, 2020 ONCA 303 at para 6.

[6] Paramount (Re), 2020 ONSEC 9 at para 3.

[7] *Orpheus Medica v Deep Biologics Inc.*, 2020 ONSC 4974 at para 2.

[8] We would caution in passing that the use of the term "pandemic" itself is not without ambiguity and it is most often used to refer to diseases affecting an entire country or multiple countries. It might be more appropriate to refer to, whether for inclusion or exclusion, the impacts of a local disease outbreak or pandemic, which sets the bar for consideration at the regional rather than the national or international levels.

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