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Emerging Trends and Future Litigation in the Wake of COVID-19

May 27, 2020

Client Advisory

Nearly every industry around the globe has been affected by COVID-19, and its impacts on businesses are being felt wide and deep. Although the pandemic is itself without precedent in our lifetime, past experience with other disruptive events strongly suggests that there will be a litigation fallout that will long-outlive the virus. We have already seen a number of Coronavirus-related lawsuits filed across the country, and it seems inevitable that many more are likely to come.

Financial Fraud

Warren Buffet famously observed that only when the tide goes out do you discover who has been swimming naked. In a similar vein, market down-turns and financial stress tend to expose practices that were hidden (or at least overlooked) when the economy was strong. This was certainly true in the case of the 2008 financial crisis, which exposed many of the questionable practices that drove the boom in the housing and financial markets in the run-up to the Great Recession but, ultimately, led to their collapse. Similarly, fraud like the massive Bernard Madoff Ponzi scheme came to light largely because the financial crisis caused redemptions that exceeded Madoff's ability to raise enough money from new investors to pay back existing investors. The financial stress being caused by the COVID-19 pandemic is virtually certain to expose similar types of financial fraud.

We have already seen several Coronavirus-related lawsuits and enforcement actions brought against individuals and companies involved in fraudulent schemes designed to capitalize on the pandemic, relating to matters such as the SBA Loan/Payroll Protection Program, cleaning and hand-sanitizing products, vaccines, test kits, and other health-care supplies. In a volatile economy where unemployment is on the rise and liquidity is of ever-increasing concern, conditions are ripe for other fraudulent schemes to come apart at the seams, including ones that are not necessarily related directly to COVID-19. For example, just as the mortgage-boom hyper-charged the economy in the run-up to the 2008 financial crisis, the post-Great Recession economy has been fueled by entrepreneurs with market-disrupting ideas, and an expansion of the means and models by which they are funded. This has spurred investments in private companies by investors attracted to potentially lucrative returns in a low-interest rate environment and the prestige of early stage investing in high-value start-ups. Many of these private companies have operated with little oversight and will now be facing myriad challenges and heightened scrutiny in a post-Coronavirus environment. When they begin facing difficulties meeting the rosy projections that contributed to their sky-high valuations, questions will undoubtedly be raised as to how investors' funds were spent and whether information supplied to them was accurate and complete.

Distressed Investments

It goes without saying that COVID-19 is continuing to cause financial distress from the economic impacts of the pandemic. Companies face increasing financial constraints that will limit or threaten their operations, including financial covenants, compliance obligations, and notice provisions in their credit facilities, particularly in cases where an event of default has occurred or is likely. As liquidity concerns grow and fundraising becomes more difficult, borrowers may draw down on available facilities, general partners may seek to accelerate fundraising or

make capital calls earlier than anticipated, and limited partners will, in turn, consider options for pulling back from commitments or exiting investments altogether. All parties will closely examine their statutory, contractual, and common law rights.

In these cases, the planning, disclosures, and responses of management leading up to and during the pandemic will be in the spotlight, with close consideration as to whether their conduct was consistent with investment and loan documentation and fiduciary duties. In some cases, there may be causes of action for inaccurate or incomplete disclosures relating to operations, material contracts or events, or in connection with the failure to adequately satisfy contractual obligations and fiduciary duties. At the same time, investors' decisions will be examined for consistency with contractual commitments and investment documentation, and disputes concerning the exercise and interpretation of the parties' respective rights is likely to result in litigation.

Force Majeure and Material Adverse Change Clauses

The abrupt halt to essentially all economic activity in many sectors and the resulting need for companies to protect their cash positions will likely result in a slew of breach of contract claims, which will in turn implicate *force majeure* and material adverse change provisions.

Force majeure provisions are typically viewed as boilerplate and are often found buried in the "miscellaneous" section at the end of a contract. Literally meaning a "superior force" in French, *force majeure* is used to refer to a provision that relieves a party from its obligations when performance has been prevented by an unforeseeable force beyond its control. These provisions most often encompass natural disasters, war, terrorism, governmental prohibitions, labor strikes, technology or communications failures, loss of power, or similar disruptive forces. Now, more than ever, businesses are turning to the back pages of their contracts to see whether there is a *force majeure* provision that might grant them some relief or, at the very least, provide some bargaining leverage to address the immediate impacts of the COVID-19 outbreak.

Similarly, and particularly when it comes to merger and financing agreements that were entered into before the outbreak, "material adverse effect" or "material adverse change" clauses are likely to be another hotly litigated topic. In some ways, these clauses are analogous to *force majeure* provisions, as they can excuse a party from performance if there has been a "material" change in conditions. However, unlike *force majeure* clauses, which are inclusive in nature (meaning that courts will look to what the parties meant to include in the definition), material adverse change provisions are typically exclusive in nature (meaning that they will generally apply to material changes, but not enumerated exceptions which may include the very "acts of god" to which *force majeure* clauses apply). There are already reports of deals being terminated on the basis of material adverse change provisions, and the numbers are likely to increase as the crisis continues to unfold. As with *force majeure* clauses, material adverse change provisions are typically construed narrowly and are fact-specific.

Real Estate Litigation

Residential real estate was the catalyst for the 2008 financial crisis, and the COVID-19 pandemic is likely to be the driver of significant commercial real estate litigation. In New York, essentially all commercial leases contain independent covenants requiring tenants to pay rent even if the landlord breaches its obligations. Although several commercial landlords and tenants have negotiated rent deferrals, a growing number of landlords are refusing to do so and taking businesses to court. Although *force majeure* provisions of the type discussed above will no doubt be deployed as defenses, courts have traditionally been resistant to expand the applicability of force majeure. It remains to be seen if COVID-19 will lead to a sea change in thinking, particularly in the context of social distancing, stay at home, and shelter-in-place directives from the government.

Litigation will not be limited to commercial landlord/tenant disputes either, as the consequences of unpaid rent frequently extend beyond the parties to the lease. Landlords must service their debt as well, and many landlords that are financing entities (like REITs) depend on the cash flow generated by rent payments to repay their lenders. Several large retailers have already filed for bankruptcy and announced plans to close underperforming locations – which will be followed by the retailers' rejection of unexpired leases in connection with the bankruptcy process.

There will also undoubtedly be scores of small businesses that will not re-open once the crisis subsides. And unless a business solution can be found, landlords may very well go into default on their obligations and be forced to make the very same types of arguments in litigation against their creditors that they are resisting against their tenants. This will cascade through every level of the investment structure from the bottom up.

Real estate ventures and construction projects, including those halted as a result of governmental non-essential project shut down orders, will also be impacted. In addition to the excess capacity that will be created by business failures, there is now a wide-ranging discussion about what social distancing will mean for work and living arrangements going forward. This is likely to mean that projects that made sense in a pre-COVID-19 world will make far less sense now. Just as the managers of these projects will be considering their rights and options for adjusting to a post-COVID-19 world, investors will be doing the same.

Financial Instruments

Financial instruments tied closely to industries that are being impacted most dramatically by the pandemic, such as retail and hospitality, are under increasing stress. As owners of commercial real estate continue to struggle collecting rents from their cash-strapped retail tenants, delinquencies on commercial real estate loans will continue to rise. Similarly, as hotels remain empty, property owners' will increasingly be unable to service their debt. Indeed, the amount of loans moving to "special servicing" status spiked dramatically in April and is expected to increase again in May. It is inevitable that these delinquencies will ricochet through financial instruments, like CMBS, that are backed by these loans. A continuing, sustained increase in defaults, as many are predicting, will inevitably trigger litigation by investors, trusts, swap counterparties, and others with issuers and firms involved in arranging, underwriting, or marketing those securities.

Similarly, the market for financial products like leveraged loans and CLOs boomed over the past several years, attracting investors seeking higher returns during a period of low interest rates. However, just as the mortgage market went through a period of relaxed lending standards in the build-up to the Great Recession, fueled by demand from structured products like CDOs, so too has the leveraged loan market, driven by CLOs. Along with the erosion of the quality of debt being financed comes an increased risk of credit rating downgrades, failed collateralization tests, and defaults as the turmoil of the pandemic continues to settle in. When defaults do occur, cash payments to holders of equity and mezzanine debt tranches typically get cut off first, and investors holding covenant-lite leveraged loans (*i.e.*, loans with fewer covenants) may find themselves with very little protection. This will undoubtedly result in disputes over the relative rights and payment priorities of investors and shine the spotlight on the disclosures and modeling assumptions associated with these often-opaque financial instruments.

Employment, Compensation and Benefits

The widespread shutdown of non-essential businesses implemented to slow the spread of COIVD-19 forced many employers to rapidly transition their employees to remote working arrangements, and to lay-off or furlough workers whose jobs could not be performed remotely. Employers that have terminated, laid-off, or furloughed employees can expect to see claims alleging discrimination based on employees' memberships in protected classes or employees' requests for time off or other accommodations to care for sick family members or children whose schools or childcare has closed. As employers re-open closed workplaces, similar claims could also arise with respect to employees' chosen (or not chosen) to return and those who are asked to return but are unable to do so.

Moreover, with employees working from home and salary reductions being implemented across nearly all industries and sectors, employers should expect to see wage and hour claims alleging violations of the Fair Labor Standards Act (FLSA). And with respect to plant closings, furloughs, and layoffs, the federal Worker Adjustment and Retraining Notification (WARN) Act, and related state laws, could give rise to litigation to the extent notice provisions were not followed. While the federal government has not issued any guidance on whether any exceptions to notice requirements apply in the context of the pandemic (*e.g.*, unforeseeable business circumstances, natural disasters, and faltering companies), New York state has indicated that there may be "sudden and unexpected circumstances beyond an employer's control,

such as government-mandated closures, the loss of your workforce due to school closings, or other specific circumstances due to the coronavirus pandemic" that might give rise to an exception.

Restrictive Covenants and Trade Secrets

In some cases, employees that have been (or will be) affected by lay-offs or furloughs may be subject to non-competition, non-solicitation, and confidentiality covenants in their employment agreements. There are likely to be significant disputes over their enforceability. Employees seeking to avoid these restrictions are likely to argue that layoffs due to the pandemic were, in essence, undertaken to serve the business interest of the employer and that the employee's interest in finding new work, even if for a competitor, should control. While that is an argument that may be facially appealing in some cases, it is not necessarily the case that pandemic-related layoffs will have been undertaken for an employer's business convenience. Rather, layoffs may have been undertaken because an employer was deemed a non-essential business, in furtherance of the public interest in social distancing and stay-at-home directives, due to a decrease in demand for services or products, or otherwise to keep the business solvent in the short term for the very purpose of rehiring employees for the long term. It is particularly in these latter situations that employers may have an argument that that they actually have the greatest need for protection in order to have any chance of recovery after the shut-down ends.

Further complicating these disputes is the new reality of working remotely. The abrupt shift to remote work has made it more difficult for employers to monitor and control the flow of confidential information, especially if the infrastructure to safeguard that information did not exist prior to the COVID-19 crisis. Steps an employer has taken to protect confidential information is often a key factor courts look to in the context of claims for misappropriation of trade secrets and confidential information. And the current reality is that, to carry on their business, companies have necessarily been forced to allow for more remote access to their central systems than would normally have been allowed. The extent to which employers may be missing or overlooking potential red flags may make it harder to show effective protection of trade secrets while simultaneously allowing employees to more easily "jump ship" with confidential information.

Cybersecurity and Data Privacy

These very same remote working practices are likely lead to cybersecurity and data privacy litigation. Zoom, the default conferencing platform used by many, is already facing litigation related to consumer privacy and the collection and disclosure of user information. There have also been reports of an uptick in cybersecurity incidents, likely exacerbated by the decentralized nature of work and the use of personal devices to perform work directly – which may lead to various forms of litigation, including claims by customers against businesses that mishandled their data and claims by those same businesses against cybersecurity insurance carriers (who may deny claims based on how remote working arrangements were implemented and monitored).

In addition, regulated industries (such as financial services and healthcare) must contend with targeted cybersecurity regulations and affirmatively demonstrate their readiness and the capacity of their IT systems and policies. Failure to do so may lead to enforcement actions and fines. State regulators in some hard-hit states like New York and California have not granted any extensions or grace periods for compliance with data privacy standards as a result of COVID-19, and in fact there may even be heightened scrutiny of policies and practices during the pandemic.

Intellectual Property

In times of business stress, companies often turn to their intangible assets – patents, trademarks and copyrights – to protect their businesses. These assets are often the result of years of investment and provide well-defined rights to maintain exclusivity and stop competitors from copying a company's products and services. As a result, there is likely to be an uptick in intellectual property disputes as companies turn their focus from expanding their businesses to protecting the businesses they have. As pandemic-related distress continues, companies will likely take

a second look at competitors, who may also be suffering a loss of sales, to make sure that they are not infringing any IP rights. Likewise, companies that are looking to respond to COVID-19-related business opportunities need to be careful not to infringe any IP rights as they try to take advantage of those opportunities.

The COVID-19 pandemic has also generated urgency around finding treatments, diagnostic products, and preventative products and services. This presents opportunities for healthcare, pharmaceutical, and material sciences companies, as well as companies that offer products and services that facilitate working from home and living at a social distance from others, to expand their businesses and provide new products and services that could address health and other issues. New IP will inevitably be created in the research and development and new business that results. Companies must take care to protect that IP while also not slowing down urgent work. The urgency of the work raises risks around inadvertent disclosures, public sharing, or offers to sell new discoveries, which will in turn limit the patentability of those discoveries. In addition, rapid development of technology and informal efforts to create companies and solicit investments will create muddled records and communications regarding the ownership and inventorship of that technology and related companies. This raises the possibility of later litigation when the new technology and company stakes increase in value.

Cannabis, Hemp & CBD

Over the last several years, the Cannabis, Hemp, and CBD industry has expanded rapidly. The weaknesses in some parts of the industry, which has already led to claims by investors accusing founders and management of presenting an overly optimistic picture, is likely to be more pronounced in the wake of COVID-19. Moreover, on the heels of expanding but untested claims related to the potential health benefits and uses of CBD in particular, the industry has received increased attention from regulators and consumer watchdog groups. Even prior to COVID-19, the FDA and FTC had already been sending warning letters to companies in the CBD space related to unsubstantiated health claims, some of which related to the supposed antiviral properties of compounds used in CBD products. This trend is likely to expand in the wake of the COVID-19 pandemic as the industry faces increased scrutiny from regulators and consumers, and potentially claims based on false or misleading advertising. This may, in turn, also attract claims against management by disaffected partners and investors.

Bankruptcy and Creditors' Rights

Bankruptcy is the classic countercyclical practice, and bankruptcy-related litigation inevitably follows a financial crisis. The current pandemic will be no different. Bankruptcy and restructuring lawyers are already dealing with countless financial challenges businesses are facing as a result of the impact of COVID-19. Companies are being confronted with supply-chain disruptions, reduced customer demand, operational challenges, and balance sheet exposure due to the turmoil in the financial markets. This distress is forcing businesses to look at restructuring relationships with customers and pursuing modifications of commitments to lenders and suppliers who are themselves facing similar challenges. As the economic distress accelerates, the focus is likely to shift increasingly to options for more formal reorganizations or liquidations under the Bankruptcy Code. Even businesses that are not themselves facing insolvency will have to deal with the bankruptcies of their customers, suppliers, and other counterparties.

A wide range of bankruptcy-related litigation is likely to ensue. That litigation will almost certainly encompass familiar themes like preference and fraudulent transfer claw-back claims. Creditors and other stakeholders will litigate over the valuation of debtors' businesses and the allocation of value among parties with claims on assets. Causes of action may also be asserted against companies' officers and directors relating to the adequacy of risk disclosures or breaches of duties in connection with planning or addressing business issues associated with the pandemic. And, of course, there is likely to be significant litigation over the interpretation of insurance policies covering business interruption or trade disruption. The bankruptcy process will also create opportunities for competing investors and others to acquire the assets of distressed businesses.

Conclusion

The scope of the business and legal impacts of COVID-19 are only beginning to take shape. Many courts in jurisdictions across the nation are still operating on a limited basis and as events continue to unfold companies remain rightly focused at present on managing their businesses through the pandemic rather than making litigation decisions. However, if past is prologue, the fallout is sure to bring with it a surge and expansion in litigation related to the pandemic that will last for many years after the virus is no longer a major public health threat.

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For more information concerning the matters discussed in this publication, please contact a member of our Litigation and Disputes Department, or your regular Carter Ledyard attorney.

Carter Ledyard has created a COVID-19 Response Group to monitor the evolving legal landscape, address client questions and ensure client compliance with the laws and regulations issued in response to the COVID-19 pandemic. The Carter Ledyard COVID-19 Response Group consists of ***Jeffery S. Boxer*** *(212-238-8626, boxer@clm.com),* ***Judith A. Lockhart*** *(212-238-8603, lockhart@clm.com),* ***Bryan J. Hall*** *(212-238-8894, hall@clm.com),* ***Alexander G. Malyshev*** *(212-238-8618, malyshev@clm.com),* ***Melissa J. Erwin*** *(212-238-8622, erwin@clm.com), and* ***Leonardo Trivigno*** *(212-238-8724, trivigno@clm.com). Clients should contact the attorneys listed above or their regular CLM attorney for any questions concerning legal obligations arising from the COVID-19 pandemic.*

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