Insights: Key Considerations For Financial Services Clients in Response to COVID-19

As the COVID-19 pandemic spreads globally, the implications for businesses are developing on a daily basis. Financial institutions are exposed to several legal and regulatory issues in the near and medium term. While the exact length and severity of the pandemic is uncertain and impossible to accurately predict at this point, what is certain is that Boies Schiller Flexner can help your firm tackle a host of issues it may be facing.

We have considered how COVID-19 may affect financial institutions in relation to litigation and regulatory matters for those firms who fall within the regulatory ambit of US and/or UK regulators.

Litigation

Financial institutions will be braced for an increase in disputes, in the short and medium term.

Short term volatility

In the short term, financial institutions can expect margin calls to deal with the effect of the market volatility, and close-out and redemption requests as market participants seek to limit exposure. Lenders may also expect to see borrowers seeking to make use of available credit, and financial institutions should assess whether they are obliged to make such credit available depending on the terms of the relevant lending documents (including whether a default exists or may exist, as to which see below).

Defaults

In the near to medium term, financial institutions should expect a raft of defaults or alleged defaults, as borrowers struggle to meet payment obligations as the pandemic impacts operations, and/or lenders seek to take proactive action to preserve their economic interest in the face of insolvency risk.

Contentious issues around defaults may include:

- Breaches of financial covenants: whilst many finance documents may be "cov-lite", where financial covenants are included, they are likely to be breached by a borrower or obligor in financial distress, or with a disrupted business following the pandemic and/or governmental responses to it.
- Material adverse effect/ material adverse change clauses: the Courts' construction and interpretation of these clauses, particularly in the context of the COVID-19 pandemic, is likely to be relatively narrow and lenders may be reluctant to declare a default and enforce solely on the basis of a (potential) material adverse

effect. However, this will turn on the specifics of the wording of the clause and the impact of the pandemic on the business of the relevant obligor. Where a borrower group's business is reliant on supply chains or physical productions, there may be real scope for the existence of a material adverse effect within the scope of the relevant finance document.

- Force majeure clauses: whilst not common in finance documents, some do contain such a clause (or similar, relating to acts of god, or other such momentous events). The availability of relief from contractual obligations will always depend on the precise wording of the clause and the particulars of the borrower group's business. Issues of mitigation (i.e. whether the obligor could have taken steps to avoid or limit the impact of the pandemic on the business) are likely to be highly relevant.
- Change of law clauses / illegality: whilst again dependent on the precise terms of the relevant clause, these type of clauses (or the English common law doctrine of illegality) may require a prohibition on performance rather than an impracticality of performance. Whilst the pandemic is ongoing (and the governmental responses to it are evolving) it is unclear whether such clauses or doctrines will be triggered.
- Insolvency-related events of default: governmental responses to the pandemic - such as social distancing and advice or requirements for employees to work from home - may result in certain businesses ceasing or being suspended, depending on the business sector of the borrower group. More formal insolvency measures will also result in defaults.

Alongside and related to this, financial institutions may also expect to see disputes around actions of borrowers and obligors in the period before any default or subsequent insolvency or restructuring. These disputes may relate to:

- Fraudulent transfers or other reviewable transactions: where companies have not received “reasonably equivalent value” (as defined in US state and federal statutes) for an asset or the transaction was transferred at an undervalue (defined in English law as “significantly less than the value of the consideration received”). There are other bases to challenge transactions, including transactions at a preference and transactions defrauding creditors. For example, payments to insiders, such as on account of loans or management fees, can also be avoided as constructive fraudulent transfers (or similar) even if made for reasonably equivalent value, if the debtor was insolvent at the time that the transfer was made.
- Payments of illegal dividends: some US states have statutes that make it illegal for corporates to issue dividends or redeem stock when they are in financial distress. For example, under section 173 of the Delaware General Corporations Law (“DGCL”), a dividend is illegal unless it is made out of “surplus” or, if no surplus exists, out of net profits for the fiscal year in which the dividend is declared or the preceding year. See also 6 DGCL § 18-607 (imposing liability on LLC members that knowingly received unlawful distributions). A share redemption is illegal under DGCL section 160 if it is made “when the capital of the corporation is impaired, or when such purchase or redemption would cause any impairment of the capital of the corporation.” Under DGCL section 174, directors who willfully or negligently approve an illegal dividend or share redemption are “jointly and severally liable” for the full amount of the wrongfully-approved transfer. New York law contains similar provisions. English law can require shareholders (and others) to make contributions in certain circumstances.

Corporate distress and restructurings

Where such waivers or amendments are unable to be agreed, contentious restructurings and insolvencies will follow. Financial institutions should be ready to take action to protect their interests in such restructuring or insolvencies.

Whilst these sort of situations always create uncertainty (and feed disputes), there is increased risk in the current circumstances:

- The UK and the US governments are implementing legislative changes which impact on such distresses – for example, the UK government has now disapplied wrongful trading requirements for the period of the pandemic.
- Bail-out and business / obligation coverage measures being implemented by the UK and US governments (for example, to cover wages of employees during this period) are likely to distort matters for some time. Businesses which were already in early-stage distress may be able to benefit from governmental support, disguising underlying issues in the business and, potentially, leading to later disputes as to the availability of such relief, and duties of directors (and shadow directors) in seeking such relief and the timing of steps to put the business into insolvency or restructuring.
- There may also be challenges as to the governmental ability to take such interventionist action, and other actions that the governments may take in the forthcoming period - such as state aid or other steps. Litigation following the global economic crisis involved challenges to State interventions on the basis of, amongst other things, expropriation of property (including claims based on loans/notes and other financial instruments).

Formalities

Financial institutions should be mindful of formalities and procedural requirements with respect to potential defaults and other events under finance documents. For example, force majeure clauses may require notices to be given, to have the stated effect.

In addition, borrower entities may be under formal obligations to provide information to lenders with respect to the impact of COVID-19 on their business, in line with information covenants or other formal requirements imposed by the relevant finance documents.

Access to the Courts

As a more practical matter, the UK and US Courts continue to operate through the COVID-19 pandemic, with video and telephone hearings quickly becoming the norm, and some more procedural matters being able to be dealt with on the papers. Whilst some more witness-intensive hearings may find themselves being postponed, the Courts are keen to ensure the continued access to justice and avoid a significant backlog of cases which would necessarily result from a widespread shutdown of the Court system.

Cases brought by or against financial institutions may be prime for continued progress through the Court system irrespective of the pandemic, as sophisticated parties and their legal representatives are able to adapt to the current circumstances. However, some delays may be expected particularly where fact or expert witnesses or legal input is required from other jurisdictions which are heavily impacted by COVID-19.

Regulatory Matters

As the COVID-19 situation develops, all financial institutions will need to:

- Ensure that their business continuity plans ("BCPs"), which should already be in place, are robust enough to deal with the practical challenges arising from COVID-19; and
- Communicate clearly and transparently with stakeholders, including customers, employees, regulators and the wider market; and
- Monitor, adopt and respond to regulatory measures across several areas of their business.

Operational resilience and cyber risk

Firms will be well aware of the need for operational resilience in ordinary business circumstances (including protecting against a high level of cyber risk) and should already have adequate systems and controls. COVID-19 is testing firms' resilience planning and requiring them to monitor and adapt systems and controls in real-time as the effect of the pandemic (together with business/government responses) changes on a daily basis. Firms should be reviewing/updating their BCPs as matters develop. In the US, FINRA has provided guidance on pandemic preparedness (Regulatory Notice 09-59) and has encouraged member firms to contact their assigned FINRA Risk Monitoring Analyst to discuss the activation and implementation of their BCPs. In the UK, the FCA has stated that it is actively reviewing firms' contingency plans and has stated that firms "*should take all reasonable steps to meet the regulatory obligations which are in place to protect their consumers and maintain market integrity*."[1]

Cyber-risk is currently heightened, particularly as employees and customers stay away from firms' premises, working and transacting remotely. In particular:

- With customers in isolation and bank branches inaccessible/closed, vulnerable customers (who are likely to be more susceptible to scams/phishing) may turn to online banking.
- Even if a firm's systems are well-equipped to handle remote working en masse, measures should be taken to ensure that staff uphold security measures, particularly if using their own computing and telephone devices for business purposes and/or handling sensitive or confidential information if co-habiting with others. For example, FINRA has advised its member firms to (1) ensure systems are properly patched with security updates; (2) check that system entitlements are current; (3) use multi-factor authentication for remote workers; and (4) remind associated persons of cyber risks.[2]
- Firms should be alert to the increased threat to network security and increase monitoring and surveillance where necessary.

[1] FCA, "FCA Information for Firms on Coronavirus (Covid-19) response" (https://www.fca.org.uk/firms/information-firms-coronavirus-covid-19-response)
[2] FINRA, "Regulatory Notice 20-08" (https://www.finra.org/rules-guidance/notices/20-08)

Disclosure to the market and regulators

Firms will need to be particularly aware of their disclosure obligations to the market and to regulators.

Corporate/financial reporting timeframes have been temporarily relaxed in both the US and the UK, including the SEC providing public companies with a 45-day extension to file certain disclosures and the FCA giving listed companies an additional two months to file audited annual financial reports. [3]

Firms who are issuers of publicly traded securities must also ensure that they make the necessary and timely disclosures to the markets as their condition changes due to COVID-19:

- In the US, the SEC has issued guidance stating that "where COVID-19 has affected a company in a way that would be material to investors or where a company has become aware of a risk related to COVID-19 that would be material to investors, the company, its directors and officers, and other corporate insiders who are aware of these matters should refrain from trading in the company's securities until such information is disclosed to the public."[4]
- The SEC has also encouraged "disclosure that is tailored and provides material information about the impact of COVID-19" and that allows "investors to evaluate the current and expected impact of COVID-19 through the eyes of management, and that companies proactively revise and update disclosures as facts and circumstances change."[5]
- From a UK perspective, the FCA has made clear that firms who are issuers of listed securities subject to the Market Abuse Regulation (EU) No 596/2014 ("MAR") must fulfil their obligations to disclose inside information (irrespective of any other temporary relief for publishing their audited financial statements). MAR and the FCA's Disclosure and Transparency Rules require issuers to disclose inside information which directly concerns them as soon as possible.[6]

Examples of disclosures that may become necessary due to COVID-19 may include: (i) significant changes or disruption to the firm's business strategy or operations; (ii) illness/death of senior employees and officers; (iii) significant failures in the firm's systems and controls; and (iv) details of any regulatory breaches or other incidents. In the UK, firms remain obliged to notify the FCA of anything which the regulator would reasonably expect notice.[7]

[3] Additionally in the UK in parallel with the FCA's announcement on reporting extensions dated 26 March 2020, the FRC has issued guidance relating to maintaining strong corporate governance and corporate reporting, together with separate guidance for auditing firms, whilst the PRA has issued guidance to banks, building societies and PRA-designated investment firms in relation to in assessing expected loss provisions under IFRS9, as set out in a "Dear CEO" letter dated 26 March 2020.

[4] *Id.*

[5] SEC, "CF Disclosure Guidance: Topic No. 9" (https://www.sec.gov/corpfin/coronavirus-covid-19)

[6] Inside information is generally defined as "*information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments*" – MAR, Article 7(1)

[7] Under Principle 11 (and, if applicable, the PRA under Fundamental Rule 7). Firms should also be mindful of obligations to notify the FCA of matters or incidents as required by SUP 15.3 and SYSC 13.4.2R, including but not limited to significant operation exposures, any matter which could affect the ability to provide adequate services to customers; significant systems and controls failure; fraud errors and other irregularities.

Market abuse

The risk of market abuse is significantly heightened by increased market volatility and firms having adapted their business processes and systems. This risk may arise in respect of (i) opportunist/rogue employees working remotely with reduced oversight from compliance staff (due to technological limitations and staff absences); (ii) weakened/adapted systems which are less able to prevent and identify market abuse (e.g. due to less effective information barriers and impaired monitoring); and (iii) certain companies' securities being more vulnerable to false or inaccurate information/rumours in the market.

The SEC has warned that it is actively monitoring markets for frauds, illicit schemes and other misconduct affecting U.S. investors relating to COVID-19, and will use enforcement tools as appropriate.[8] Indeed, the SEC has already imposed several trading suspensions, including in relation to the shares of:

(i) Medical/pharmaceutical companies Eastgate Biotech and Aethlon Medical, due to the accuracy and adequacy of information relating to the company's work on coronavirus treatments; and
(ii) The videoconferencing company Zoom Technologies (which has become increasingly popular as individuals self-isolate and work remotely), due to, amongst other things, the adequacy and accuracy of publicly available information including its financial condition and its operations.

With respect to reducing the risks of market abuse, in the UK, the FCA has expressly stated that firms "should continue to record calls, but we accept that some scenarios may emerge where this is not possible" and has requested that firms make the FCA aware if they are unable to meet these requirements.[9] But this is not a get out of jail free card - in the same announcement, the FCA has also stated that firms should continue to take all steps to prevent market abuse risk, which "*could include enhanced monitoring, or retrospective reviews*".

Conduct risk

Firms are exposed to other forms of misconduct beyond market abuse (and the increased risk that employees seek to cover up such misconduct) as a result of working remotely or with reduced oversight due to COVID-19, including:

- Non-compliance with proper standards of market conduct, rules and regulations;
- Failure to meet best execution requirements;
- Failure of management to ensure that their accountable function is able to be controlled effectively;
- Insider-fraud, as well as inducements and bribery; and
- Failure to perform roles with due skill, care and diligence.

[8] SEC, "SEC Coronavirus (COVID-19) Response" (https://www.sec.gov/sec-coronavirus-covid-19-response)
[9] FCA, "FCA Information for Firms on Coronavirus (Covid-19) response" (https://www.fca.org.uk/firms/information-firms-coronavirus-covid-19-response)

Many of these risks can be mitigated by reminding employees of their professional and regulatory obligations. Beyond this, a number of technical measures will be vital to reducing these risks, such as ensuring that:

- Employees' remote systems are functioning properly;
- Trades and phone lines continue to be recorded where possible; and
- Compliance teams are sufficiently resourced to deal with the increased volume of chats and emails (including with sufficient coverage in place in case of staff absences).

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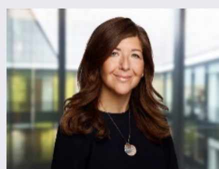

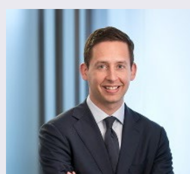

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