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BOARD DIVERSITY

Accelerating Gender Diversity on Boards: Reviewing Legislative Action

By Stewart M. Landefeld, Evelyn Cruz Sroufe, Allison C. Handy, and Christopher Wassman

> *Diversity may be the hardest thing for a society to live with and perhaps the most dangerous thing for a society to be without.*
> *— William Sloan Coffin, Jr.*[1]

For the past generation, mainstream public companies in America have slowly increased the gender and racial diversity of their boards of directors to better reflect the faces of the American consumer and the shareholder base. Diversity on the boards of larger U.S. public companies has been a sign of success in the effort to show inclusion in corporate leadership: in 2019, almost half of the open board spots at S&P 500 companies went to women, and all S&P 500 companies had at least one female director.[2]

And by 2019, women made up about 26% of S&P 500 corporate directors, up from just

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16% of directors in 2009.[3] While the largest U.S. public companies have dramatically increased their board diversity, the pace of change for many smaller companies has lagged by comparison. As of the fourth quarter of 2019, the percentage of women on Russell 3000 boards was at 21.5%, with 7.7% of Russell 3000 companies having no female directors.[4]

Eight states have now taken legislative action seeking to increase the speed of board diversification.[5] State legislatures have taken three approaches: statutes mandating gender diversity on corporate boards; laws mandating disclosure of board diversity; and resolutions advising corporations to increase diversity on their boards. Years ahead of these state legislative efforts, private players have successfully used other means to increase the number of diverse directors. For example, institutional investors and proxy advisory firms are increasingly adopting voting policies encouraging board diversity.

One such investor, State Street Global Advisors, has indicated that it will vote against a company's nominating and governance committee members if gender diversity criteria are not met.[6] Additionally, private groups have developed an ever-growing pool of strong board candidates through a blend of identifying potential directors, educating them on corporate governance and the requirements of board service, and then connecting these qualified candidates to public company boards.

Overview of Statutory Approaches

In adopting various statutory approaches aimed at increasing gender diversity on corporate boards, state legislatures have cited a number of reasons, including (a) the belief that increasing the representation of women on corporate boards will improve the performance of those boards, and (b) the concern that, without a legislative impetus, progress in increasing gender diversity will simply be too slow.[7] In Washington state, supporters of a gender diversity bill reviewed their recommended approach with various groups, including the national organization, 2020 Women on Boards, which advocates for increasing the number of women on corporate boards to 20% by 2020.

State legislative actions to promote greater gender diversity on boards of directors have largely followed three main approaches:

California: Senate Bill 826

In 2018, California became the first state to mandate gender diversity on corporate boards through enactment of Senate Bill 826. The bill applied to publicly[8] held corporations with principal executive offices located in California, whether or not the company was incorporated in the state.[9] By the end of the 2019 calendar year, each subject corporation was required to have at least one female[10] director on its board of directors. By the end of 2021, subject corporations must have at least:

Gender Diversity Legislation

Legislative Approach	Diversity Mandates	Disclosure Mandates	Advisory Resolutions
States	California	Illinois	Colorado
	Washington	Maryland	Illinois *(passed prior to disclosure mandate)*
		New York	Maryland *(passed in the same bill as disclosure mandate)*
			Massachusetts
			Pennsylvania

- One female director for a four-person board
- Two female directors for a five-person board, and
- Three female directors for a board of six or more directors.

Covered corporations are subject to a fine of $100,000 for failing to provide board member information to the California Secretary of State and to fines ranging from $100,000 for a first offense to $300,000 for repeated offenses if they fail to comply with the substantive gender representation requirements.

Opponents of the bill, such as the California Chamber of Commerce, argued that it would violate the equal protection provisions of both the U.S. and California Constitutions by creating a gender classification that could result in reverse discrimination against males.[11] Some also argued that the bill, by exclusively promoting the representation of women, undermined broader efforts to diversify corporate boards ethnically and racially.

Two potential bases to challenge the California statute have been articulated: (a) the broad argument that the statute violates the equal protection clauses of the U.S. and California Constitutions by using express gender classifications, triggering strict judicial review of the alleged constitutional violation, and (b) the narrower argument, based upon the commerce clause of the U.S. Constitution, that issues such as the election of directors are matters of internal corporate affairs that should be governed by the laws of the state of incorporation,[12] so that the California statute should not apply to a corporation incorporated in another state.

For example, the election of the board of directors of a corporation formed in Delaware is generally governed by the Delaware general corporation law. For a Delaware corporation that is a "covered corporation" under California Senate Bill 826, the election of the directors would be governed by both Delaware law and California law. To avoid this conflict, opponents argue that the election is a matter of the "internal affairs" of a Delaware corporation, and that Senate Bill 826 should be disregarded.[13]

If the internal affairs argument should prevail, California corporations incorporated in Delaware or other states would not be subject to Senate Bill 826, leaving a much smaller pool of California-incorporated companies subject to the statute.[14] If the equal protection arguments should prevail, the statute would be entirely invalidated.[15]

Lawsuits were promptly filed challenging Senate Bill 826. In *Robin Crest, et al. v. Alex Padilla*,[16] Judicial Watch, a conservative foundation, sued in Los Angeles County Superior Court on behalf of three California taxpayers, seeking: (a) to declare illegal any expenditure of taxpayer funds and taxpayer-financed resources to enforce Senate Bill 826 because the statute violates federal and state equal protection provisions, and (b) to enjoin the Secretary of State (Mr. Padilla) from making such expenditures. This case is still pending trial at the time of writing.

A second lawsuit challenging the statute, *Meland v. Padilla*[17] filed in federal district court, was recently dismissed. Plaintiff was a shareholder of a publicly held corporation incorporated in Delaware but domiciled in California. Like the plaintiffs in *Robin Crest*, he argued that Senate Bill 826 contained a sex-based classification that "harms shareholder voting rights and violates the Fourteenth Amendment."[18] The court found, however, that the plaintiff did not have standing to sue, based both upon the constitutional requirements of Article III of the U. S. Constitution and upon nonconstitutional prudential considerations.

Article III of the U.S. Constitution requires that a "plaintiff must have suffered an injury in fact [, that is] fairly traceable to the challenged action of the defendant [and] that it must be likely [to] be redressed by a favorable [judicial] decision."[19] The court noted that Senate Bill 826 imposed compliance and penalties on the *corporation*, not on its shareholders. As a shareholder,

Mr. Meland was free to vote as he wished for any candidate for the board. Furthermore, the court took judicial notice of the fact that the corporation had already appointed a woman to its board and was, therefore, in compliance with the statute, so no penalty would be imposed on the corporation.

The prudential standing considerations required the court to examine "whether the plaintiff is asserting her own rights or the rights of third parties."[20] Because the plaintiff's claim asserted injury to the corporation, under either California or Delaware law it was derivative. Accordingly, the plaintiff failed both prongs of the standing argument and his claims were dismissed.[21] The court, therefore, did not reach the substance of his constitutional arguments.

Although it is possible that a corporation subject to Senate Bill 826 could sue on its own behalf and meet the standing requirements for an equal protection challenge to the law, it is increasingly unlikely that the board of directors of a publicly held corporation would choose to be identified as opposing a gender equality requirement. Investor sentiment, as evidenced by the positions of proxy advisors and institutional investors, is strongly in favor of greater gender equality on corporate boards as discussed further below.[22] Accordingly, and perhaps unsurprisingly, a recent report by KPMG found that 96% of California publicly held companies are complying with Senate Bill 826.[23]

Washington: Senate Bill 6037

Earlier this year, Washington became the second state to mandate gender diversity on corporate boards when Governor Jay Inslee signed Senate Bill 6037 into law.[24] Senate Bill 6037 requires at least 25% of the board of directors of public companies formed under the Washington Business Corporation Act (WBCA) to be women, or the company must provide a board diversity discussion and analysis to its shareholders. The drafters, including the Washington State Bar Association's Corporate Act Revision Committee, avoided some of the challenges of California's Senate Bill 826. Senate Bill 6037 will apply to a "public company," defined as a Washington corporation that has a class of shares registered with the U.S. Securities and Exchange Commission (SEC) under applicable statutes.[25]

The heart of Senate Bill 6037 is the requirement for women to represent 25% or more of a public company's board:

> Beginning no later than January 1, 2022, each public company must have a gender-diverse board of directors or that public company must comply with the requirements in subsection (2) of this section [requiring a "Diversity Discussion and Analysis"]. For purposes of this section, a public company is deemed to have a gender-diverse board of directors if, for at least two hundred seventy days of the fiscal year preceding the applicable annual meeting of shareholders, individuals who self-identify as women comprise at least twenty-five percent of the directors serving on the board of directors.

Not all public companies formed under the WBCA must comply with these gender diversity requirements. Senate Bill 6037 has five core exceptions:

- *Unlisted companies*. A company that has shares registered under Sections 12 or 15 of the Securities Exchange Act of 1934, or Section 8 of the Investment Company Act of 1940, but that does not have outstanding shares of any class or series listed on a U.S. national securities exchange.

- *An "emerging growth company" or a "smaller reporting company."* A business as defined in SEC regulations[26] that is subject to a lighter regulatory burden while it is small. This exception will generally exempt emerging companies, for some period of time following its initial public offering, and small public companies.

- *A controlled company.* A partial subsidiary of, or a company controlled by, another entity or group of persons. A controller may be another public company, a private equity investor, or another person or group that holds or controls over 50% of the voting power of the controlled company.

- *Companies with voting groups designating directors*. A company whose articles of incorporation, by designating classes or series of shares, authorize voting groups to elect all or a set number of directors.[27]

- *Companies without an annual meeting.* A company that is not required to hold an annual meeting of shareholders (under Washington or U.S. law).

Trap for the Unwary. Senate Bill 6037 contains a small trap for the unwary, when complying during the initial year, 2022. The 25% requirement applies in connection with annual meetings held on and after January 1, 2022, but is first measured in the fiscal year preceding the applicable annual meeting. The first test for a public company with a calendar fiscal year will be to measure whether the board, for 270 out of 2021's 365 days, included at least 25% women.

For example, if a company at its May 2020 annual meeting did not elect a board consisting of at least 25% female directors, it will have difficulty achieving this 25% mandate for 2021. The company will need to make a calculation and potentially add women to the board prior to March 31, 2021. That would likely be before its 2021 annual meeting. If that company does not have 25% women on the board by March 31, 2021, it will not be deemed compliant when measured on January 1, 2022.

Disclosure is an alternative, with a "Diversity Discussion and Analysis." If the public company does not have a gender-diverse board by January 1, 2022 (as measured in the prior fiscal year), then it must publish (on its website or in its proxy or information statement) a board diversity discussion and analysis, which must include information regarding the public company's approach to developing and maintaining diversity on its board of directors. The diversity discussion and analysis must address diversity more broadly than just inclusion of women, covering other diverse groups including racial minorities and historically underrepresented groups.

While the Washington statute avoids the internal affairs argument that can be made against California's Senate Bill 826, it may be subject to the same equal protection arguments as were made in *Meland v. Padilla*. A shareholder seeking to make those arguments, however, would have to overcome the same standing hurdles that faced the plaintiff in *Meland v. Padilla*. Like Senate Bill 826, the Washington statute imposes obligations on the corporation, not on its shareholders.

Perhaps most importantly, while a Washington corporation could sue in its own right, corporate shareholders, the public company governance community, and the current public zeitgeist all strongly favor diversity on boards. There is no reason to believe that Washington corporations are any more willing than California-headquartered corporations to publicly oppose a gender equality statute.

Disclosure Requirements

Rather than mandate board representation based on gender, some states have opted to mandate public disclosures to spur greater diversity on corporate boards. These laws require certain corporations to report to the state on the composition of their boards in order to allow state agencies to publish reports regarding board diversity. Implementing disclosure mandates has been seen as a more measured approach than the diversity requirements imposed by California and Washington.

Illinois. In 2019 Illinois considered a bill[28] that followed the diversity mandate approach of California. The Illinois bill went a step further, however, by including racial—as well as

gender—mandates. The bill would have required public companies incorporated in or with principal offices in Illinois to have at least one female director, one African American director, and one Latino director on their board by the end of 2020. The version of the bill that passed the Senate dropped the diversity mandates in favor of requiring disclosure regarding gender and minority diversity.

Under the bill, by no later than January 1, 2021, publicly held domestic or foreign corporations with their principal executive offices in Illinois are required to disclose the diversity of their boards and executive officer ranks, along with their plans to promote director and officer diversity, in their annual reports filed with the Illinois Secretary of State. The bill—signed into law in August 2019[29]—also requires the University of Illinois to publish an annual report card on Illinois companies' diversity.

New York. Taking a similar approach to Illinois, New York enacted the Women on Corporate Boards Study law in 2019.[30] The legislation applies more broadly than the Illinois legislation, requiring that domestic corporations and foreign corporations authorized to do business in New York report the number of female directors on their board and the total number of board members. After the law goes into effect on June 27, 2020, companies must provide this information about their directors as part of their routine filing statements.[31]

The N.Y. Department of State must also publish a study by February 1, 2022, and every four years thereafter, including the number of female directors and the total number of directors that constitute the board of each corporation, an analysis of the change in the number of female directors compared to prior years and the collective percentage of female directors on all such boards.

Maryland. Maryland enacted similar legislation in May 2019 titled Gender Diversity in the Boardroom.[32] Effective as of October 1, 2019, the Maryland law requires any tax-exempt domestic nonstock corporation with an operating budget over $5 million or any company with total sales exceeding $5 million registered or qualified to do business in the state to report the number of female board members and total number of members of their boards.

However, privately held companies are excluded from the reporting requirement if at least 75% of the company's shareholders are family members. The law also requires the Maryland Comptroller to publish a report for the Maryland General Assembly regarding the percentage of female representation on boards and make the report publicly available.

Advisory Resolutions

Several other states have focused their legislative efforts on passing nonbinding resolutions encouraging companies to increase gender diversity in their leadership ranks.

Colorado. Colorado passed a resolution in 2017 encouraging public companies in that state with nine or more board members to have at least three female board members, companies with five to eight board members to have two female board members, and companies with fewer than five seats to have at least one female on their board by the end of 2020.[33] Given this resolution's purpose of promoting gender equality more generally, the legislature did not clarify whether the resolution applied only to public companies with principal offices in Colorado or to all companies doing business in the state.

Illinois. Prior to enacting its diversity disclosure mandate, Illinois passed a nonbinding resolution similar to Colorado's resolution encouraging every publicly held corporation in Illinois with nine or more board members to have at least three female board members, those with five to eight board members to have two female board members, and those with fewer than five seats to have at least one female on their board by 2018.[34] Similar to the Colorado legislature, the Illinois legislature did not clarify whether this applied only to public companies

with principal offices in Illinois or to all companies doing business in the state.

Massachusetts. Massachusetts adopted a resolution encouraging all companies doing business in the state, both publicly traded and privately held, to disclose the number of female board members and total board members, and—similar to Illinois—encouraging all such corporate boards with nine or more board members to have at least three female board members and all boards with fewer than nine members to have a minimum of two female directors by the end of 2018. Additionally, the resolution advises all companies doing business in the state, both publicly traded and privately held, to adopt policies designed to increase gender diversity for the leadership ranks of all corporate boards.[35]

Pennsylvania. In 2017, Pennsylvania passed a resolution encouraging public, private and nonprofit companies doing business in Pennsylvania to increase female representation on their boards to at least 30% by 2020 and measure progress toward a goal of equal gender representation in leadership positions on an annual basis.[36]

Maryland. As part of the bill enacting Maryland's disclosure mandate discussed above,[37] the legislature also urged that by December 31, 2022, all nonprofit, privately held and publicly traded companies doing business in Maryland to have a minimum of 30% female directors and measure progress toward a goal of equal gender representation in leadership positions on an annual basis.[38]

Nonlegislative Drivers of Board Diversity

In addition to broader cultural changes, a number of organized efforts have been constructive in increasing board diversity. First, a variety of groups, including regional efforts such as OnBoarding Women, and leading national campaigns such as 2020 Women on Boards and the Athena Alliance, have combined identification of board candidates with education of women who stand out as potential public company directors, thus providing a strong pool of candidates for public company nominating and governance committees.[39]

Second, institutional shareholders are playing a larger role in the push for greater diversity on boards. Leading shareholders, such as Vanguard and BlackRock, Inc., have policies encouraging progress on diversity, while others, such as State Street Global Advisors, have stated they will vote against directors for companies that do not meet their gender diversity criteria.[40] For example, while BlackRock, Inc., acknowledges that "diversity has multiple dimensions," it encourages companies "to have at least two women directors on their board."[41] Finally, proxy advisory firms ISS and Glass Lewis have both included statements in their policies that they would recommend votes against the election of the nominating committee chair of an all-male board, barring certain mitigating factors.[42]

Third, other key market participants have weighed in favor of gender diversity. For example, Goldman Sachs recently announced that it will take companies public only if there is "at least one diverse board candidate, with a focus on women . . . And we're going to move towards 2021 requesting two."[43] While many investor efforts discussed above have focused on large public companies, Goldman Sachs' announcement has the potential to create change in a population of emerging companies that have so far been less subject to these investor pressures.

While larger S&P 500 companies have been more affected by these non-legislative drivers, small to mid-sized companies are often not on the radar for shareholder advisory groups like ISS and Glass Lewis, and their stock may be less likely to be held by institutions such as BlackRock, Inc., State Street Global Advisors or other large institutional holders. This can insulate these companies from certain pressures to conform on gender diversity.

In addition, CEOs and nominating and governance committees of smaller companies may

be more likely to rely on people they know in their circle of acquaintances to fill board seats, sometimes in order to avoid incurring search firm fees.[44] These different pressures may explain why small and mid-sized companies have experienced different levels of progress on board gender diversity.

Finally, other governance trends are beginning to create more opportunities for women to join corporate boards. Institutional investors and shareholder advisors oppose "overboarding" in which directors take on so many board seats that they become at risk of not competently serving on all.[45] Although board policies such as age or term limits can result in more board turnover, these advocates have generally favored rigorous board evaluation processes as a better means of effecting board refreshment.[46] More directors reducing the number of boards on which they serve or rotating off of corporate boards will create more open seats that are available to be filled by women.

Future Statutory Changes

As states consider gender diversity mandates, we suggest that they carefully consider the pros and cons of the California and Washington models, particularly the lessons incorporated into Washington's mandate with the benefit of observing California's effort. Key considerations for drafters include:

1. Avoid hard quotas with numbers in favor of minimum percentages;

2. Favor "comply or explain", a model successfully used for years by the SEC over monetary penalties;

3. Clarify that the statute does not change the fundamental corporate law board duties of directors; and

4. Specify that noncompliance will not impact the validity of corporate actions.

One Practical Step

There is one practical step that board leaders can take right now. Nominating and governance committee chairs can lead the effort to look for diverse candidates outside the ranks of CEOs. Though the ranks of female CEOs at major companies are still fairly slim, there are many extremely qualified women in other public company executive roles. Nominating and governance chairs can add gender diversity to the board while also filling out other key director characteristics, including expertise in areas such as finance, technology, marketing, or a specific industry.

Conclusion

Social forces have led to more diverse boards of directors. But achieving greater diversity, including gender diversity, remains a work in progress for many corporate boards. While successful models have developed to encourage gender diversity, two states have adopted statutes that mandate numbers or percentages of women on boards. Other states may follow. The drafters of those statutes will find lessons from the case law developing around California Senate Bill 826, and the careful drafting of Washington Senate Bill 6037. And the most important impetus for change may still come from other societal forces and private actors who continue to provide deep and diverse pools of competent candidates for directors of American public companies.

Notes

1. William Sloane Coffin, "The Heart Is a Little to the Left: Essays on Public Morality" at 69–70 (Dartmouth Coll. Press, 1999).

2. 2019 U.S. Spencer Stewart Board Index, at 1 (2019); Vanessa Fuhrmans, The Last All-Male Board on the S&P 500 is No Longer, Wall St. J. (July 24, 2019, 5:20 PM), *https://www.wsj.com/articles/the-last-all-male-board-on-the-s-p-500-is-no-longer-11564003203*.

3. *Id.*

4. Q4 2019 Gender Diversity Index, Equilar Board Edge (Mar. 9, 2020).

5. *See* discussion *infra* Overview of Statutory Approaches.

6. Summary of Material Changes to State Street Global Advisors' 2020 Proxy Voting and Engagement Guidelines, State Street Global Advisors 2 (Mar. 2020), *https://www.ssga.com/library-content/pdfs/global/proxy-voting-and-engagement-guidelines.pdf*.

7. California's legislature, for example, cited numerous independent studies showing that publicly held corporations with women board members perform better overall than corporations with no female board members, and that without proactive measures, it could take as many as 40 to 50 years to achieve gender parity among directors. *See* S.B. 826, 2017-2018 Leg., Reg. Sess. (Cal. 2018).

8. A "publicly held corporation" under Senate Bill 826 is a domestic or foreign corporation "with outstanding shares listed on a major United States stock exchange". *See id.*

9. Based on the corporation's Form 10-K filed with the Securities and Exchange Commission.

10. "Female" is defined in the statute as "an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth."

11. *See* Loren Kaye, *Legislating Is Hard When Up Against Reality*, Capital Insider (May 14, 2018), *https://capitolinsider.calchamber.com/2018/05/legislating-is-hard*.

12. *Edgar v. MITE Corp*., 457 U.S. 624, 645 (1982); *McDermott Inc. v. Lewis*, 531 A.2d 206, 209 (Del. 1987).

13. *See* Steven Yoder, *Will SB 826 Survive?*, Comstock's Magazine (Mar. 7, 2019), *https://www.comstocksmag.com/article/will-sb-826-survive*.

14. Fewer than 10% of the 761 publicly traded companies headquartered in California. *See* Joseph A. Grundfest, *Mandating Gender Diversity in the Corporate Boardroom: The Inevitable Failure of California's SB 826* (Stanford Law Sch. and The Rock Center for Corp. Governance, Paper No. 232, 2018), *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3248791*.

15. Patricia Brown Holmes, *All Aboard*, Best Lawyers (Apr. 18, 2019, 10:39 AM), *https://www.bestlawyers.com/article/california-s-mandatory-gender-diversity/2379*.

16. L.A. Super. Ct., No. 19STCV27561 (Apr. 17, 2020).

17. No. 2:19-cv-02288-JAM-AC (E.D. Cal. Apr. 20, 2020).

18. *See id.* at 3.

19. *See Lujan v. Defs. of Wildlife,* 504 U.S. 555, 560–61 (1992) (citation omitted). Importantly, standing is not "dispensed in gross," and, accordingly, a plaintiff must demonstrate standing for each claim "he seeks to press and for each form of relief that is sought." *See Davis v. FEC*, 554 U.S. 724, 734 (2008) (internal quotation marks omitted). Moreover, when there are multiple parties to a lawsuit brought in federal court, "[f]or all relief sought, there must be a litigant with standing, whether that litigant joins the lawsuit as a plaintiff, a coplaintiff, or an intervenor as of right." *See Town of Chester v. Laroe Estates, Inc*., 581 U.S. ___, No. 16–605, slip. op. at 6 (June 5, 2017).

20. Order at 11, *Meland v. Padilla*, No. 2:19-cv-02288-JAM-AC (E.D. Cal. Apr. 20, 2020) (ECF No. 16).

21. Mr. Meland has noted an appeal of the decision to the Ninth Circuit Court of Appeals.

22. *See infra* Nonlegislative Drivers of Board Diversity.

23. J. Jennings Moss, *How California Public Companies Have Done on Board Diversity*, Silicon Valley Business Journal (Feb. 20, 2020, 11:04 AM), *https://www.bizjournals.com/sanjose/news/202%2/20/california-public-companies-women-on-boards-kpmg.html*.

24. S.B. 6037, 66th Leg., Reg. Sess. (Wash. 2020). Senate Bill 6037 was signed on Friday, March 27, 2020, with an effective date of June 11, 2020, and comprises a new section of Chapter 23B.08 (Directors and Officers) of the Washington Business Corporation Act (WBCA).

25. WBCA § 23B.01.400(28).

26. 17 C.F.R. § 240.12b-2.

27. WBCA § 23B.08.040.

28. H.B. 3394, 101st Gen. Assemb., Reg. Sess. (Ill. 2019).

29. Act of August 27, 2019, Pub. Act 101-589, 2019 Ill. Laws 589.

30. Assemb. 6330, 2019 Leg., Reg. Sess. (N. Y. 2019); S. 4278, 2019 Leg., Reg. Sess. (N. Y. 2019).

31. N.Y. Bus. Corp. Law § 408.

32. H.B. 1116, 2019 Leg., 440th Sess. (Md. 2019); S. 911, 2019 Leg., 440th Sess. (Md. 2019).

33. H.R. J. Res. 17-1017, 70th Gen. Assemb., Reg. Sess. (Colo. 2017).

34. H.R. Res. 439, 99th Gen. Assemb., Reg. Sess. (Ill. 2015).

35. S. Res. 1007, 189th Gen. Ct., Reg. Sess. (Mass. 2015).

36. H.R. Res. 273, Gen. Assemb., 2017 Sess. (Pa. 2017).

37. *See supra* Disclosure Requirements.

38. H.B. 1116, 2019 Leg., 440th Sess. (Md. 2019); S. 911, 2019 Leg., 440th Sess. (Md. 2019).

39. *See* OnBoarding Women, *https://onboardingwomen.org* (last visited May 22, 2020); 2020 Women on Boards *https://2020wob.com* (last visited May 22, 2020); Athena Alliance *https://athenaalliance.org* (last visited May 22, 2020). In addition, many other organizations are serving as a bridge between board opportunities and board-ready candidates. *See generally* Women in the Boardroom,

https://womenintheboardroom.com (last visited May 22, 2020); theBoardlist, *https://theboardlist.com/home* (last visited May 22, 2020); Him for Her, *https://www.himforher.org* (last visited May 22, 2020).

40. *See* Investment Stewardship 2019 Annual Report, Vanguard 18 (2019), *https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf*; BlackRock Investment Stewardship: Corporate governance and proxy voting guidelines for U.S. securities, BlackRock 5 (Jan. 2020), *https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf*; Amy Whyte, State Street to Turn Up the Heat on All-Male Boards, Institutional Investor (Sept. 27, 2018), *https://www.institutionalinvestor.com/article/b1b4fh28ys3mr9/State-Street-to-Turn-Up-the-Heat-on-All-Male-Boards*.

41. BlackRock Investment Stewardship: Corporate governance and proxy voting guidelines for U.S. securities, BlackRock 5 (Jan. 2020), *https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf*.

42. *See* ISS Americas Proxy Voting Guidelines Updates for 2020, Institutional Shareholder Services 5 (Nov. 11, 2019), *https://www.issgovernance.com/file/policy/latest/updates/Americas-Policy-Updates.pdf;* 2019 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice United States, Glass Lewis 26 (Oct. 24, 2018), *https://www.glasslewis.com/wp-content/uploads/2018/10/2019_GUIDELINES_UnitedStates.pdf*.

43. Goldman Won't Take Companies Public Without At Least One Diverse Board Candidate, CEO Says, CNBC (Jan. 23, 2020, 5:57 PM), *https://www.cnbc.com/202%½3/goldman-wont-take-companies-public-that-dont-have-at-least-one-diverse-board-candidate-ceo-says.html*.

44. 2020 Women on Boards Gender Diversity Index 2019 Progress of Women Corporate Directors of Russell 3000 Index Companies (Oct. 2019), *https://2020wob.com/wp-content/uploads/2019/10/2020WOB_Gender_Diversity_Index_Report_Oct2019.pdf*.

45. *See* Vanguard Funds Summary of the Proxy Voting Policy for U.S. Portfolio Companies, Vanguard 4 (Apr. 1, 2020), *https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020_proxy_voting_summary.pdf*. *See also* Andrew R. Brownstein et al., Institutional Investors Signal a Mix of Tougher Standards and Heightened Flexibility for the 2020 Proxy Season, Wachtell, Lipton, Rosen & Katz (Apr. 29, 2020), *https://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.26936.20.pdf*.

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Securities Offerings During Closed Windows and Blackout Periods

By Joseph A. Hall, Michael Kaplan, Yasin Keshvargar, Nicholas A. Kronfeld, John B. Meade, Emily Roberts, Byron B. Rooney, Sarah K. Solum, Richard D. Truesdell, Jr., and Daniel Reichert

Many companies are taking a close look at their sources and uses of cash over the next several quarters and beyond in the face of a potentially prolonged period of market and business uncertainty associated with the coronavirus (COVID-19) pandemic. In a turbulent market, many public companies and their underwriters want to be prepared to take advantage of potential opportunities to raise debt or equity capital, even if they occur during a company's self-imposed blackout period.

During a blackout period, company insiders are barred—as a matter of company policy—from trading in the company's securities. These blackout periods typically begin before the quarter ends and continue until shortly after the quarter's earnings announcement.

Companies choose to impose blackout periods on their insiders as a prophylactic measure to prevent the appearance that securities were sold at a time when their insiders had material non-public information or "MNPI" about the company. The existence of a self-imposed blackout period does not, however, as a legal matter, prevent a company from selling securities, as long as the company has provided adequate disclosure.

This memo discusses what factors public companies and their underwriters should consider when contemplating a securities offering—including equity, equity-linked or debt offerings, and PIPE (private investment in public equity) transactions—during a blackout period.

What Is a Blackout Period and Why Do Companies Impose Them?

The securities laws in the U.S. and other jurisdictions prohibit insiders from trading based on any material non-public information they have obtained from the company. Accordingly, public companies typically require insiders who wish to sell securities to obtain clearance from the legal

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the Corporate Governance advisor

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department before trading to ensure they don't possess MNPI.

To protect insiders from regulatory investigations and the possible appearance of impropriety, as well as to avoid forcing the general counsel to make a call when the facts may be developing rapidly, most companies impose a blackout period during which insiders cannot trade. This period often starts before quarter-end, when the company and its insiders are likely to possess MNPI. But, importantly, this is a preventative measure, not a hard-and-fast rule imposed by law or regulation.

Can an Offering Be Completed during a Blackout Period?

At the risk of repeating ourselves, there is no legal prohibition on the sale of securities during a regularly scheduled blackout period. Rather, issuers have disclosure obligations to purchasers at the time of an offering and sale of securities, and information about the company's performance for a nearly-completed or recently-ended fiscal quarter as well as trends impacting the business is often judged to be material information.

And even though companies typically take pains to exclude forward-looking guidance or projections from the information provided to investors in the context of an offering, a company's failure to "meet or beat" expectations when earnings are announced is likely to result in a stock drop and could lay the groundwork for claims that the issuer misrepresented or failed to disclose underlying trends in the business at the time of the offering.

It may be possible to complete a securities offering during a blackout period when:

- management has enough information about the current (or recently ended) quarter to be able to predict with a fair degree of confidence what the company's reported results are likely to be;
- management has a good track record of being able to judge its anticipated results at similar points in the information-gathering and reporting cycle;
- management's expectations for the quarter, and future periods, are either (i) at least in line with "the market's" expectations as well as with management's own previously announced guidance (if any)—or (ii) if management's expectations are not so in line, the company and its underwriters conclude that the deviation is not material or the company is willing to "pre-release" its current expectations prior to the earnings release. In certain circumstances, such as those relating to the impact of the COVID-19 crisis, management may not be able to predict the company's results beyond the current quarter, with a high degree of confidence. In those scenarios, a company may decide to withdraw previously issued guidance and not issue new guidance. Nevertheless, withdrawing guidance is not a substitute for disclosure of underlying trends and uncertainties that could affect financial and operational performance; and
- management's analysis of the going-forward impact on the company's business of COVID-19 is sufficiently developed that disclosure can be made at the time of the offering that will be in line with what is disclosed when the 10-K, 20-F, 10-Q, 6-K or other filing is made.

Management's information. The inquiry into management's current information should normally include careful diligence focusing on the "known knowns" and the "known unknowns," and an effort to quantify the "known unknowns" is usually essential. The "unknown unknowns," of course, cannot be quantified, and for this reason, *all participants in the transaction must understand and accept that there is some quantum of risk—reputational as well as legal—that cannot be excluded when conducting a securities offering in the period leading up to the company's formal announcement of results*.

Some companies have systems (such as flash reports) to track performance weekly, or even

daily, and have a strong grasp on what is happening on a near real-time basis. Other companies may experience more of a lag before negative information or a developing negative trend becomes apparent to management—the "unknown unknowns" would be more of a concern here. Today, many companies are just starting to assess the effects of the COVID-19 pandemic and are considering the limited nature of the information they've gathered so far in light of the rapidly evolving environment.

Management's track record. An assessment of management's track record can sometimes be informed by comparing the company's earnings or other forward-looking guidance to its reported results for the last several quarters, in order to get a sense of whether the company has a history of "underpromising and overperforming," or vice versa. Not all companies provide public guidance, however. For companies in either camp, it is usually helpful to have a working group discussion focusing on where the company is in its information-gathering and reporting cycle, and whether it is currently at a point, based on past experience, to be able to forecast results with some degree of accuracy.

Market expectations. Market expectations are not always easy to discern, and there is no single way to go about determining them. Many working groups will start with services such as Thomson One, or another service that aggregates the published views of securities analysts, in order to determine the "consensus" view for the current (or recently ended) quarter, the full year and sometimes the next year. Because the consensus is usually reported as an average (whether of estimates of future revenues, earnings, EPS or EBITDA, or other metrics closely followed in the company's industry), it is usually helpful to look beneath the consensus to see whether it is being driven up or down artificially by an analyst or two who may be an outlier.

Likewise, if the company will meet market expectations largely because of one or more factors that the market is unaware of, or maybe aware of but is likely to discount (such as a one-off or non-operating gain), and the company would be below expectations if its results were based only on the factors normally incorporated in the analysts' models, the working group may decide that the company is not clearly and comfortably meeting market expectations despite a superficial similarity.

Because most analysts do not update their published views more frequently than quarterly, sometimes the "consensus" may be outdated. As an example, if the company is a brick-and-mortar retailer and its earnings will deviate from consensus simply because sales have declined due to previously announced store closures since the analysts last published, the working group may be able to conclude that investors will not be surprised by the deviation. However, for each offering, the working group should try to understand whether the reason the company is likely to deviate from consensus, and the magnitude of that deviation, is something that ought to be apparent to and expected by the investing public or is instead based on information not available to the market.

Beyond looking at the numbers, the company and its underwriters should consider any other available information, such as:

- the company's understanding of where investors and analysts are currently focused,
- the views of coverage bankers involved in the transaction,
- recent announcements by industry peers or others that may be recalibrating market expectations, and
- the views of any sell-side research analysts who are "over the wall"—*i.e.*, an analyst employed by an underwriter involved in the transaction who has been informed about it. Because an analyst who is brought over the wall is usually prohibited from speaking to investor clients about the company until the transaction has been publicly announced, it is generally not customary to bring analysts over the wall until shortly before announcement.

A company that does not provide public guidance or that has withdrawn its public guidance may reasonably ask why market expectations about the company's upcoming earnings announcement should be relevant to the question of whether it can conduct a securities offering. The issue is whether or not investors are likely to be disappointed when the company announces earnings. Even if the company does not provide or has withdrawn guidance, the market still has expectations, generally based on the company's results in prior periods; the fact that those expectations were not informed by the company's own guidance is a nuance that may be lost on the disappointed investors and the plaintiffs' lawyers who specialize in filing lawsuits on their behalf.

What If Management's Expectations Are Not In Line with the Market's?

If management's expectations for the quarter are not in line with the market's, many companies will decide to put off a securities offering until after earnings are announced and the related 10-K, 10-Q or 6-K is filed. For a company that is nevertheless prepared to proceed, the company and its underwriters should agree on a strategy for recalibrating the market's expectations. This involves two decisions: what to say, and how to say it.

What to say. This, of course, turns primarily on the facts. Frequently, the issue is simply a non-trivial risk that one or more of the company's reporting metrics will be lower than the market's current expectations. Sometimes this can be solved simply by disclosing or highlighting a fact or trend (such as a slowdown in orders from a major customer or a supply chain disruption) that the market has not previously considered or that analysts have not yet factored into their reports. Often, the company cannot say precisely what it will report in a few weeks, but is fairly certain that the market's expectations are above the range of reasonably likely outcomes; in this case, it may be appropriate to disclose that range. In situations where the longer-term effect of a trend is unknown, it may be appropriate to withdraw longer-term guidance, such as annual guidance, and instead qualitatively discuss the trends and impacts currently being experienced.

How to say it. Because of the sensitive nature of information about a gap between management's and the market's expectations, the communication strategy should take into account the requirements and spirit of Regulation FD—even when there is a technical Regulation FD exemption, as may be the case with a public offering. Thus, companies will often announce the new information in an 8-K or 6-K filed immediately prior to launching the transaction.

If the quarter-end has passed, disclosure under Item 2.02 may be needed; otherwise an Item 7.01 8-K or press release may suffice. Whether to also include (or incorporate by reference) the information in the offering document and/or roadshow materials is a subject for working- group discussion. When the information includes forward-looking statements, the working group may conclude in some situations that it is preferable to leave it out of the offering materials.

What Else Should the Working Group Consider?

Updates to risks, trends, and uncertainties. Particularly in a volatile macroeconomic environment, "meeting or beating" guidance and street expectations should not be the only yardstick for up-to-date disclosure in the context of a securities offering. As an example, a company that expects to meet its guidance for the recently completed quarter and that does not provide full-year guidance needs to consider whether it is aware of underlying trends in its business that could weigh on the outlook that it provides in its next earnings call.

If an issuer is incorporating the MD&A and Risk Factors sections of its previous 10-K, 20-F, 10-Q or 6-K by reference in its offering

document, it should carefully examine whether the risks, trends, and uncertainties disclosed in that incorporated filing are accurate and complete as of the date of the offering. And if a company updates its risk factors or other disclosure in an offering memorandum relating to an unregistered offering, it should consider whether the changes are material such that they should also be publicly filed on Form 8-K or 6-K, as applicable. In light of the COVID-19 pandemic, issuers that have not already done so in an 8-K or 6-K filing may update their risks, trends and uncertainties disclosure in the upcoming 10-K, 20-F, 10-Q or 6-K. In the context of an offering carried out before that filing, it will be important for the offering disclosure to be in line with what will be reported in the future filing.

Selective disclosure issues. Companies conducting confidential marketing of securities, such as in a wall-crossed registered equity offering or a PIPE, are likely to grapple with challenging Regulation FD questions in a rapidly changing business environment. In order to participate in a confidential marketing process, investors agree to keep confidential any MNPI that they receive and not to trade in the company's securities until an agreed future cleanse date. On or before the cleanse date, the issuer must either broadly disclose the confidential information to the market, such as in a press release or 8-K, or determine that the non-public information is no longer material.

The very existence of a contemplated equity offering is ordinarily MNPI; in fact, in many wall-crossed registered equity offerings, it is often the only MNPI that the investor receives. If an issuer has sufficient cash or access to financing, companies and their advisors often conclude that a proposed offering is "opportunistic"—meaning that if the issuer abandons it, the abandoned attempt to raise capital is not material information, and no cleansing disclosure will be required. In a volatile market in which both access to financing and projected expenses are uncertain, these judgments are more difficult and could even change through the course of the confidential marketing.

In certain circumstances, investors may be unwilling to indicate interest in a proposed offering without receiving additional, current information about the issuer's estimates or outlook—information that is almost certain to be considered MNPI. This is particularly true in a PIPE, in which one or more investors purchase a relatively sizable equity stake in the company. In such situations, issuers will need to carefully consider whether and when to share such information in the confidential marketing process and to be cautious about any cleansing requirements from potential PIPE investors.

Reputational risks. All offering participants—the company and company management as well as the underwriters—risk damage to their reputations if an offering is conducted and the company's subsequently reported results to disappoint investors in the offering. This is the case whether or not the company felt it needed to disclose new information in order to reset the market's expectations.

Legal risks. A materially disappointing earnings release issued after an offering can be an invitation for a lawsuit, which of course is distracting and potentially costly even if not well-founded. The working group should bear in mind that whether there's a "material" difference between the company's offering-related disclosures and its subsequently announced results is a question that will be judged with hindsight—based at least in part on how the market reacts when the results are made public.

On a related note, the company's accountants generally will not be in a position to provide "comfort" with respect to ranges or projections and may be unable to provide comfort with respect to periods of a few weeks before and after the quarter-end. Similarly, prior to filing the 10-K, 20-F, 10-Q or 6-K, the company's accountants are generally unable to provide a formal review or audit of financial information for the quarter or year. In a subsequent lawsuit, therefore, the offering participants may not have the full benefit of an accountant's comfort letter to help establish their due diligence defense.

Underwriters will therefore often seek to document and substantiate their diligence of ranges, projections, earnings-release information and other financial information about the quarter through alternative means, such as by conducting meetings with the company's management and senior accounting personnel to discuss the basis for the company's expectations, obtaining a CFO certificate attesting to numbers or ranges included in the offering document and/or having a confirmatory conversation with a member of the company's audit committee, in addition to obtaining the company's representations and warranties in the underwriting or purchase agreement and reviewing read-outs from financial systems.

Though the exact procedures may vary from situation to situation, it will be important to demonstrate that a robust process of vetting management's expectations and underlying assumptions for the quarter and future periods was undertaken with the participation of the working group.

Are Your Financing Agreements Immune from COVID-19? Considerations for MAE, Force Majeure, and Other Contractual Defenses

By Michael A. Karpen, Gary Marsh, Alexandra S. Peurach, Christian Chad Warpula, Justin A. Wood, and Frank Montes de Oca

As the United States and the rest of the world continue to feel the substantial economic impact wrought by the coronavirus (COVID-19) pandemic and related shelter in place orders, lenders and borrowers may be evaluating potential defaults under their financing agreements caused by the significant business interruption that has occurred as a result.

Amidst the more notable global supply chain disruptions, mandatory closure of businesses throughout the world, government shutdowns and massive workforce layoffs, seemingly less significant and often ignored covenants and provisions in loan documentation may lead to unanticipated defaults. These potential defaults, together with the potential for subsequent payment defaults due to decreased revenue and profits, has led many lenders and borrowers to question how any applicable material adverse effect (MAE) and force majeure clauses in their loan documentation, as well as other common law contractual defenses, may be implicated.

Whether it is a lender seeking to invoke an MAE clause to trigger default or deny an advance of funds, or a borrower seeking to use force majeure or common law defenses such as impossibility, impracticality or frustration of purpose to excuse a potential default, it is important for both sides to understand these seldom applied contract terms and common law defenses. As outlined below, MAE, force majeure, and other common law contractual defenses are likely fruitless pursuits when seeking to excuse performance under finance contracts in response to the coronavirus pandemic.

This article explores the applicability of MAE clauses, force majeure provisions and common law contractual defenses, and offers practical considerations for lenders and borrowers regarding their effect on financing agreements.

Material Adverse Effect

As a preliminary matter, it should be noted that the use of an MAE as a trigger for a default by a lender is generally not advisable where other more clearly defined and objectively measurable defaults may have occurred, or may be expected to occur after the passage of time.

As explained below, MAE-related provisions are purposefully subjective and lack sufficient analysis by the courts in the lending context. As such, it is likely preferable for a lender seeking to call a default to rely on provisions in its loan documentation that are based on objective and definite measures, such as non-payment or a breach of financial or other specific covenants. In addition, asserting the occurrence of an MAE presents reputational risk to lenders in the marketplace, and many lenders have responded to the coronavirus pandemic by taking a more constructive posture with their borrowers.

In finance transactions, MAE clauses are used to measure the effect of some event, and

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whether that event meets a certain threshold determines if a material adverse effect has occurred. MAE, which is often used interchangeably with Material Adverse Change, is generally defined as: "a material adverse effect on (a) the business, assets, properties, liabilities (actual or contingent), operations, financial condition or prospects, of the borrower, individually, or the borrower and its subsidiaries taken as a whole; (b) the collateral, (c) the ability of any loan party to perform its obligations under any loan document to which it is a party; or (d) the validity or enforceability of any loan document or the rights and remedies of the lender."

Negotiated changes often result in changing "condition (financial or other)" to "financial condition" and/or the deletion of "prospects" but typically do not include further substantive changes to the standard definition, and financing documents seldom include "market MAC" or force majeure-type language (either as a specific MAE or a specific exclusion). Unlike the use of MAE in merger and acquisition (M&A) transactions, which typically require the seller to be disproportionately affected by an MAE that otherwise affected the industry as a whole, MAE clauses in finance documentations are focused specifically on the effect on the borrower and collateral without regard to whether the impact is disproportional.

MAE provisions play a variety of roles in complex loan documents but, for purposes of this article, we will focus on (i) those related to defaults that are triggered due to the occurrence of a material adverse effect, or the occurrence of an event that may, with the passing of time, result in a material adverse effect, and (ii) the non-occurrence of a material adverse effect as a condition to advancing funds.

To illustrate the first point above, consider the non-performance by a third party to a borrower's material contracts because of COVID-19–related restrictions resulting in the borrower no longer having access to a critical product needed in the operation of its business. This, of course, could ultimately lead to declining revenue for the borrower and an inability to pay its debt service. Both the borrower and its lender may find themselves having to analyze whether the breach of this material contract triggers the occurrence of an MAE under the loan documents.

Despite the frequent appearance of MAE provisions in loan documentation, there is a dearth of guidance from courts on how MAE provisions may be interpreted in lending transactions. Rather, the most helpful judicial guidance arises in the context of M&A litigation.[1] In interpreting the application of MAE provisions in the M&A context and determining whether a material adverse effect has occurred, courts typically look at the underlying event's long-term, rather than immediate, impact. *See e.g.*, *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 68 (Del. Ch. 2001) ("[T]he Material Adverse Effect should be material when viewed from the longer term perspective."); *Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTL, 2018 LEXIS 325, at *122 (Del. Ch. Oct. 1, 2018) (noting in its analysis of whether the magnitude of the threshold effect was "material" that "[a] short-term hiccup in earnings should not suffice" and that instead a "longer-term perspective" needed to be adopted in making such determination).

For a lender, this is especially useful guidance as determining whether an MAE default may be triggered will require the lender to prove that the triggering event is likely to "substantially threaten the overall earnings potential of the [borrower] in a durationally-significant manner." *Akorn*, 2018 LEXIS at *123. Because lenders have records of prior financial statements of borrowers, lenders may use these historical financials to determine how significant the effect of COVID-19 (and government action in response thereto) has been on the business of a particular borrower. Seasonality and other business trends of the borrower must be taken into consideration.

A significant drop in revenue for an average business for a length of a quarter or two may certainly bring in to question the applicability of an MAE default, but what if the

borrower is a business who's revenue tends to spike significantly during the final quarter of the year? In such a scenario, it is difficult to imagine a lender having a colorable argument that an MAE default has occurred. This may be underscored by the fact that the lender has previously waived similar defaults by the borrower arising out of a general business downturn, or by the fact that other defaults may exist or soon exist.

Typical examples given the above hypothetical facts are defaults covering defaults under material contracts and financial covenant breach arising out of projections that appeared reasonable at the time of closing. Nonetheless, given the nature of a loan transaction, in which a lender expects a return on its investments by way of periodic payments of interest or principal (and accrued interest) negotiated at arm's length, it is possible that courts may take a shorter-term approach in determining whether the threshold effect is significant enough to trigger an MAE.

Since the COVID-19 pandemic began causing significant economic disruption, several companies have begun to take action to cease or delay the closing of pending M&A transactions by claiming that an MAE has occurred.[2] Given the recency of these claims, we should expect developments from courts over the coming months on how MAEs will be treated in light of COVID-19. While the focus is likely to be in the M&A context, it may nevertheless provide insight into the potential determination of COVID-19–related MAEs in the lending context.

Furthermore, MAE as a condition precedent to an advance may serve as a critical determination for a lender who may no longer want to advance funds to a borrower it feels has been irreparably harmed by COVID-19. Often, MAE is used as condition to a lender's obligation to advance additional funds under a revolving line or delayed draw term loan facility. Lenders, however, should be careful to ensure that it may invoke an MAE to refuse an advance or that it otherwise has such discretion under the loan documents.

If the lender is bound by a committed obligation under the loan documentation to advance funds upon the satisfaction of the conditions to each advance or if the lender consistently made advances under a non-committed facility irrespective of a careful analysis of the financial condition of its borrower, a lender should carefully determine whether an alternative to denying an advance exists, as opposed to declaring the MAE condition as not being satisfied (or otherwise using it as a reason to deny an advance). Lenders should remember that the effect of not making an advance could itself have severe adverse consequences for a borrower far beyond the amount of the requested advance.

Because of the subjective nature of the language in MAE provisions and the complexity in determining whether an event or events really did have a material impact on borrower, a lender may subject itself to potential litigation and liability and may need to prove that its choice to deny an advance otherwise meets aspects of good faith, and the resulting reputational risk could impact its relationships with other borrowers and potential new business efforts.

Force Majeure as a Defense to a Default by a Borrower

Although many in and outside of the legal profession may be aware of force majeure provisions, it may be surprising to know that force majeure provisions are seldom included in finance and loan documentation. As discussed below, because the nature of lending contracts heavily benefits lenders as it regards the relative risk allocation, force majeure provisions are not included as borrowers would generally be their intended beneficiaries. Even if included, most force majeure provisions (and courts interpreting force majeure provisions) exclude payment obligations as an obligation that may be suspended by such an intervening force majeure event. As such, force majeure is unlikely to provide borrowers an excuse for their non-performance and/or defaults.

Force majeure contract clauses allow parties to excuse defaults in their agreements due to the failure to perform when unforeseeable circumstances beyond their control caused such failure. In the context of a lending transaction, force majeure clauses could provide borrowers a potential excuse for a default that may have resulted from certain events outside of the control of the borrower, such as the rapid spread of the COVID-19 virus and the various restrictions imposed by governments on individuals and business alike in response thereto.

Specifically, "acts of god" are frequently included as force majeure events that excuse a party's contractual performance. Force majeure is often defined to include governmental action or inaction, inclement weather, war, terrorist acts, and epidemics or pandemics. Because courts tend to narrowly construe force majeure provisions, a party may only excuse its non-performance or default if the threshold event is embraced by the force majeure clause found in the relevant loan documentation. This is because the agreed-upon contours of force majeure in an agreement, "dictate the application, effect, and scope of force majeure." *Constellation Energy Servs. of N.Y., Inc. v. New Water St. Corp.*, 46 N.Y.S. 3d 25, 27, (N.Y. App. Div. 2017) (quoting *Route 6 Outparcels, LLC v Ruby Tuesday, Inc.*, 931 N.Y.S. 2d 436, 438, (N.Y. App. Div. 2011)).[3] Moreover, a borrower seeking to avoid payment obligations under a force majeure clause must show that its actual ability to make the payment itself was impaired, rather than a general decline in its financial condition as a result of such event made such payment difficult.[4]

A possible work-around to this is the inclusion of "catch-all" language such as, "other similar events beyond the reasonable control of the party impacted by the force majeure event." Although here, the specifically enumerated acts of god or threshold events will be relevant in determining whether the catch-all language extends to the event not specified in the force majeure clause.

Another important consideration of the applicability of force majeure is the foreseeability of the event. Courts generally hesitate to excuse a default if the event complained of as causing the non-performance could have been foreseen and its impact mitigated. See *Missouri Pacific Railroad Co. v. Terrell*, 410 S.W.2d 356 (Mo. Ct. App. 1966) (finding that freezing weather was not an act of God and thus not a valid excuse to nonperformance because freezing weather was to be expected in the winter season). This is especially true when the event is not one that is specifically listed. 14 Corbin on Contracts § 74.19 (2019) ("[E]xculpatory provisions that are expressed in general terms 'have long been construed as excusing only unforeseen events which make performance impracticable.'"). Assuming the language is applicable to the given scenario, courts will then seek to determine whether the event complained of as the force majeure was in fact the proximate cause of that contractual party's failure to perform and that the impacted party sought to mitigate the effect of any such force majeure event.

With that in mind, a borrower who is considering invoking force majeure because of COVID-19 as a potential defense to a default under their loan documentation should immediately confirm that their contracts contain force majeure language. Without this, there is no further inquiry needed and force majeure will not excuse a default. If the loan documents do contain a force majeure clause, a borrower should carefully analyze the applicable force majeure language with its legal counsel to ensure that the contours of the provision are sufficiently broad to encompass disease, epidemics, pandemics or governmental action. Even then, whether a default may be excused by the COVID-19 pandemic and resulting governmental action will depend on whether such force majeure event is the proximate cause of the borrower's default.

As an example, a borrower may be able to seek to excuse its failure to deliver audited financials within the applicable period if its auditors are unable to physically inspect the borrower's books and records during such period due to a governmental order mandating citizens to stay in place. Force majeure clauses occasionally appear in construction loan agreements

to permit the extension of a deadline to complete construction before an event of default is triggered if the delays are the result of a force majeure event.

The same, however, is unlikely to be true for a payment default. This is because courts generally disfavor excusing non-performance where the party seeking such relief could have guarded against such default in the contract and, in the relative risk allocation of loan transactions, a borrower generally bears the risk of macro-economic and market events that disrupt its ability to do business and the resulting negative financial impact.

Moreover, impairment to payment obligations comes in two forms: (1) inability to process payment, such as if the government restricts payments to a payee in a prohibited country, or (2) lack of sufficient funds, such as declining revenue based on a financial crisis. The first type would typically be excused in a force majeure context so long as outside the party's control. In the absence of a specific contractual provision, courts are loath to characterize the second type of financial hardship as a force majeure event.

Although government shut-downs, work force reductions, and lack of sales revenue directly impact a party's financial stability, they do not necessarily prevent a party from paying amounts due under a loan agreement to the same degree that a plant closure would likely excuse a party's obligation to manufacture products. To prevail in avoiding payment obligations, the borrower claiming such excuse should be prepared to prove that the force majeure event directly impacted its ability to make the payment or otherwise comply with the loan documentation, not simply that the profitability or financial wherewithal of the party had been impaired due to an economic downturn caused by the event.

Therefore, borrowers should be cautious as to the choice to invoke force majeure as an excuse to default rather than seeking to resolve the issue directly with the lender and coming to an agreement on a waiver of the specific default, forbearance or some other agreement excusing the borrower's default. Unlike in other commercial contracts, such as for the sale of goods or mergers and acquisitions, the relative allocation of risks in loan agreements tends to significantly favor lenders, with borrowers bearing the risk of significant market disruptions and downturns in the broader macro-economic environment. Moreover, a borrower bears the (often significant) burden of establishing that a force majeure occurred under their loan documentation. *See Red River Res., Inc. v. Wickford, Inc.*, 443 B.R. 74, 79 (E.D. Tex. 2010).

Application of Other Common Law Contractual Defenses in the Finance Context

As an alternative to force majeure, borrowers may be considering whether common law defenses to contractual defaults such as impossibility of performance and impracticability may be applicable in light of the COVID-19 pandemic. Borrowers should be cautioned against attempts to implicate these common law defenses. Not only are these common law doctrines difficult to prove in court, the case law would suggest that these contract defenses would not apply solely to payment defaults in a finance agreement where the primary purpose is advancing and repaying funds.

This is because impossibility deals with a contractual party's physical inability to perform (*e.g.*, the bank's internet site is down so the borrower could not timely make an electronic payment) while impracticability deals with performance becoming commercially impracticable and excessively burdensome (which would not apply to a borrower repaying funds already received in the form of a loan). It is highly unlikely that a court will agree that the COVID-19 pandemic has made it impossible for a borrower to make a payment when the physical means to do so remain (regardless of whether there are sufficient funds to do so with).

Furthermore, as previously discussed herein, the relative risk allocation in lending transactions

generally is such that a borrower's requirement to make payments is unlikely to be excused, even if it may be objectively commercially impracticable or excessively burdensome to its business. It is possible that impossibility or impracticability may apply to non-payment–related defaults, such as timely financial reporting if delayed due to governmental orders making physical access to non-electronic books and records impossible, but nonetheless will be subject to the incredibly high threshold applicable to such defenses.

Borrowers are also cautioned against attempting to invoke the common law defense of frustration purpose doctrine to a payment default arising during the COVID-19 pandemic. Frustration of purpose provides a defaulting party a defense to excuse contractual non-performance where an unforeseen event, such as the COVID-19 pandemic, defeats the underlying purpose of the agreement. Except in circumstance where the proceeds of the loan are used for a specific purpose, such as construction of a project which is completely halted by government action, frustration of purpose is unlikely to be implicated and would likely only excuse failure to comply with certain covenants, such as timely completion of construction, but would still likely require the loan proceeds to be repaid.

Conclusion

Parties to loan documents should carefully review their agreements with the assistance of legal counsel before deciding to trigger MAE defaults or seek excuse for non-performance because of force majeure. Depending on the circumstances, lenders seeking to exercise their remedies and/or accelerate the repayment of outstanding debt, should consider waiting for the occurrence of a concrete and objectively measurable default, rather than invoking MAE as a potential default.

Borrowers seeking to excuse a default are encouraged to discuss their failure to comply with their legal counsel and lenders and to seek potential payment deferrals, waivers, or forbearances to such defaults rather than attempting to immediately prove the very onerous and high threshold that is a force majeure event.

Notes

1. For guidance on MAEs in the M&A context by Troutman Sanders professionals, *see* Sean Ehni, *Material Adverse Effects in the Onslaught of the Coronavirus*, TROUTMAN SANDERS (March 16, 2020), *https://www.troutman.com/insights/material-adverse-effects-in-the-onslaught-of-the-coronavirus.html*.

2. *See* Alexandra S. Peurach et. al, *Shots Fired: Recent Claims to Terminate M&A Deals over COVID-19 MAEs*, TROUTMAN SANDERS (April 8, 2020), *https://www.troutman.com/insights/shots-fired-recent-claims-to-terminate-manda-deals-over-covid-19-maes.html#_edn28*; Scott Flaherty, *Court: L Brands, Sycamore trade new blows in 'material adverse effect' dispute over Victoria's Secret deal*, DEBTWIRE (April 24, 2020), *https://www.debtwire.com/intelligence/view/intelcms-wgrmqc?shared&u=435E000B-C046-4DEE-8DC2-B1562D25A7B3* (describing how Sycamore Partners filed suit seeking a declaratory judgment that the spread of COVID-19 qualified as a MAE and L Brands' response in a separate suit to prevent Sycamore from backing out of the deal). Shortly after the initial publication of this article, L Brands and Sycamore Partners entered into an out of court agreement to drop their respective lawsuits and end their plans to take Victoria's Secret private. *See* Kimberly Chin, *L Brands, Sycamore Agree to Scrap Victoria's Secret Deal*, WSJ (May 4, 2020), *https://www.wsj.com/articles/l-brands-sycamore-agree-to-scrap-victorias-secret-deal-11588633861*.

3. For additional guidance on force majeure provisions from Troutman Sanders and Pepper Hamilton professionals, please refer to the following client alerts on this topic: Christian Chad Warpula et. al, *Is Coronavirus Infecting Your Commercial Contracts? Excusing and Enforcing Performance Amidst Worldwide Uncertainties*, TROUTMAN SANDERS (March 12, 2020), *https://www.troutman.com/insights/is-coronavirus-infecting-your-commercial-contracts-excusing-and-enforcing-performance-amidst-worldwide-uncertainties.html*; Jeremy Heep et. al, *Drafting Force Majeure Clauses to Provide for Pandemic-Related Contingencies*, PEPPER HAMILTON (March 19, 2020), *https://www.pepperlaw.com/publications/drafting-force-majeure-clauses-to-provide-for-pandemic-related-contingencies-2020-03-19/*.

4. *See Kyocera Corp. v. Hemlock Semiconductor, LLC*, 886 N.W.2d 445 (Mich. Ct. App. 2015).

Will Business Interruption Insurance Provide Coverage for Coronavirus Losses?

By Julie E. Nevins and Robert Lewin

With COVID-19 disrupting global supply chains and sales, businesses are losing income and incurring additional expenses as a result of the disruption. There likely will be an increase in insurance claims against insurance policies offering business interruption and/or contingent business interruption coverage. Whether the claims are covered will depend on the terms and conditions of the insurance policy and the circumstances of the loss.

One of the largest independent claim managers has cautioned that "successful claims under business interruption coverage for infection are not common."[1] Indeed, there are no reported cases in the United States regarding business interruption coverage in connection with human infectious disease epidemics or pandemics. Commerce, however, has never been as global as it is today.

There are challenges to business interruption coverage. Some of those challenges are summarized below.

What Is Business Interruption Insurance?

Business interruption insurance protects against economic losses resulting from a business's inability to put insured property damaged by a covered peril to its normal use. Business interruption typically indemnifies for loss of revenue that would have been earned had there been no business interruption and the continuing normal operating expenses incurred during the time it takes to restore the damaged property. While coverage language frequently varies depending on the insurer and the coverage negotiated, the following is a sample insuring provision for business interruption coverage:

> This policy insures against loss resulting directly from necessary interruption of business caused by physical loss or damage by a peril not otherwise excluded herein to insured property of the Insured, all subject to the terms and conditions of this policy.[2]

Typically, under standard business interruption policies, the following is required for a recoverable business interruption loss: (1) physical damage, (2) to insured property, (3) caused by a covered peril, (4) resulting in quantifiable business interruption loss, (5) during the period of time it takes to restore the damaged property.

Physical Damage to Property Is Typically a Threshold Requirement

Business interruption coverage is often part of a commercial property policy. Therefore, physical damage to insured property is typically required to trigger coverage. Business interruption by itself is not enough.

For example, in *Source Food Technology v. U.S. Fidelity and Guaranty Corp.*,[3] a company that sold cooking oil and shortening made from beef tallow sought indemnity for business interruption coverage after the USDA prohibited the importation of beef products from Canada after cows tested positive for

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mad cow disease. The court concluded there was no coverage under the policy because the embargoed beef product the insured sought to import was not contaminated or damaged in any way.[4]

Source Food indicates that, depending on the language of the policy and the circumstances of the loss, contamination of property may constitute physical damage to property if there is sufficient proof of contamination.[5]

Civil Authority Coverage

Commercial property policies may include coverage for losses caused by forced closure of property by civil authority. The coverage typically applies when an insured is unable to access its property due to a government order as a result of physical damage to adjacent or nearby property. Thus, civil authority coverage typically requires physical damage to property to trigger the coverage. If the policy requires physical damage to adjacent or nearby property and the insured is unable to establish a causal connection between the government order and that physical damage, then there likely will be no coverage.

For example, in *United Air Lines, Inc. v. Insurance Company of State of Pennsylvania,*[6] United Airlines sought indemnity for economic losses relating to government closure of Ronald Reagan Washington National Airport in connection with the September 11 terrorist attacks on the World Trade Center and the Pentagon. The relevant policy provision provided:

> This policy insures against loss resulting directly from the necessary interruption of business caused by damage to or destruction of the Insured Locations resulting from Terrorism, Sabotage, Insurrection, Rebellion, or Coup d'Etat.
>
> This section is specifically extended to cover a situation when access to the Insured Locations is prohibited by order of civil authority as a direct result of damage to adjacent premises, not exceeding, however, two (2) consecutive weeks.[7]

The court held that United Airlines was not entitled to civil authority coverage because the airport was shut down before the attack on the Pentagon and was not "as a direct result of damage" to adjacent property, as required by the policy. The evidence showed that the shutdown was based on the fear of future attacks.[8]

In *Sloan v. Phoenix of Hartford Insurance Company et al.,*[9] the court, however, interpreted the civil authority provision as not requiring physical damage to property to trigger coverage. Owners and operators of movie theaters made a claim for business interruption coverage following a curfew ordered by the Governor of Michigan in response to widespread riots. The policy provided:

1. This policy covers against loss resulting directly from necessary interruption of business caused by damage to or destruction of real or personal property by peril(s) insured against during the term of this policy, on premises occupied by the insured and situated as herein described.

***

> 7. Interruption by Civil Authority. This policy is extended to include the actual loss as covered hereunder, during the period of time, not exceeding 2 consecutive weeks, when as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority.[10]

After reviewing the plain language of the policy, the court held there was business interruption coverage under the civil authority provision for losses incurred to comply with the Governor's order.[11]

Furthermore, only government orders causing a business to close will constitute a civil authority order. If a business closes because of government action that does not rise to the level of an order, such as an advisory to stay off the streets following a hurricane, then there will be no civil authority coverage.[12]

Lastly, following September 11, Hurricane Sandy, and other disasters, insurers tightened policy language to make clear that property damage was a requirement for coverage and added hours clauses which specified that business interruption coverage would not be triggered for days.

Contingent Business Interruption Coverage

Contingent business interruption coverage protects against economic losses resulting from damage to the property of a person on whom the insured depends for its business, such as a supplier or a customer. The terms of the coverage vary from policy to policy and may be limited to damage to a direct supplier's property or may extend to damage to the property of indirect suppliers, such as suppliers of suppliers.

For example, in *Pentair, Inc. v. American Guarantee and Liability Insurance Co.*,[13] the insured sought coverage under a manuscript all-risk property policy following an earthquake in Taiwan. A substation that supplied electricity to Pentair's Taiwanese factory suppliers was damaged by the earthquake, disrupting the factory suppliers' ability to manufacture goods to be shipped to the insured. A "Contingent Time Element" provision in the policy "extended the business interruption coverage to include losses incurred by Pentair as the result of 'damage' to 'property of a supplier of goods and/or services to the Insured' that is caused by a covered peril."[14] The court held there was no coverage because the electrical substation was not a supplier of goods and services to the insured.[15]

Virus and Disease

Viruses and disease are typically not an insured peril unless added by endorsement.[16] Furthermore, viruses and disease may be excluded expressly.[17]

In *Meyer Natural Foods, LLC v. Liberty Mutual Fire Insurance Company,*[18] the court held that a contamination exclusion barred coverage for the contamination of beef with *E. coli* while in the insured's possession. The exclusion provided:

> We will not pay for loss or damage caused by or resulting from any of the following, regardless of any other cause or event, including a peril insured against, that contribute to the loss at the same time or in any other sequence:
>
> ***
>
> 10. The actual or suspected presence of any virus, organism or like substance that is capable of inducing disease, illness, physical distress or death, whether infectious or otherwise, including but not limited to any epidemic, pandemic, influenza, plague, SARS, or Avian Flu.[19]

Causation and Financial Losses

Business interruption losses must be caused by a covered peril. For example, in *Dictiomatic, Inc. v. U.S. Fidelity & Guaranty Co.,*[20] an insured, the seller of translating devices, made a claim for business interruption coverage following a major hurricane that damaged the office building where it leased space, preventing access to its office for a couple of weeks. The court held there was no coverage under the policy because the insured "suffered income losses throughout its entire period of operation immediately prior to the hurricane, and further that there is inadequate proof that [the insured] would have achieved profitability during the period of

business interruption or immediately thereafter . . . and would have been unprofitable even without the business interruption."[21]

In addition, losses may arise from multiple causes—covered and uncovered. Whether there is coverage for a combination of covered and uncovered causes will be based on the policy language and the jurisdiction's law regarding concurrent causes.

Furthermore, proof of financial losses can be complex, similar to proving lost profits damages in a commercial case. Causation and losses must be well documented and mitigation efforts should be made where possible.

Insurance Industry Response to Coronavirus

Standard business interruption policies typically include an endorsement excluding viruses and/or epidemics. In response to past epidemics, specialty insurance, however, was developed to respond. For example, in October 2014, in response to the Ebola epidemic, specialty brokers in conjunction with the Ark Specialty Program of Lloyds of London offered a new type of coverage called "Pandemic Disease Business Interruption Insurance" to cover loss of income arising from government-mandated closure of healthcare facilities and diminished revenue in the aftermath of a quarantine.[22]

The insurance industry is responding to the coronavirus epidemic. In early February 2020, ISO developed two new endorsement forms—"Business Interruption: Limited Coverage for Certain Civil Authority Orders Relating to Coronavirus" and "Business Interruption: Limited Coverage for Certain Civil Authority Orders Relating to Coronavirus (Including Orders Restricting Some Modes of Public Transportation)."[23] These forms provide coverage or actual loss of business income and extra expenses caused by a government order closing the insured's premises or quarantining all or part of the premises and from government suspension of some modes of public transportation. If dependent properties are included in the coverage, such as a supplier's or customer's premises, then the coverage applies to the dependent property as well. Note, the forms were not filed with any states and are not being added to ISO's form portfolio.[24]

If the past is any indication, there may be further responses, including specific exclusions for coronavirus.

Now Is the Time

Experts on climate change warn that there will be serious disease outbreaks in the future as temperature rises.[25] Now is the time for insurers to review their policies to determine whether their policies may be construed to provide coverage for losses resulting from disease outbreaks, like the coronavirus, and for consequential losses not directly caused to the insured, such as where a supply chain is interrupted and the insured is impacted. Now is also the time for insurers to evaluate the opportunity to provide insurance coverage for risks like the coronavirus as insureds experience the potentially uninsured dislocation such disease outbreaks may cause.

Notes

1. Crawford & Co., The Insurance Impacts of 2019 Novel Coronavirus 4.

2. *Baxter Int'l., Inc. v. Amer. Guar. & Liability Ins. Co.,* 369 Ill. App. 3d 700, 704 (1st Dist. 2006).

3. *See Source Food Tech., Inc. v. U.S. Fidelity & Guar. Co.*, 465 F.3d 834 (8th Cir. 2006).

4. *Id. at 838.*

5. *See also Sentinel Mgmt. Co. v. New Hampshire Ins. Co.*, 563 N.W.2d 296, 300 (Minn. App. 1997) ("[W]e must conclude that contamination by asbestos may constitute a direct, physical loss to property under an all-risk insurance policy."); *General Mills, Inc v. Gold Metal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001) (finding "direct physical loss" when oats were sprayed with an unapproved, but non-toxic, pesticide and could not be sold pursuant to FDA

regulations, even though they were safe for consumption); *see also Source Food Tech., Inc.*, 465 F.3d at 838.

6. 439 F.3d 128 (2d Cir. 2006).

7. *Id.* at 131.

8. *Id.* at 134–35.

9. 46 Mich. App. 46, 207 N.W.2d 434 (1973).

10. *Id.* at 49, 436.

11. *Id.* at 49–50, 436–37.

12. *See, e.g., Penton Media, Inc. v. Affiliated FM Ins. Co*., Case No. 3cv2111, 2006 WL 2504907, at *6 (N.D. Ohio Aug. 29, 2006), *aff'd*, 245 Fed. Appx. 495 (6th Cir. 2007) (holding that FEMA's take-over of the Javits Center pursuant to a lease agreement following the attacks of 9/11 did not constitute an "order of civil authority").

13. 400 F.3d 613 (8th Cir. 2005).

14. *Id.* at 614.

15. *Id.* at 615; *see also Millennium Inorganic Chems. Ltd. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 744 F.3d 279 (4th Cir. 2014) (holding "direct supplier[s] of materials to the Insured's locations" did not include supplier of natural gas with whom the insured lacked contractual privity and who had no control over the gas once title to the gas passed to an intermediary that sold the gas to the insured).

16. Health care endorsements may include communicable disease coverage, such as:

We will pay for the following under Communicable Disease Coverage:

> (1) Direct Physical loss or damage to Property Insured caused by or resulting from a covered communicable disease event at the premises described in the Declarations.
>
> ***
>
> (3) If the Declarations show you have Business Income with Extra Expense Coverage . . ., we will pay for the actual loss of business income, rental value, or necessary extra expense or expediting expense that you sustain due to the necessary full or partial suspension of operations during the period of restoration. The suspension must be caused by direct physical loss or damage caused by or resulting from a covered communicable disease event at the premises described in the Declarations.

Catholic Med. Ctr. v. Fireman's Fund Ins. Co., Case No. 14-cv-180, 2015 WL 3463417, at *2 (D.N.H. June 1, 2015) (emphasis in original). "Communicable disease" was defined as "any disease caused by a biological agent that may be transmitted directly or indirectly from one human or animal to another;" and "communicable disease event" was defined as an "event in which a public health authority has ordered the premises described in the Declarations be evacuated, decontaminated, or disinfected due to the outbreak of a communicable disease at such premises." *Id.* at *3 (emphasis in original).

17. *See, e.g.,* Robin Paxton, "As virus spreads, insurers exclude Ebola from new policies," Reuters, Oct. 22, 2014, *https://www.reuters.com/article/health-ebola-insurance-idUSL3N0SG69X20141022* (last visited Mar. 1, 2020).

18. *Meyer Natural Foods, LLC. v. Liberty Mutual Fire Ins. Co.,* 218 F. Supp. 3d 1034 (D. Neb. 2016).

19. *Id.* at 1037–38.

20. *See Dictiomatic, Inc. v. U.S. Fidelity & Guar. Co.*, 958 F. Supp. 594 (S.D. Fla. 1997).

21. *Id.* at 603–04; *see also Dickie Brennan & Co. v. Lexington Ins.,* 636 F.3d 683 (5th Cir. 2011) (holding insureds failed to establish causal link between evacuation order issued prior to arrival of hurricane and damage to nearby property to recover under civil authority provision).

22. Stephanie Goldberg, "NAS offers coverage for Ebola-related business closures," Business Insurance, Oct. 17, 2014, *https://www.businessinsurance.com/article/20141017/NEWS06/141019880/NAS-offers-coverage-for-Ebola-related-business-closures* (last visited Mar. 1, 2020).

23. Christine G. Barlow, Coronavirus spurs ISO to provide business interruption endorsement, PropertyCasualty360, Feb. 10. 2020, *https://www.propertycasualty360.com/202%2/10/iso-provides-business-interruption-endorsement-in-response-to-coronavirus-414-171888/* (last visited March 1, 2020). In 2014, ISO had released similar forms in response to the Ebola epidemic in 2014. *See* Verisk, "ISO Creates Insurance Options to Help Businesses Survive Ebola," *https://www.verisk.com/archived/2014/december/iso-creates-coverage-options-to-help-businesses-survive-ebola/* (last visited Mar. 1, 2020).

24. *Id.*

25. David Wallace-Wells, The Uninhabitable Earth: Life After Warming 109-14 (2019).

How to Clean Up a Corporate Mess

By Louis Lehot

In my law practice serving as outside general counsel and deal lawyer to well over a hundred emerging private growth companies from formation to liquidity, clients sometimes engage with me at creation, and sometimes later in their life cycle. In today's environment where startups are managed cleanly with minimal cash and when founders increasingly handle their own legal, accounting, and fundraising efforts, it is not surprising that shortcuts are taken and corporate formalities are not followed, with potentially unpleasant legal, accounting, and financial consequences.

Not to fear, however, as the State of Delaware enacted Section 204 of the General Corporation Law, and other states have adopted analogous provisions, to enable corporations to rectify defective corporate acts. Section 204 of the DGCL comes in especially handy before a round of financing, or upon a sale of a company, when a due diligence investigation turns up the errors.

The statute provides direct instructions for how a company's board of directors and shareholders can ratify otherwise voidable or void actions purported to have been taken without proper corporate authorization. For example, if a company issued SAFEs to investors without prior approval from the board of directors, the board can retroactively ratify that issuance. In addition, Section 204 can ratify the appointment of a CEO or a director who had not been duly appointed and can ratify all prior actions taken that unauthorized officers and directors had made.

There are some limitations, however, in Section 204, insofar as it is not a time machine that can be used to change history. For example, if shares were not issued, the board ratification will not be deemed to have caused the issuance at a prior date in time. By the same token, if a board reviewed a proposed action and rejected it, a later board action can not deem that it had been approved at the prior meeting.

Following are the guidelines for using Section 204 of the DGCL to cleanup a corporate mess:

1. The currently presiding board of directors must affirm by unanimous written consent or adopt resolutions at a duly convened meeting resolutions that itemize the prior defective corporate act, including all relevant information, such as the reason for the need for reliance on Section 204.

2. If shareholder authorization would have been required at the time of the purported corporate action, then the company's current stockholders must adopt resolutions approving and ratifying the prior purported defective action, and then issue notices to both the prior shareholders as well as the other current shareholders, whether or not the holders were holding validly issued stock or putative stock (*e.g.*, stock that was intended to be issued but not properly issued).

3. If the prior defective corporate act would have required a filing with the State of Delaware, then the company will need to file a certificate of validation upon ratification pursuant to Section 204.

While a corporate mess can often be cleaned up by compliance with Delaware Section 204, the cost and timeline should not be ignored. There is a not insignificant filing fee for a certificate of validation, the timeline is not easily expedited, and obtaining the consent of the

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directors and shareholders time consuming and potentially some negotiation.

Section 204 of the Delaware General Corporation Law is a great tool to clean up corporate messes, but should not be a reason to delay implementation until a financing or liquidity event, as it could cause unnecessary delays, costs, and compromises that you might not otherwise need to make.

Negotiating Deals During the Pandemic

By Louis Lehot

Broc Romanek sat down with Louis Lehot, the Founder of L2 Counsel and the video blog series—#askasiliconvalleylawyer—to discuss negotiating mergers and acquisition transactions during this pandemic.

Personal rapport, trust, and confidence are critical ingredients of successful mergers, acquisitions and investment transactions, and building these elements is key. For deals to get done, dealmakers need to inspire trust and confidence in one another and the working group. With quarantines in place and face-to-face meetings out of the question, following are answers to frequently asked questions on how to negotiate transactions in the new "normal" successfully.

Romanek: Will corporate development and business unit leaders on the buy-side be receptive to looking at potential acquisitions during the pendency of "shelter-in-place" orders?

Lehot: The answer is an unequivocal "*yes*." Despite the lack of physical proximity to targets, corporate development, and business unit leaders continue to be responsible to their stakeholders for growing their businesses, both organically and inorganically, and for stopping the bleeding that might otherwise occur. On many occasions, M&A transactions will be timely and opportune.

New corporate partnerships may take shape. New technologies and innovations may be created and adopted. Clearly, M&A deals have continued and will continue to be struck during and after the pandemic. Their character may change, however, as buyers look for businesses that can tap into the "new normal" environment.

Romanek: Besides the obvious challenges of not being able to meet in person, what are some of the difficulties in doing M&A deals remotely?

Lehot: The challenges of doing deals remotely are numerous:

- How to gather original documents, signature pages, and ensure that they are fully complete, with all current exhibits, schedules, and amendments
- How to physically inspect land, structures, and sites in the face of travel challenges
- How to meet groups of people and observe how they interact
- How to negotiate when you cannot do so in person
- How to guard against an increased propensity for fraud to be introduced by unscrupulous characters

Romanek: What are some of the technologies and other tools to counter-act the challenges of remote deals?

Lehot: Certainly, increased technology, communications, and collaboration tools are required to counter-act the challenges of doing deals remotely:

- DocuSign, HelloSign, and many of the digital tools for electronic document signing are plentiful and not new. Adopting a protocol and training the workforce on how to follow it, can help.
- Remote team members and specialist consultants who have proximity to land, structures,

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and sites are increasingly being engaged to inspect them to avoid the risk and expense of travel.

- Zoom, Webex, Google Hangouts, Go-To-Meeting, and Microsoft Teams are some of the many video and collaboration tools available for meetings concurrent with document sharing, as well as in negotiating deals.

- Dropbox, Box, OneDrive, GoogleDrive, NetDocs, Evernote, and many others are being used for document storage, sharing, and collaboration.

  Asking more and better questions can be especially valuable in building confidence when the parties are separated by distance. This low-tech method is unfortunately often overlooked.

Romanek: What are some due diligence items that need special attention in light of the pandemic?

Lehot: Here are a few:

- ***Operating performance.*** Is the target business able to operate, and if so, under what restrictions?

- ***Solvency.*** In the best of times, executing an M&A transaction can take 90 days. Will the target have sufficient funds to maintain operations during the pendency of the deal? Is debt or equity financing available? Can section 363 or Chapter 11 of the bankruptcy code help keep the business afloat to get a deal done?

- ***Credit lines.*** As liquidity is fettered by customers stretching out payments, if not canceling or deferring purchases altogether, are modifications to the target's lines of working capital required? What communications have occurred with lenders?

- ***Workforce.*** What steps have been taken to protect, preserve, retain, and make productive the existing workforce? Has it been right-sized? Were regulations followed in making terminations? How, when, and under what conditions can the workforce return to productivity? Is there a remote work policy in place, and does it make sense?

- ***Government restrictions.*** Is the target operating an "essential" business, which is mainly exempt from shelter-at-home orders, or is it non-essential? Are workers remote or onsite? If remote, what steps are being taken to observe wage and hour laws?

- ***Government resources.*** What government resources are available, and have they been fully tapped?

- ***Real estate leases.*** Is the target in breach of its lease? Has it paid rent? What are the conditions of forbearance of lease payments? Have rent reductions, deferrals, or force majeure provisions been sought or exercised?

- ***Material contracts.*** Are customer contracts being consummated and enforced? Are there "material adverse effect," "force majeure," "frustration of purpose," or termination clauses that could impair the target's business going forward? Does the target anticipate a failure to perform under a contract, either by the counterparty or itself?

- ***Supply chain.*** Is it secure? Has it been traced to its origin to understand that it remains operational? The analysis applied to material contracts is also germane, here. Are suppliers to be replaced suppliers on commercially reasonable terms or at all? Are changes required?

- ***Insurance.*** Does the target maintain adequate insurance, will it be renewable, and is it available to offset losses or claims made?

- ***Litigation.*** What is the impact of the pandemic on pending or threatened litigation? Is a settlement possible?

- ***Governance and compliance policies.*** Now more than ever, IT systems governance and compliance policies are being stress-tested. Do they work? Is it enough? Is data being protected? If the company is tracking its employees' health, is it HIPAA compliant?

Romanek: How can we build the trust and confidence to do a deal without meeting in person?

Lehot: To build trust and personal rapport with clients and counterparties, M&A dealmakers typically spend a lot of time on the road, conducting face-to-face meetings, attending conferences and events, going out for meals, and watching or engaging in sports.

In the face of the "new normal" of working in solitude, dealmakers will need to work harder to build trust and confidence through their personal interactions over email, text, and calls, and increasingly use video calls to create the feeling of a personal experience.

During these interactions, dealmakers will need to make sure their words and deeds are:

- ***True and honest***. This means showing up on time for calls and meetings. Keep the video function on where able, even if for a short time. Honor your commitments to deliver information and follow-up on a timely basis. Avoid making promises that have the potential of not being met.

- ***Clearly communicating the message***. This means being transparent and authentic about your goals and making sure that your words and deeds are always consistent.

- ***Building trust over time, gradually***. Babies learn to crawl before they walk and walk before they run. Similarly, your outreach to potential deal counterparties should be gradual and allow for extra time for potential issues to be fully vetted and considered. Breaking a process into smaller steps can help. Take things at a measured pace to avoid spooking others.

- ***Consistent***. By being consistent, you become predictable, and by being predictable, you can be trusted.

- ***Open***. This means that you are transparent and authentic, and that you listen and give clear and respectful feedback, to all of the parties. Giving mixed messages or telling different stories to different people can quickly inspire mistrust and fear.

- ***Helpful.*** Make sure your words and deeds are viewed as constructive, practical, and commercially minded, always. People trust people they consider to be beneficial.

- ***Emotive.*** People also trust people who show they care for others. Being open about your emotions can help inspire true connection, a building block of trust.

- ***Not self-promoting.*** This means recognizing the efforts of other team members instead of claiming credit for yourself. Nothing inspires mistrust like transparent self-promotion.

- ***Consistent with your actual beliefs.*** Acting with unity of purpose and belief, openly and transparently, helps to communicate your authenticity and inspire trust. Sacrificing your personal values can be viewed as sacrificing trust.

- ***Admit mistakes***. Humility does not have to be self-effacing and when you own up to your missteps, you inspire trust.

Romanek: What are some tips for doing M&A deals that transcend the time and circumstances of the pandemic?

Lehot: Consider these:

- Call out and come up with a plan to address the real due diligence issues early in the game.

- Get buy-in from senior leaders on plans and communicate openly about known issues.

- Plan and strategize around the known issues and anticipate the unexpected.
- Use timeline and responsibility checklists.
- Manage processes with digital project management tools.
- Identify the deal breakers.
- Make sure relevant parties are fully invested and accountable.
- Keep your sights on the end goals.
- Always engage with reputable experts and bring on specialists to plug holes and fill gaps where needed.
- Anticipate social issues (*e.g.*, leadership, headquarters, locations) and tread carefully through the politics.

Romanek: What are some tips on negotiating M&A deals, particularly when doing so remotely?

Lehot: Here are some tips:

- ***Connect on a personal level***. Connecting on a human level is paramount in negotiation, and your attitude and energy at the outset will set the tone and drive outcomes. If you go in with guns blazing, you will likely shoot first and ask questions later. If, on the other hand, you go in with a win/win mindset, looking for ways to make the deal to the advantage of all parties, you are more likely to get a deal done. Given that in-person meetings are not possible in many places, doing video calls is the way to go (and make sure everyone turns the video ON).
- ***Know who you are dealing with***. In the absence of face-to-face meetings, knowing who you are dealing with requires extra effort. This goes beyond doing a LinkedIn search and reviewing your counterparty's resume, it means spending time listening to where they want to go, not just where they have been. The Internet can help give you obtain limited background history on a person but engaging a third-party background check firm to dig into a target and a target's management team is particularly important to detect fraud.
- ***Cast a wide net with your list of issues, and negotiate more items, instead of fewer***. Each side should communicate its position fully and completely, and not just ask for the bare minimum. While many issues can be solved quickly, and are not contentious, they offer the chance for some confidence-building win/win outcomes.
- ***Disclose known issues and be transparent***. Information-sharing and transparency creates credibility, which is a foundation of trust. Dropping in some bad news into the data room late in the process in the middle of a pandemic can be a deal-killer. Get out ahead of bad news. No surprises.
- ***Intangible and social issues***. Integrate as many intangible and social issues into the negotiation process as possible. Even if a premise of a deal is obvious, communicating about its upside (and downside) from the outset can help build momentum. These issues can also help fill in the spaces between all of the legal, financial, accounting, tax and commercial aspects of a deal, and create momentum and positive energy. Particularly in the time of a pandemic, helping counterparties feel heard and understood can mean the difference between success and failure in negotiation.
- ***Look beyond financial and short-term incentives***. Money is a key part of a transaction, but not the only part. Consideration in a deal is often measured only by cash exchanged at closing, but frequently the deal's most important benefits are recognized years later. If the money consideration is not closing the gap, look to non-financial and long-term incentives, safety, and security.
- ***Balance positive momentum with friction points***. While sticking points must be solved, racking up "wins" of positive agreement can

create the positive momentum needed to push through and get to a yes. In a pandemic, there can be a default to punting until after the lockdown. Maintaining forward movement is important, and small wins can help keep it going.

- ***Incremental and gradual***. Not all open points can be or should be solved at once. An incremental, gradual process will likely generate more momentum required to power through friction.

- ***Avoid false deadlines.*** There are occasions when the impending excitement about announcing a deal at an upcoming industry conference or sales event can help drive to getting a deal done faster. At other times, deadlines cause more problems than solutions. With all of the obstacles to getting deals done in a pandemic, a deadline—especially a manufactured one—may be counter-productive.

Romanek: If not already begun, what are some things you can do to help boost your odds of success, now?

Lehot: To effectively operate an M&A program, whether on the sellside or the buyside, there are steps you can take to be ready:

- Put a Google alert on any pronouncements from the government regulator relevant to your industry, or to regulators that would be relevant to buying or selling your company.

- Put a Google alert on anything that pops up on the Internet regarding transaction counterparties, as the normal ways of information dissemination might not otherwise be transmitting.

- Make sure your company has adopted or tailored its compliance policies for the current circumstances, such as:

  - The enabling of digital execution and storage of documents, contracts, and commercial arrangements.

  - Socially distanced interactions where legally permissible.

  - Instituting more video-calls to replace phone or face-to-face meetings, with care to do so securely.

  - Being mindful about avoiding circumstances where confidences could be abused and fraud potentially introduced (ask more and more questions).

- Be proactive in your communications with regulators to understand how to comply with scenarios that you could now foresee in light of the pandemic.

Romanek: *To sum up, what are some evolving best practices for doing deals remotely?*

Lehot: In the post-COVID world, we must expect the unexpected, and as a result, we can try harder:

- To use our emotional as well as intellectual intelligence, expect circumstances to evolve, and be open to adapting.

- To ask more questions. When something does not appear to be verifiable in the normal way, listen, ask more questions, and be creative.

- Consider whether a change is temporary or permanent, and if temporary, when it can be evaluated.

- Use existing collaboration tools and introduce new ones to facilitate a remote work environment. Asana, Zoho Projects, and many more tools exist to enable working together in different spaces.

- Plan for more time to get things done and expect delays.

Examples abound of buyers and investors exhibiting courageous decisionmaking and striking the most lucrative deals in times of crisis. Even in light of coronavirus and social

distancing, with a healthy dose of optimism, positivity, and creativity, deals can be identified, marketed, structured and financed intelligently, so that you can preserve valuation, sustain market momentum, and execute in a timely manner.

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