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Impact of the Coronavirus Disease 2019 (COVID-19) on Public and Private Securities Offerings

The rapidly developing news on the spread of the Coronavirus Disease 2019 (“COVID-19”) in the United States and other nations across the world has resulted in significant turmoil in global financial markets, bringing renewed attention to the manner in which unforeseen circumstances of this nature should be reflected in underwriting, structuring and arranging securities offerings and applying the terms of existing securities offerings.

BACKGROUND

While the United States continues to experience near record-low unemployment and the national economy is strong according to other key economic indicators, the turmoil in the financial markets reflects uncertainty as to the impact of the virus’ outbreak on the national economy in the near- and long-term, with many economic forecasters predicting that the outbreak could trigger another recession that would be difficult to manage because of its suddenness and unique circumstances. The significant impact on U.S. businesses that rely on China, Italy and other countries impacted by the outbreak as a significant market for their goods and services or as a manufacturing or supply center is already demonstrated. Specific industries including travel and leisure and entertainment have already been especially hard hit. The impact on other industries is less certain. Discretionary spending by consumers may decline as consumers limit their activities voluntarily and in response to government guidelines while businesses may experience reduced productivity due to disruptions in their supply chains and absenteeism in the workplace, all of which could affect businesses more generally. While the Chinese government has reported more recent progress in containing the outbreak in China as of the date of this alert, the United States and other countries appear to be in a more preliminary stage of the outbreak that could repeat the same cycle experienced in China and that could take longer to contain. Many of the measures instituted by Chinese government may not be feasible to institute on the same scale in the



United States and other countries in containing the outbreak. Other less developed countries may lack sufficient resources or the infrastructure required to contain the outbreak. Nations that are successful in containing the outbreak bear the risk of repeat outbreaks.

The U.S. Federal Reserve recently followed the lead of national banks in other countries in addressing turmoil in the financial markets through fiscal policy by making the largest cut to the federal funds rate since the last recession. The failure by financial markets to respond in a positive manner to the cut to the federal funds rate is a further reflection of the uncertainty as to the potential near- and long-term impact on the national economy of the outbreak, which in turn reflects uncertainty as to the potential severity and duration of the outbreak. As interest rates are already extremely low by historical standards, the U.S. Federal Reserve also has less “dry powder” to impact economic conditions through lowering interest rates, with economic forecasters raising the possibility of negative interest rates seen in other nations as the U.S. Federal Reserve is anticipated to make further cuts to the federal funds rate in the near future and may even reduce the federal funds rate to zero. Other affected nations similarly have limited capacity to improve economic conditions through fiscal policy, with some of them already experiencing negative interest rates.

Set forth below are certain considerations to be addressed in underwriting, structuring and arranging securities offerings and applying the terms of existing securities offerings in light of these developments. Additional considerations that apply specifically to underwriting, structuring and arranging of public securities offerings are also discussed below.

DUE DILIGENCE

The due diligence customarily performed at a preliminary stage in the underwriting, structuring and arranging of a securities offering should be expanded to address the potential legal and financial impact of the outbreak on the particular issuer of the securities. Parties should consider conducting the due diligence necessary to assess how the issuer of the securities may be impacted by the outbreak. For example, if the issuer of the securities relies on China or other nations that have been more directly impacted by the outbreak as a significant market for its goods and services or as a manufacturing or supply center, that aspect of the issuer’s business requires particular attention, including the terms of sales contracts, supply contracts and other relevant contracts entered into with parties in affected areas. The capacity of the issuer to terminate and replace supply contracts and other contracts entered into with parties in affected areas and the availability of alternative markets and supply chains may also be appropriate to diligence. If the issuer of the securities or its affiliates are parties to existing financings that will remain outstanding, the underlying documents for the financings should be assessed to determine if a decline in revenues or net income generated by the issuer or its affiliates as a result of the outbreak may trigger breaches of financial covenants and other provisions that result in events of default or other similar events. The management for the issuer of the securities should also be directly asked as part of the due diligence process as to their own assessment of the potential legal and financial impact of the outbreak on the issuer and what steps if any are being taken to address that impact. Heightened due diligence could be appropriate for issuers in the industries that are expected to continue to be more hard hit by the outbreak and also issuers whose business is concentrated in the areas more seriously affected by the outbreak. Issuers whose business is highly concentrated in specific geographic areas of the United States or other nations also require special attention even if the outbreak has not yet affected those areas or other nations. As part of their due diligence, we recommend that as a preliminary step, the underwriters, structurers and arrangers of securities offerings inquire into an issuer’s “assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable,” consistent with SEC Chairman Jay Clayton’s recommendation to publicly traded companies set forth in the recent SEC Release (see the SEC’s March 4, 2020 release (the “*SEC Release*”, available [here](#))).



The questions asked by the underwriters, structurers and arrangers to the issuer as part of the due diligence review process to assess the potential legal and business impact of the outbreak on the issuer and its affiliates may include, among others:

- the current and potential impact of the outbreak on the issuer’s areas of business and operations generally;
- the current and potential impact of the outbreak on the issuer’s industry;
- any current or potential supply-chain disruption and steps taken or to be taken to address such disruption;
- policies and procedures implemented to plan and prepare for, and respond to, the outbreak in the near- and long-term under different scenarios as to the severity and duration of the outbreak;
- the availability of business interruption insurance and other applicable insurance coverage to mitigate losses associated with the outbreak;
- what changes, if any, are anticipated to insurance coverage or pricing by insurers in response to the outbreak;
- any reports and other correspondence between the issuer and its auditors, accountants and advisors related to the outbreak;
- any claim, action, inquiry, suit, proceeding or investigation related to any failure to adequately plan and prepare for, or respond to, COVID-19 (e.g., violation of HIPPA Privacy Rule); and
- any assessment as to the risk of breaching or triggering any financial covenants or other provisions under the documentation for any existing financing arrangements.

OFFERING MATERIALS

The materials prepared in connection with an offering of securities should address the actual and prospective financial impact of the outbreak on the issuer and the issuer’s anticipated response. In a recent release regarding the impact of COVID-19, SEC Chairman Jay Clayton noted that “how companies plan and respond to [COVID-19] events as they unfold can be material to an investment decision”, a clear indication that the SEC (and the plaintiff’s bar) will expect robust COVID-19 disclosure in offering materials.

MD&A and Recent Developments. A management discussion and analysis of the actual and prospective financial impact of the outbreak on an issuer of securities and its plan of action for addressing consequences of the outbreak would be appropriate to include as part of the description of the business of the issuer or in a section of the offering materials describing “recent developments”. Where the issuer has recent quantitative or qualitative financial data reflecting the impact of the outbreak on its financial performance that is materially different than the most recent quarterly unaudited or annual audited financial statements included as part of the offering materials, it may be appropriate to include as “flash” numbers in a section on recent developments on the issuer (particularly when the impact is adverse).

Forward Looking Projections. It may also be appropriate for the management of the issuer to forecast the potential impact of the outbreak on the financial performance of the issuer under different scenarios where future financial performance is expected to differ materially from past financial performance. It is important that projections of financial performance under future scenarios are properly caveated, including by acknowledging that the actual performance is expected to differ, and may differ materially, from what is forecast and that projections are made in a manner that is in compliance with Regulation FD when appropriate. In the SEC’s recent release, Mr. Clayton reminded issuers that “companies providing forward-looking information in an effort to keep investors informed about material developments,



including known trends or uncertainties regarding coronavirus, can take steps to avail themselves of the safe harbor in Section 21E of the Exchange Act for forward-looking statements.”

Risk Factors. The risk factor section included in the offering materials for a securities offering should also specifically address any risk of a material nature to the issuer and its lines of business resulting from the outbreak. Many lines of business including travel and leisure, dining and other industries already customarily address these types of risk and can be further expanded to address the risks specifically associated with the outbreak. In addition, where disruptions of supply chain and suppressed demand create cash flow concerns, risk factors should properly reflect any heightened risk of covenant default of debt instruments.

The SEC (and the plaintiff’s bar) values specificity and context in risk factor disclosure. On numerous occasions, the SEC staff has cautioned the importance of not relying on boilerplate language and merely hypothetical risks, especially when in fact, such risks have been or are occurring.

Recent examples of specific risk factor disclosure include:

- *“To manufacture our [products], we rely on third parties to supply the required raw materials. We will likely need to secure alternative suppliers for these raw materials, and such alternative suppliers are limited and may not be readily available, or we may be unable to enter into agreements with them on reasonable terms and in a timely manner. For example, we source certain materials used in the manufacture of our products from China; the coronavirus outbreak or other similar global disruptions could make access to our existing supply chain difficult and could impact our business.” See Wave Life Sciences Ltd. Form 10-K for the year ended December 31, 2019, filed with the SEC on March 2, 2020*
- *“Currently, the majority of our stores (company-operated and franchise) in China are temporarily closed due to coronavirus concerns, including as a result of related government-imposed restrictions. Further, the stores that are open are operating for limited hours and are experiencing significantly lower than planned traffic and sales trends. Greater China is expected to account for approximately 7% of the Company’s 2019 revenue and the Asia Pacific region is expected to account for approximately 16% of the Company’s 2019 revenue. Additionally, approximately 20% of the Company’s global sourcing is derived from China, including approximately 10% of sourcing inbound to the U.S.” See PVH CORP. Form 8-K, filed with the SEC on February 12, 2020*

It is also worth noting that where the underwriters, structurers and arrangers of a securities offering work with multiple issuers in the same industry and across different industries, they should strive to consider the same standard of care and due diligence and the same level of disclosure for similarly situated issuers at each stage of the securities offering. The underwriters, structurers and arrangers should also be alert to market standards that develop over time in addressing the legal and financial risks associated with the outbreak in securities offerings.

PURCHASE AND SALE—CLOSING OF OFFERINGS

The purchase and sale of securities in a securities offering is typically made pursuant to a note purchase agreement or subscription agreement (with respect to exempt offerings) or an underwriting agreement (with respect to registered offerings). In our practice, parent, subsidiary and affiliate entities of the issuer may also be party to such agreements.

Material Adverse Change (Market MAC) Closing Conditions. Where the agreement is entered into at the pricing of the transaction or other date prior to closing, the agreement customarily includes a provision commonly referred to as the “market MAC” provision permitting the underwriter(s), initial purchaser(s) or placement agent(s) or, in the case of a 4(a)(2) or other similar offering agreement, the investor(s), to elect not close the transaction upon the occurrence of



certain events such as (i) a material disruption or suspension of trading in securities generally on the New York Stock Exchange or the NASDAQ or trading in any securities of the issuer or any of its affiliates on any exchange or in the over-the-counter market, (ii) a general moratorium on commercial banking activities that has been declared by federal or state authorities or (iii) a material adverse change in general economic, political or financial conditions, that, in the judgment of the underwriter(s), initial purchaser(s), placement agents(s) or investor(s) (as applicable), makes it impracticable or inadvisable to proceed with the offering or purchase of the securities on the terms and in the manner contemplated by the offering. The agreement may also include as additional grounds for termination any other circumstance that has a material adverse effect on the issuer or its business or the issuer's ability to perform its obligations under the securities or the underlying transaction documents in the judgment of the underwriter(s), initial purchaser(s), placement agent(s) or (when applicable) the investor(s). Such provisions are intentionally written broadly in order to permit such parties to exercise their judgment in determining whether to close the securities offering. For example, there is typically no further elaboration on what constitutes a material disruption or suspension of trading in securities or how long such disruption or suspension or a general moratorium on commercial banking activities would be required to continue. Similarly, the right of the underwriter(s), initial purchaser(s), placement agents(s) or investor(s) (as applicable) to terminate the offering due to a material adverse change of the type described in clause (iii) above is typically not defined in order to provide more latitude to such parties in electing not to close the securities offering. In light of the potential impact of the outbreak on the financial markets and on the legal and business performance of individual issuers it may be prudent to specifically consider outbreaks such as COVID-19 in negotiating such provisions, including addressing more specifically what would constitute a material disruption or suspension in trading in securities markets (particularly after trading in the New York Stock Exchange was suspended for a short period of time on March 9, 2020) and also what would constitute a material adverse change of the type described in clause (iii) above to minimize the risk of dispute between the parties as to the applicability of such provisions at this time.

Absence of Changes Representation. Typically, note purchase agreements and underwriting agreements will also provide representations that there have been no adverse changes since the most recent audited financial statements, including events such as fire, explosion, flood, labor disturbance or dispute or court or governmental action, order or decree, except as noted in the offering materials or properly disclosed to investors. The primary objective of an absence of changes representation is to encourage thoughtful disclosure of known adverse facts not captured by earlier-issued financial reports. The events of the past few weeks should give issuers pause to properly vet offering materials along the lines described above and negotiate such provisions to avoid inadvertent breach.

Force Majeure. Where the agreement pursuant to which the securities are purchased is entered into at closing, we expect that most transactions will still include a provision along the lines of the "market MAC" provision described above as a condition to closing or as a representation by the issuer and its affiliates that such condition does not exist at closing, to provide a remedy to investors in the securities if such condition is later determined to have existed at closing. We expect issuers to be more active in negotiating more specific language around outbreak at this time to help with certainty of transaction closing, but it remains to be seen how market practice will develop in addressing such comments from issuers.

STRUCTURING TRANSACTIONS

The structuring of the terms of a securities transaction should also reflect the potential financial impact on the issuer of the outbreak. Where the issuer is subject to financial covenants and other provisions that, if breached, may trigger an event of default or similar event, supply chain disruptions and suppressed demand could result in liquidity-shortfalls, missed EBITDA targets and non-compliant leverage and coverage ratios that could result in unforeseen default events. Efforts to carefully structure financial covenants in debt instruments should be the goal of both investors and issuers. The



issuer may also be subject to additional representations, warranties and covenants—in addition to enhanced notice and reporting requirements—in response to the outbreak, including heightened reporting obligations on the continuing impact of the outbreak on the issuer’s financial condition and performance and special attention to covenants to maintain adequate business interruption insurance coverage and other applicable insurance coverage. Where the issuer offers securities with a floating rate of interest, floors are generally being put in place across the market to ensure that negative rates of interest will not apply post-closing.

Issuers with outstanding securities should assess the risk that financial covenants and triggers may be breached in preparing for how to respond to any such breach. Prospective issuers may also need to assess whether covenants and triggers written more generally, such as those applying a material adverse effect in respect of the issuer or its business, may be breached.

CONCLUDING REMARKS

King & Spalding will continue to monitor the impact of COVID-19 on financial markets in the United States and abroad in advising clients on the most effective means to address this impact in underwriting, structuring and arranging public and private securities offerings.

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