Q&A: Directors' Delaware Law Questions During the Pandemic

Contributor

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Skadden partner Edward Micheletti, who heads the litigation practice of the firm's Wilmington office, answers common Delaware law questions facing boards of directors during the COVID-19 crisis.

Many boards of directors of Delaware corporations are facing extreme circumstances due to the COVID-19 pandemic. In addition to the crisis' general economic impact and the demands of day-to-day decision-making, boards are being forced to address employee health concerns and government-mandated shutdowns of core business operations. What guidance does Delaware law offer boards facing such unprecedented circumstances?

Delaware law offers straightforward, basic principles that guide boards of directors and provide them with flexibility when addressing even the most unique and complicated circumstances. These include the well-defined fiduciary duties of care and loyalty (which encompass disclosure and oversight responsibilities) and the deferential business judgment rule, which prevents a court from second-guessing good faith, well-informed decisions by boards comprised of a majority of disinterested and independent directors. Focusing on these core Delaware corporate law principles, whether as part of normal business operations or during a time of crisis, such as the COVID-19 public health emergency, should help directors make good faith decisions for their business in real time and protect against exposure to potential liability. For more information, see our February 19, 2020, client alert, "Directors' Fiduciary Duties: Back to Delaware Law Basics."

The COVID-19 health emergency has had an unexpected, negative impact on many corporations, having implications on assessment of value. Many boards have been forced into "crisis mode," requiring them to engage in damage control and make very difficult decisions about the business and affairs of a company. How should boards approach these issues?

Again, boards should rely on core Delaware corporation law principles to tackle these problems. Boards can, for example, inform themselves by listening to management about the impact COVID-19 is having (or is anticipated to have) on the company's business operations. Boards can also ask legal or financial advisors to provide their insight as well. When the board makes well-informed, good faith determinations, without self-interest, that are in the best interest of the company and its stockholders, such decisions — even out of the ordinary decisions addressing COVID-19's impact on business operations or corporate value — should be afforded the benefit of the business judgment rule. I suspect that boards will be considering the impact of COVID-19 on business operations and corporate value throughout 2020, even after "stay at home" orders and other government-mandated closures have been lifted. Boards will need to make decisions as facts and circumstances develop and exercise their business judgment consistent with their fiduciary duties to address them.

How does the duty of oversight come into play?

From an oversight standpoint, boards should be aware that, in times of crisis, it is important to focus on maintaining, or even augmenting, board-level reporting and oversight structures so that the board receives the information it needs to assess and address business risks. For example, boards (or applicable board committees) may conclude that more frequent meetings and reports from management, or further augmentation of existing controls, may be warranted to address COVID-19 related concerns. A further discussion on considerations for boards of directors on the COVID-19 crisis can be found in our March 20, 2020, client alert, "Thoughts for Boards of Directors on the COVID-19 Crisis."

In addition to navigating the day-to-day business impact of COVID-19, some directors face the additional challenge of managing the pandemic's effect on their efforts to close a pending merger or acquisition. What issues do directors of buyers and sellers face?

Along with managing COVID-19's impact on a company's day-to-day business, employees and customers, some boards must also manage a number of important issues relating to pending mergers or other transactions. This has been a significant topic of interest for both buyers and sellers with pending deals over the last several weeks in particular. Whether the COVID-19 pandemic has had a "material adverse effect" (MAE) on or may constitute a "material adverse change" (MAC) to a particular business is a determination guided by the specific language of the transaction agreement at issue and fact-specific considerations. Among other things, one critical challenge in demonstrating an MAE or MAC is that, under Delaware law, a party must be able to show a durationally significant adverse impact on a company's fundamental value. Given that COVID-19's impact on the United States in general, and its businesses and economy in particular, arguably manifested itself during the past few months, there will be debate over whether it has been durationally significant enough to support an argument that an MAE or MAC has occurred. Similarly, predicting any long-term impact of COVID-19 will require parties, for example, to analyze the facts and circumstances for an individual business and the industry in which it operates. Other context-specific issues related to COVID-19 include whether the MAE definition in a particular merger agreement directly or indirectly excludes an impact from COVID-19. The exclusions to the MAE or MAC definition can differ in each merger agreement, and merger parties will need to examine the particular language of those exclusions to determine whether a COVID-19-related impact is excluded. Similar issues also may arise when a transaction participant looks for a way out of the deal, for example, by examining a seller's compliance with interim operating covenants and a buyer's conduct in withholding, conditioning or delaying consent for the seller to take certain specified actions to address COVID-19.

Are there any recent Delaware law decisions that address these issues?

Again, these types of issues, including whether a court would order specific performance of any covenant obligations and/or consummation of the transaction, are fact-driven and their resolution may vary from case to case. Two recent post-trial decisions by the Court of Chancery involving MAE/MAC issues help illustrate the matter. In *Akorn, Inc. v. Fresenius Kabi AG*, Vice Chancellor J. Travis Laster denied a seller's request for specific performance of a merger agreement and determined that the buyer did not have to close the deal because it had made the showing necessary to establish an MAE, including based on the seller's significant downturn in performance over five quarters. In *Channel Medsystems, Inc. v. Boston Scientific Corp.*, Chancellor Andre G. Bouchard granted a seller's request for specific performance and determined that the buyer wrongfully terminated the merger agreement. The court held that concerns about potential products liability litigation, competitive harm and future regulatory action were unsubstantiated and did not demonstrate that an MAE was reasonably expected to occur. As MAE/MAC cases are litigated in response to COVID-19, a recurring debate will be whether the particular facts are closer to those in *Akorn* or *Boston Scientific*.

Has COVID-19 resulted in an increase in stockholder litigation at this point, and what should boards do to stay prepared?

Not yet. However, given COVID-19's impact on business and the economy, it would not surprise me at all to see a wave of stockholder litigation arise from this situation. One early indicator would be an uptick in stockholder demands for books and records to investigate "wrongdoing" focused on

the board's response to COVID-19. These demands are usually a precursor to a derivative action, which is how most oversight claims are raised. Board-level materials, such as minutes or board presentations, are almost always requested, but a recent trend has emerged in which stockholders try to push the envelope beyond such formal records and attempt to access board communications in emails or even text messages. Keeping accurate, formal records of board decision-making in response to COVID-19 is important, and may help defeat or limit a stockholder's request to access such electronic communications.

Are there any other developing stockholder litigation trends that bear mentioning?

Another trend that began to develop shortly before COVID-19 is using Section 220 demands to explore whether officers, in addition to boards of directors, were involved in any "wrongdoing." This has been of significant interest to plaintiff lawyers because under Delaware law, officers owe fiduciary duties of care and loyalty, but unlike directors, officers are not covered by a company's Section 102(b)(7) exculpatory provision for money damages stemming from breaches of the duty of care.