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COVID-19 Crisis Response and Post-Recovery Planning: Financial Litigation Considerations

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As the COVID-19 outbreak continues to disrupt global economic activity, financial markets and market participants have been, and will continue to be, impacted. As a result of these unprecedented market disruptions, financial market participants are likely to face significant issues that may result in litigation disputes. Potential areas for litigation include disputes relating to committed financings, market value declines and valuation, limitations on liquidity for consumer finance transactions, disclosures related to crisis readiness and response, insurance coverage, as well as data privacy and cybersecurity issues.

In this *White Paper*, we assess a number of complex litigation risks for financial market participants in COVID-19 crisis response and post-recovery planning and identify contractual and other considerations for mitigation of those risks.

The novel coronavirus (COVID-19) continues to spread at an alarming rate. In addition to the health and humanitarian crisis, financial market participants may face significant financial litigation challenges in the coming weeks, months, and years due to unprecedented market disruptions. This *White Paper* provides an overview of key financial litigation considerations that financial institutions should address as part of their COVID-19 crisis response and post-recovery planning.

COMMITTED FINANCINGS IN TROUBLED MARKETS

In the midst of the current market situation, both borrowers and lenders in committed financing situations face potential issues related to draw requests, including making and responding to draw requests. Specifically, borrowers should conduct a careful review of all credit documentation (including conditions to draw), should be prepared to exercise or respond to information rights requests, and should ensure that any draw request complies with requirements, such as with respect to use of funding.

Lenders, for their part, will face increased requests to draw down due to the current market situation. Lenders will want to consider if any Material Adverse Effect ("MAE") or Material Adverse Change ("MAC") clause in the documentation justifies declining a draw request or creates an Event of Default, keeping in mind that such clauses are highly fact-specific, dependent on the specific contractual language (which typically include a large set of negotiated exclusions, particularly in M&A agreements), and courts have been historically reluctant to find an MAE or MAC. The same is true in the United Kingdom—a generic MAC or "financial condition" trigger alone is unlikely to be sufficient.

In all events, both borrowers and lenders should engage in a careful review of all applicable credit agreements, keep privilege issues in mind with respect to any commercial discussions related to the decision to draw down or refuse a request, and consider any reputational issues surrounding draw requests and refusals to fund. All parties should also consider any legal or statutory obligations to act in good faith or in a commercially reasonable manner when dealing with any drawdown or covenant waiver request. This is especially important for cross-border transactions; many countries impose an overarching duty of good faith on commercial parties—even those countries that do not (e.g., the United Kingdom) may impose obligations to act for a "proper commercial aim."

DECLINES IN MARKET VALUE ACROSS ASSET CLASS AND PRODUCTS

For the first time in modern history, commercial loans comprise the largest group of assets held by banks, surpassing mortgage loans. As financial institutions face decreased earnings and production and supply-chain interruptions, many will face difficulty paying back corporate debt. As a result, financial market participants may also face a variety of litigation risks due to rising defaults and product-specific losses, including valuation-related disputes.

With respect to valuation disputes, declines in collateral values may result in disputes related to margin calls, terminations, close-outs, foreclosures, and other forced liquidations. Relevant considerations include whether market value is contractually defined, whether third-party valuation sources are required or available, who the calculation agent is under the contract, and whether the contract provides a mechanism for termination or liquidation. Also important to keep in mind is whether there is a contractual dispute resolution mechanism and the potential consequences of failing to adhere to it.

Deteriorating collateral values and rising defaults also typically trigger investor claims to recoup investment losses, including: (i) mis-selling claims against sellers alleging they misrepresented known risks or the investment vehicle was part of a fraudulent scheme; and (ii) conflicts of interest claims against financial market participants alleging self-dealing that resulted in the investors' losses. With respect to each, financial market participants should consider whether they have made sufficient disclosures of the roles played by transaction participants and any potential conflicts of interest, and engage in efforts to document all business decisions underlying any exercise of discretion.

If collateral values continue to decline and corporate loan defaults rise, among the products to watch are Collateralized Loan Obligations ("CLOs"). CLOs, a form of securitization that is collateralized predominately by pools of corporate loans, have skyrocketed in popularity over the past decade and hold some of the riskier corporate loans. The first types of litigation disputes to arise around such securitizations are often related to the secured short-term financing arrangements before the CLO launches and the pool of loans is still in the warehouse. Warehouse lenders may face unique challenges and litigation risks as collateral values begin to deteriorate and must keep in mind counterparty risks due to inability to meet margin calls or insolvency, and lender liability risks due to liquidations or allegations of fraudulent conveyance.

Another product that is a growing segment of the market are passive investment vehicles tracking indices, such as Exchange Traded Funds ("ETFs"). There are indices for almost every conceivable sector

of the economy and stock market. Therefore, as the number and variety of indices grow, so too do the number and variety of products that track them, with ever more complex ETFs now a significant part of the market. ETFs could face significant challenges due to unprecedented market disruptions. One primary risk faced by ETFs is a failure of the arbitrage function to keep ETF prices in line with their correlating indexes. Not only is there the potential for the ETF price to fall more than the components of the index it tracks, but ETF price declines may also have an impact on the price of the underlying products, potentially giving rise to claims around the disclosures and design of the ETFs.

CONSUMER FINANCE ISSUES

Consumers and small business borrowers may face a liquidity crunch due to government limitations on business hours and social distancing. In response, European governments have started to announce payment holidays or other relief for borrowers affected by COVID-19. For example, Italy has confirmed a countrywide mortgage/loan payment holiday, and the United Kingdom has emphasized that lenders must act fairly and give appropriate holidays or extended terms to affected borrowers. In the United States, President Trump announced that the Department of Housing and Urban Development would suspend all foreclosures and evictions through April 2020. President Trump also announced a waiver of federal student loan interest until further notice.

For now, federal financial institution regulators are encouraging financial institutions to work constructively with affected borrowers to meet their financial needs. In a March 9, 2020, press release, the regulators said that "Prudent efforts that are consistent with safe and sound lending practices should not be subject to examiner criticism." This limited guidance from U.S. regulators suggests minimal scrutiny for prudent conduct. At a minimum, however, lenders and servicers should account for general "fairness" in dealing with consumers and small businesses. Example issues include decisions to terminate or alter available credit under consumer HELOC or line of credit products or small business line of credit products, or charging fees/changing terms of in-process consumer products due to COVID-19-related delays.

CONTRACT CLAUSES YOU SHOULD KNOW

Borrowers, lenders, and other market participants face significant legal challenges due to market disruptions caused by the spread of COVID-19. To best prepare to face these legal challenges, the following contractual provisions should be carefully reviewed and considered as part of any COVID-19 crisis response and post-recovery planning:

Choice of Law and Forum Selection Clauses

In any contractual dispute, parties should consider which law applies and the jurisdictions in which a lawsuit may be commenced. Relevant considerations include the scope of the choice of law and forum selection provisions, including if they govern only contractual claims or also extra-contractual tort and statutory claims, and whether the choice of law provision governs procedural as well as substantive law.

Notice Provisions

Notice provisions should be among the first types of contractual provisions to be confirmed, in order to ensure compliance with all required deadlines and preserve all contractual or legal rights or remedies. The method for providing notice should also be confirmed to ensure there are no issues raised by COVID-19 closures.

Force Majeure Clauses

Market participants may seek to turn to contractual *force majeure* clauses amid the COVID-19 outbreak to excuse nonperformance due to supply chain or production interruptions, or other issues created by COVID-19. The application of *force majeure* provisions depends on the specific language of the clause—parties seeking to invoke *force majeure* clauses should consider whether the clause and applicable law support the contention that COVID-19 excuses performance. This is an especially important consideration for certain types of contracts, such as energy or commodity derivative contracts, where *force majeure* clauses are typically a highly negotiated point and the COVID-19 outbreak could impede performance, which is typically physical delivery.

In countries where the concept of *force majeure* is limited absent a specific contractual clause (e.g., the United Kingdom), financial market participants may still need to address the concept of frustration.

Risk Disclosures

Risk disclosures in registration statements, marketing materials, offering documents, subscription agreements, indentures, or other transaction documents will be relevant in assessing any fraud-related claims. Market participants should consider the risk disclosures related to forward-looking statements and the strength of applicable defenses. Parties also should consider if they have a special relationship giving rise to a duty to update or duty to disclose. It is equally important to keep in mind the potential risks presented by partial disclosure in the absence of a duty to disclose. In the wake of a market-disrupting event, such as 9/11 in 2001 or the credit crisis in 2008, the disclosure-related claims typically amount to complaints about disclosures around risk profiles and liquidity contingency plans.

Standing-Related Clauses

In any litigation assessment, parties should consider who can sue and potential contractual barriers that belie standing, including any no-third-party beneficiary clauses, no-action clauses, voting rights requirements, and anti-assignment provisions.

CORPORATE DISCLOSURES

Historically, stock drops have often resulted in shareholder class actions alleging securities fraud under Section 10 of the Securities Exchange Act of 1934, and Rule 10b-5. These allegations typically assert that disclosures were false or materially misleading.

First, disclosure duties under federal securities laws require the timely filing of all required SEC reports (10-K, 10-Q, 8-K, etc.), as well as correction of prior factual statements that were materially false or misleading when made or updates of prior disclosures that later prove incorrect. While federal securities laws do not expressly contemplate a "duty to update" forward-looking statements, courts are divided as to whether such a duty exists. Courts upholding a "duty to update" typically apply it to statements that "remain alive" in the minds of a reasonable investor and have become subject to fundamental changes. When updating prior disclosures, financial institutions should proceed with caution and avoid being too definitive, avoid promising future updates, and provide meaningful, cautionary statements. Financial institutions should also keep in mind that oral statements create the same exposure as written statements.

Second, and more generally, financial market participants with listed shares or debt will need to manage their internal processes for risk disclosures in compliance with laws and regulations. For instance, insider lists may need to be updated if a wider group of people is involved in any analysis. Companies should consider a refresher on market abuse and/or insider trading for relevant employees (even if no new people are added to the insider list).

INSURANCE COVERAGE CONSIDERATIONS

While the scope of insurance coverage will depend upon the specific terms of each insurance policy, a variety of insurance policies may respond with insurance for the types of COVID-19-related exposures that commercial policyholders have already or will soon experience.

Commercial property insurance policies may provide coverage for business interruption losses resulting from COVID-19-related disruptions to the operations of a business or its customers and suppliers, including when due to the actions of a "civil or governmental authority." In addition, a number of commercial property insurance policies contain express "communicable disease" coverage extensions, the terms of which can vary significantly from insurance policy to insurance policy.

Insurance coverage may also be available for COVID-19-related liabilities. In particular, commercial general liability ("CGL") insurance policies should potentially respond with coverage for bodily injury claims that a business allegedly failed to exercise reasonable care in guarding against, or warning of, the risk of exposure to coronavirus. Likewise, directors and officers ("D&O") insurance may provide coverage for the costs and liabilities arising from shareholder lawsuits regarding the alleged inadequacy of a financial institution's COVID-19-related disclosures or the actions of its directors and officers in response to the COVID-19 pandemic.

Similarly, claims that employment practices in response to the COVID-19 pandemic are discriminatory or violate employee privacy rights may be covered under employment practices liability insurance programs. Finally, the cyber insurance policies may respond with coverage for losses resulting from COVID-19-related social engineering and phishing campaigns, as well as cyberattacks occasioned by increases in telework/remote access and the use of employees' personal electronic devices.

Given substantial variations in both insurance policy language and the scope of insurance coverage within the market, any insurance coverage analysis for COVID-19 exposures must include a careful review of a financial institution's specific insurance program. For a more in-depth discussion of coronavirus-related insurance coverage considerations, see our Jones Day *Commentary*, "Time for a Policy Checkup: Maximizing Insurance Coverage for Coronavirus Losses."

DATA PRIVACY/CYBERATTACKS

The COVID-19 pandemic also gives rise to numerous challenges related to data privacy and potential cyberattacks. First, financial institutions should avoid systematic and generalized health data collection from employees and visitors. The collection and use of personal health information is subject to stringent privacy laws in the United States and foreign countries. Care should be taken to ensure compliance with HIPAA, ADA, and other federal, state, and international privacy regulations, including GDPR (Europe) and CCPA (California).

In addition, with more employees working outside of the office, financial institutions also face significant risks from telework/remote access and use of personal electronic devices. The Firm has already seen incidents involving the use of COVID-19 in social engineering and malware campaigns via phishing. Moreover, increased use of personal devices and limited visibility on virtual data storage environments creates greater risks. Financial institutions should strive to provide guidance on how the workforce can safely work remotely and be alert to phishing scams.

CONCLUSION

As the COVID-19 outbreak continues to wreak havoc on daily life and the markets, and imperfect visibility regarding when or how the COVID-19 crisis will resolve, it is important for financial market participants to consider litigation risks and plan and prepare for the multidisciplinary legal and regulatory issues that could arise across business lines, products, and jurisdictions. When crafting crisis response and post-recovery planning, among other things, market participants will want to consider duties and obligations under contract or law and consider issuing guidance where appropriate on how the workforce can safely work remotely, such as being alert to phishing scams.

The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

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