

Sam Gandhi:

The Coronavirus is spreading around the world. It's officially a pandemic. Fears of recession have increased in the United States and global markets have fallen to their lowest level since the financial crisis. Companies are scrambling to deal with this rapidly evolving and dangerous reality. How do boards of directors react? How do they navigate an M&A transaction or avoid litigation? We'll find out in today's podcast.

Brian Fahrney:

For some companies this outbreak is existential.

Yvette Ostolaza:

Sometimes the best thing you can do is walk away from a contract and to say you know litigate.

Brian Fahrney:

The closing risk for buyers when they get into a contract in light of all of this is going to be more on them than it is on the sellers.

Yvette Ostolaza:

What we recommend is that there be an action plan and that people are designated at the board level to respond and to assist. Normally you are nose in, fingers out. In a time of crisis, it's a little bit more fingers in and nose in.

Sam Gandhi:

From the international law firm Sidley Austin this is The Sidley Podcast where we tackle cutting edge issues in the law and put them in perspective for business people today. I'm Sam Gandhi. Hello and welcome to this special edition of The Sidley Podcast part of Sidley's ongoing efforts to stay on top of the legal developments in the Coronavirus crisis. You can find more information in our special COVID-19 Resource Center at Sidley.com. Today, we focus on the effect of the Coronavirus on M&A transactions and the potential risk of litigation.

I'm joined by Sidley partners Yvette Ostolaza and Brian Fahrney. Yvette is the co-global practice leader of Sidley's litigation practice and office

managing partner of our Dallas office. A significant portion of Yvette's practice involves counseling boards, special committees, and directors on sensitive internal investigations and crisis management. Brian is co-global practice leader over our M&A and Private Equity practice and is a partner in our Chicago office. Brian regularly represents a wide variety of public and private clients in M&A and other strategic transactions and provides guidance to boards of directors on governance matters. Yvette joins us from our Dallas office and Brian joins us from our Chicago office. Great to be with both of you.

Brian Fahrney:

Good to be here.

Yvette Ostolaza:

Good afternoon, Sam.

Sam Gandhi:

Brian, let's start on M&A. The full effect of the Coronavirus on global M&A activity probably won't be known for some time, but as buyers and sellers continue diligence deals and negotiate transactions what can they do to protect against unexpected risks from this outbreak?

Brian Fahrney:

It's really two ways of protecting yourself. One is due diligence and one is provisions in the documentation. On the due diligence side, we are advising buyers in respect of these COVID-19 issues to look at several broad categories. First, what is the current effect on core operations? So there's a bunch of questions that you need to be asking as a buyer of the target. Where are key facilities located? Are they remaining open? How is the spread of the virus affecting demand for your products or services? If the target is a manufacturing company how is its supply chain affected? So a number of these questions bearing on current core operations.

Secondly, we're having target, and really this is more of a banker function but we're focused on it as well, we're having buyers focus on whether the target is still comfortable with its projections for 2020 and 2021. Obviously, deal pricing is typically based on very recent earnings and then projected earnings and we're having our clients dig into that with targets and it obviously can be a basis for a very difficult, but in these markets and with

the outbreak it clearly is an issue as to whether or not you can hold to the pricing that you had originally indicated. And then the last area of diligence is really preparedness and contingency planning. Does the target have a good plan for what to do if it, say, has a serious outbreak at one of its facilities if it loses its main source of supply from its key supplier if it gets sued by its JV partner? And so there's a lot of questions around that.

Sam Gandhi:

Do you see people still continuing with the M&A process? I mean, normally when we talk about diligence you're talking about a buyer trying to kick the tires. Well, you can't really kick the tires if you can't travel to see the factory or company. Do you see buyers and sellers trying to move the M&A process along in kind of different ways than what they would normally do?

Brian Fahrney:

Well, actually it's actually pretty similar to the normal way and that's because we've moved to a virtual data room environment. So all of the documents that are going to be transferred and looked at are going to be made available on a virtual data room. And then clearly there have been and will be fewer in-person meetings, but a lot of this takes place over the phone anyway. So, the answer is you can still do this kind of due diligence in this environment without having in-person meetings.

Sam Gandhi:

And then we expect businesses to generally take risks so the economy and certainly external events is part of doing business. But there's so much uncertainty here and it's such a rapidly changing environment does this virus rise to the level of material adverse change for a signed transaction? What are you seeing in the market?

Brian Fahrney:

This is a difficult question to answer sort of in the abstract. You have to look at the contractual language, you have to look at the underlying facts, but there are a few general observations you can make. And the short answer to your question, Sam, is yes this could be a basis depending on the company, depending on the industry this could be a basis for invoking a material adverse effect provision. Most of the MAE provisions that would be implicated by your question were drafted before the Coronavirus you know

the COVID-19 outbreak was as serious as it is now and most of those provisions will not specifically address this.

So, you won't have a carve out, per se, what you will have to look at is whether the underlying facts give rise to a material adverse effect. As everyone knows it is very difficult to assert a material adverse effect and I'm focused on Delaware law here right now. The requirements for an MAE based on a downdraft in results are quite a hurdle to get over. The test is generally that the event or circumstances are giving rise to poor results that are durationally significant, that's the term that's used, and this generally means multiple quarters. So, for example, in the Akorn case that the Delaware Supreme Court came down with not too long ago they were focused on five straight quarters of poor results, you know, serious declines in revenue, serious declines in operating income.

And so that's kind of the standard you have to get over. Is it possible that we could have this outbreak go on for quarters and ultimately get to the level where you could say that it's durationally significant? Maybe. I hope not, but maybe. But it certainly can be said that you ought to be looking at a material adverse effect provision thinking about what is actually going on with the business and at the very minimum you may raise the specter of invoking a material adverse effect provision as a way, and this is often done, as a way of renegotiating price.

Sam Gandhi:

Say today a potential buyer calls you up to represent them in the acquisition of a new company. Now, given all the tumult that's out there and the issues that are out there does that change what would be a material adverse effect or change if they are starting the process now? I don't know how many people are really doing that in this uncertain market, but does that make a difference?

Brian Fahrney:

Yeah. Look, we're starting processes, we're in the middle of processes and as we speak contractual provisions around allocation of risk of this virus outbreak are being negotiated by parties. It appears that because this is so much in the news and you know everyone has knowledge of it, I guess, at some level it appears that the risk allocation, at least in terms of closing

conditions and the way you negotiate the terms of the MAE provision, are settling on a notion of buyer beware.

And the MAE provisions in some recent deals where the agreements have been made public we're seeing basically a carve out to the MAE for the COVID-19 effects on the business except to the extent it's disproportionate with others in the industry, which is a pretty common way to slice and dice an MAE provision. And I think with that, if that sort of continues to hold, at least the closing risks for buyers when they get into a contract in light of all of this is going to be more on them than it is on the sellers.

Sam Gandhi:

So, Brian, should buyers ask for additional representations and warranties of a seller? Should they restructure closing conditions just given the uncertainty from the outbreak?

Brian Fahrney:

Buyers should clearly be asking for additional reps. This is obviously, you know, it's a two-way street and obviously is going to be heavily negotiated. In terms of asking for closing conditions this kind of goes to the earlier point about how the material adverse effect language and definition is drafted. I think it's going to be pretty hard to get very specific closing conditions on this point. We certainly can try and of course every deal is different and the leverage may be different, but you certainly at a minimum, as a buyer, ought to be getting reps that go to the current state of play at the target company in so far as its exposure to the COVID-19 outbreak and at a very minimum you ought to be getting that.

To flip it around if you're selling you need to be very careful that you either accept closing risks with full knowledge or if you're giving reps don't give reps that inadvertently put you into a problem with a closing condition because you have to bring those reps down to closing. And so, there are obviously some techniques that you can do to minimize the risks that you get whipsawed on by kind of a backdoor closing condition through a rep that was not carefully thought through.

Sam Gandhi:

And now we're seeing a lot of transactions, in fact, a number of transactions that basically have insurance for rep and warranties. How do you see this outbreak affecting that market, if at all?

Brian Fahrney:

Well, we are getting some, again this is somewhat anecdotal, but some early indicators that the insurance carriers who provide the rep and warranty insurance policies are carving out losses relating to the COVID-19 situation. And that doesn't mean you can't use or rely on these policies you just have to do so with full knowledge that those won't be covered if there's a policy exclusion. And so, what that does is put the onus back on the parties to allocate the risks as between buyer and seller of those items.

And I think what's really going to happen is there'll be more, perhaps, special indemnities that will be drafted where in certain circumstances sellers will indemnify buyers for certain losses associated with it. And then you may also get into more bespoke pricing and valuation mechanics to try to allocate who is going to be bearing the brunt of a sustained period of downward pressure on the results of the business between signing and closing.

Sam Gandhi:

The one thing that we didn't really talk about in terms of fundamentals of an M&A transaction is that in every difficult market we've seen financing sources have serious concerns about lending into this market. What do you think M&A buyers should be focused on?

Brian Fahrney:

Well, again, and this is the same as the things you should be focused on with the seller, is a clear understanding about how you're going to allocate risks. If, as a buyer, you are assuming some risk of COVID-19, vis-à-vis you're a seller, then you need to make sure your bank documents mirror that. What you don't want to have is a situation where you're on the hook to buy a business and you go to look at the material adverse change and other closing provisions and your financing documents and they don't marry up with the similar provisions in your acquisition agreement. And so there ought to be a lot of focus on that.

Also, it would be important to think about how long your financing commitment in your commitment papers is going to be open. It may take longer to get deals done between sign and close simply due to the fact that governmental agencies are going to shutdown. And if you need a clearance in, pick a country, France you may not be able to get that clearance as quickly as you ordinarily would. And you just want to make sure that your financing commitment doesn't expire before you're able to satisfy all the conditions on the acquisition agreement.

Sam Gandhi:

This is a special episode of The Sidley Podcast our quick take on the impact of the Coronavirus on the corporate world. And we're speaking with Yvette Ostolaza, Sidley's co-global head of litigation from our Dallas office and Brian Fahrney, Sidley's co-global practice leader of our M&A and Private Equity group from our Chicago office. Yvette, in the last few years we've seen a dramatic increase in event-driven litigation. What should the board be doing to manage risks and particular litigation risks in the wake of this pandemic?

Yvette Ostolaza:

Well, we've learned from previous, whether it was 911 or after when we had some issues when the last bubble burst, that there's a couple of things that boards can do to at least create a record and make sure they're in the best possible position with respect to stock drop suits as well as derivative suits. And there's a couple of specific items in connection with pandemics. We're already seeing plaintiffs lawyers troll around and saying that disclosures were not sufficient about the risks that there were in light of what was already happening in China with respect to the first quarter financials. So, I think one of the things that boards can do to mitigate damages here is to look and see whether their current disclosures, in light of the ever developing events that there are, are still accurate.

And just by way of example, the President shutdown certain travel from Europe and certain portions of Europe. In light of that does that impact your particular company and is there something about your financials that now have changed or additional risk factors that need to be disclosed? That's an example of something they can be doing. I think boards, to the extent that they haven't already done that depending on what industries they are, should be focused on liquidity and making sure, in some instances, that

they're considering whether they draw on their lines of credits to stockpile cash. Whether they also should be considering employee action risks and planning for the fact that in some industries demand will be down. Also, whether their insurance on a D&O side is appropriately at the levels that it should be as they're doing renewals or whether they take advantage of other policies that they have not bought in the past in light of these.

These are all examples of things to manage risks that a board can be paying attention to and focusing on so that if the derivative suit comes in instead of the stock price suit and we look back that they can be viewed as exercising the business judgment role to make sure that the company is in the best possible situation to weather a storm. Another example that we see companies doing, especially where there are supply chain disruptions or whether there are costs that are not going to be done to minimize risks, is we're, for example, looking right now at a number of contracts that companies have and saying can we get out of these contracts? Should we be triggering force majeure clauses or other impossibility defenses? There are interesting things that happen once government takes action in certain jurisdictions that may trigger your ability to not be able to perform under a contract and to get out of it and to minimize your legal risk.

Sam Gandhi:

So, what does a company do in that case in which they may be faced with, say, an inevitable breach of contract? You talked about the President shutting down travel to Europe, at least we think, and you know a company who's got people that have got to back and forth like a consulting company and they certainly can't perform. If they're faced with an inevitable breach of contract what are they supposed to do?

Yvette Ostolaza:

Well, it depends on whether you want to get out of the contract or not. If you want to stay in the contract then obviously you're going to provide other opportunities for the client to make them whole. To say look it's reasonable to do videoconferencing if I'm in a consulting firm or it's reasonable to do another way. I think everybody's looking for an excuse to get out of contracts and to preserve cash in particular in some industries like energy where they've had the double whammy of the Coronavirus as well as the trade wars. And I think what every member of management needs to be

thinking about in their industry what contracts may they no longer need and what do they do to minimize the risks?

Sometimes the best thing you can do is walk away from a contract. And we're not used to not honoring our contracts but that may be in the best interest of a company and its shareholders and to say, you know, litigate. Because sometimes in litigation you have to minimize and mitigate your risks and your damages on the other side. And we know that litigation, if somebody sues you, it takes years to pay and you may have already weathered the storm or you may end up getting a better settlement than performing under the agreement.

Sam Gandhi:

Companies are also facing potential risks in terms of keeping their employees safe, in terms of employees that are maybe quarantined, maybe at risk of getting the virus. What are the risks that a company may have from their own employees that they need to manage?

Yvette Ostolaza:

Look, I think there's a couple of things. One is this continuity is extremely important and I think every business has to be focusing on at an office-by-office level the percentages of people, what the risks are. If you're not implementing what's considered to be best practices in the location that you're in somebody can later challenge you and argue that the welfare of the employees was not put in or that they were exposed to unnecessary risks with respect to the Coronavirus. So, the things that we're seeing employers do is, for example, make sure that there's best practice in terms of cleanliness, that's there's organizations that if there is a breach they can come in and clean.

If you're in the hospital industry the standard of care is very different than in a factory or in a professional services organization. Making sure that you're staying attune of what the best practices are in the moment are going to be really important. I've been asked, for example, is there a workman's comp claim here because of the Coronavirus? And the answer is generally not. Workman's comp comes from something that you're required to do in your job. But if you're in healthcare that may be a different answer. Certainly, those are the kinds of questions we're getting. We're getting questions about privacy and risk of privacy when people are being asked too much

information. So those are all factors that employers need to consider that vary from state to state.

Sam Gandhi:

Is now the time to be looking at whether they've got insurance for this? What should they be doing in terms of managing their risks to the extent it can be covered by insurance?

Yvette Ostolaza:

That's a good question, Sam. One of the practice pointers that we're telling boards is that this is the absolute time if you're renewing insurance and you can add certain types of riders that you see derivative riders, investigation riders changing your retention. Because we've learned from other crises that there is a lot of litigation that comes from it and to the extent that you can get that additional policy at this time that's great. There's errors and omissions policies that we're seeing. We're seeing privacy breach. One of the examples is a lot of people are going to be telecommuting and working from home. Of course, that opens up a higher chance that there's going to be breaches of some sort of networks and those are examples of things we're telling boards that they should be focusing on with management.

Sam Gandhi:

Given the fact that this issue is so rapidly evolving how do you guide a board in terms of how often they should be meeting and how often they should be considering these issues?

Yvette Ostolaza:

Well, that is tailored to the industry that you're in and what's happening. But I will say that we're having a lot of virtual board meetings by phone where boards are, you know, if you're, for example, in the energy industry and your stock has dropped, I mean, people are meeting daily to determine how quickly are you moving on cutting expenses? If you're in an industry that's not impacted by Europe or Asia perhaps that's not as important for you to meet as often. But I think the key thing is for management and the board to work together to make sure that all angles of the business are being looked at and that best practices across the industry are being looked at and making sure that they have professionals that are advising them. Because I think most people are stretched in their jobs already. They had a day job

before the Coronavirus came in and you couple this crisis on top of that and it can make for some poor decision making.

So, what we recommend is that there be an action plan of some sort and that people are designated at the board level to respond and to assist. If it's, for example, crisis management in making sure that your public disclosures are there that there is a person contacted and maybe it's the chair of your audit committed and that there's discussions almost on a weekly basis. If it's an issue that you're having to have plant closures or layoffs maybe it's the board member that's more involved with those issues. But the key thing is to make sure that management and the board are working together and are available to address the things, as they're coming up, depending on the industry that they're in.

Sam Gandhi:

This is a special episode of The Sidley Podcast. This is a very quick take on the effects of the fast-moving Coronavirus and the effect on the corporate world. We're speaking with Yvette Ostolaza, Sidley's co-global head of litigation from our Dallas office and Brian Fahrney, Sidley's co-global practice leader of our M&A and Private Equity group from our Chicago office. Finally, when you're both advising the board on how to manage through this risk how do you ensure that the board's making an informed decision consistent with their duties given how fast things are moving?

Yvette Ostolaza:

Well, the way that I would recommend that it be done is that there be professionals that are providing advice to the board and that that's being documented. So, for example, if there's an HR issue and you're trying to decide whether you need like some of the airlines are experiencing right now or places in hospitality, how quickly you're going to have to address the fact that your demand has dropped. That you make sure that the person that is in charge of HR is actually doing presentations, that there is a cost analysis and there's a legal analysis, so that quickly a plan is implemented. Here, days may matter and months may matter in terms of what companies are going to be the companies that survive on the other side of the Coronavirus as well as you know what's happening in the markets and those that don't.

The same thing goes for if they're in the middle of a transaction, I know Brian talked about it earlier, is making sure that there's documenting at the board level all options of whether you're getting in a deal or you stay in a deal, whether you're negotiating what the market is. I know that in some instances companies are hoarding cash not only because they think there's liquidity issues, but actually for the companies that are very liquid. Because they think there's going to be wonderful opportunities to move in and perhaps acquire that competitor or acquire a group of businesses or assets. So, I think, like with every crisis there is a good side and a bad side of it. And I think boards should also be looking at what opportunities from a business standpoint they should jump on at this time period and not just be on the defensive side.

Brian Fahrney:

Sam, I guess, to give my take on this you really have to put it into a few categories. For some companies and in some industries this outbreak is existential and clearly the board's posture and its level of activity is going to be different there than it may be in other companies and industries. For those companies, and as Yvette said, they need an action plan, they're in crisis mode, they ought to be meeting very frequently and they ought to be directing management if management is not being proactive to develop the plan. And that plan needs to focus on liquidity, it needs to focus on operational changes, it needs to be focused on headcount reduction and cost savings. And it also ought to have, if there is a danger of being you know in the vicinity of insolvency, it ought to have contingency planning relating to insolvency type actions. And so that's sort of one category.

There's another category, which is most companies, which is just responding to the day-to-day. And a lot of the questions I get from board members is how much do we need to be involved in this? And I guess I would liken it to or maybe put it into two buckets. There are certain decisions that you need to make and obviously those decisions, if you want to be protected by the business judgment rule in discharging your duty of care. You know you need to be reasonably well informed as to the decision you're making, you are entitled to rely on management, you are entitled to rely on experts to the extent they have something to say on the subject and are competent on the subject. And so that kind of decision making is just like any other decision making.

And then there's another aspect to it, which is more akin to the duty of oversight that you have in Delaware, the Caremark duty of oversight, which is having a reporting structure in place, having a monitoring structure in place dictating to management that they put that in place and then comply with it and then periodically checking on it. And I think boards need to follow that roadmap and have a protocol, but obviously as a board member you're not spending every hour of every day focusing even on an issue like this that is moving so quickly.

Yvette Ostolaza:

And I completely agree with Brian. I will say that in times of crisis one of the things that I tell boards is normally you are nose in fingers out on the day-to-day operations of a company. You're a board member you're not supposed to be in the know of everything or be involved. In a time of crisis it's a little bit more fingers in and nose in depending on what's going on there. So I would say the business judgment rule and exercising it in times of crisis requires more involvement than unfortunately boards normally would want or have to do. And I think it depends on which parts of the board need to be more involved depending on, like Brian said, the nature of what's happening in their industry.

Brian Fahrney:

That's a good point, which is there is clearly more that needs to be done by your average board, even for your average company in terms of exposure. And so there will be special meetings, there ought to be additional information flow, and potentially looking at more frequent updates from management and potentially hiring experts. And so clearly, and I like the nose in fingers out or nose in and fingers in way of thinking about, for most companies this one is certainly not nose in fingers out its nose in and fingers in as often as is necessary to make sure that the crisis is being tended to appropriately.

Sam Gandhi:

We've been talking about the impact of the Coronavirus crisis. Events are moving really fast right now and I appreciate you putting it all in perspective for us today. Thanks.

Yvette Ostolaza:

Thank you.

Brian Fahrney:

Good to be here.

Sam Gandhi:

Before we wrap up a word about Sidley Insights the content section of our website. We've setup a special page with a COVID-19 Resource Center. You can read articles related to various legal issues impacted by the Coronavirus crisis including the effects on mergers and acquisitions, securities disclosure, environmental law, and contract disputes. And we're going to be posting more in the coming days and we're planning future podcasts too. You can find our COVID-19 Resource Center by going to Sidley.com. You've been listening to The Sidley Podcast. I'm Sam Gandhi. Our executive producer is John Metaxas. You can hear more episodes at Sidley.com/sidleypodcasts or subscribe on Apple Podcast or wherever you get your podcasts.

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