Securities
Regulation Daily

March 13, 2020

Coronavirus (COVID-19) May Bring Litigation Fever

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Every day brings updated news about the devastating human cost of the coronavirus (COVID-19). At the same time, uncertainty is increasing about COVID-19's potential economic impact. On March 1, 2020, a report from McKinsey & Company presented three possible scenarios. The *best-case* scenario described a "quick [economic] recovery" in which community transmissions would be limited to East Asia, Europe, and the Middle East – and brought under control in March and April of 2020. The economic impact would be "mostly restricted to Q1 [2020]."[2]

Only five days later, as of March 5, 2020, the number of infected had exceeded 95,000 in 86 countries. This includes community transmissions and 129 confirmed cases in the U.S.[3] McKinsey's best-case scenario had become outdated in less than a week. As of the writing of this article, there were over 118,000 infected individuals in 113 countries, including more than 650 cases in the U.S.[4]

The inability of even the most informed observers of the global coronavirus crisis to predict COVID-19's spread and economic impact has brought uncertainty to businesses and financial markets worldwide. However, one thing is almost certain: Litigation will arise from the turmoil, and this litigation will continue for years to come. What began as a localized disruption in global supply chains – "patient zero" in a business context – could result in a viral spread of commercial business litigation.

Supply chain disruptions may result in lawsuits between suppliers and purchasers

Starting with the obvious, COVID-19 has already disrupted global supply chains, especially those with connections to China, as a result of the shutdown of manufacturing facilities and disruptions to shipping.[5] Companies in a wide variety of industries – such as manufacturers of electronics (e.g., Apple[6]), automobiles (e.g., General Motors[7]), and consumer products (e.g., Procter & Gamble[8]) – have disclosed shortages or delays in supply inputs.

One can easily imagine supply disputes arising between, on the one hand, suppliers making triage decisions as to which products and customers on which to focus their limited labor and material resources; and on the other hand, frustrated would-be purchasers who perceive

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themselves to have been short-changed in their suppliers' calculus and subsequently claim breaches of supply contracts. Aggrieved purchasers' calculations of unexpected shortages of supply inputs could quickly transform into calculations of lost revenues and profits in the courtroom. Given that supply chains often have multiple tiers, the number of lawsuits could multiply quickly even along a single supply chain.

Travel disruptions and home quarantine will likely affect the global economy

Supply chain disruptions were just the first symptom of stress on the global economy. As COVID-19 has spread beyond the original source of the illness in China, another aspect of the global economy has been crippled: the travel and leisure industry. Many large employers – such as Microsoft, Facebook, and Google – have canceled conferences, restricted travel, and/or encouraged their employees to work from home.[9] Many would-be travelers have canceled both business [10] and personal trips.[11]

Meanwhile, retail consumers have begun raiding grocery, warehouse, and hardware stores for not only facemasks but also all imaginable types of shelf-stable consumables, ranging from toilet paper to ramen.[12] It seems that many in the general public, perhaps in fear of viral contagion or in response to employer directives to work from home, are preparing for some form of Armageddon – or at least, home quarantine – in the coming weeks.

This general reduction in current and planned activity affects not only business activities and travel and leisure-related companies (e.g., airlines, hotels, conference centers), but the entire global economy.[13] For example, Starbucks had to close 2,000 cafes in China in January.[14] While many of those Starbucks have subsequently reopened, the coffee giant will likely also experience reduced sales in the U.S. when Americans who are anchored at home skip their $5 lattes on the way to work. While homebound consumers avoiding shopping malls and other crowded areas can buy some products online, they cannot drink virtual lattes.

Insurance coverage for business interruption losses may be disputed

As business losses mount from reduced economic activity, some companies may look to their insurers to cover at least a portion of their business interruption losses. At the same time, insurance companies themselves may face an excessive amount of financial stress. Coronavirus-related claims will hit insurance companies all at once, rather than the typical one-off disparate claims that insurance companies generally anticipate.

Although some insurance policies may explicitly exclude losses related to epidemics and pandemics,[15] it is hard to imagine that there will not be litigation arising from coverage disputes, especially given the likely volume and magnitude of insurance claims and the resulting financial stress on insurers.

A rise in bankruptcies has already begun

If business interruptions are severe or continue long enough, some companies will not be able to sustain themselves in the long term, resulting in bankruptcies. For example, COVID-19 was the final straw for U.K.-based airline Flybe, which had financial troubles prior to the coronavirus outbreak and declared bankruptcy on March 4, 2020.[16] Another example is New Jersey-based Valeritas Holdings, a diabetes drug technology company that sells insulin delivery devices manufactured in China. Due to the financial stress from coronavirus-driven disruptions in its supply chain, Valeritas Holdings filed for Chapter 11 bankruptcy protection on February 9, 2020.[17]

Bankruptcy filings can generate many types of lawsuits, such as those against directors, officers, and auditors for alleged failures to disclose/uncover companies' areas of risk or financial stress prior to their bankruptcy filings. Litigation can also erupt among a bankrupt company's stakeholders (e.g., secured creditors, unsecured creditors, equity holders) who may dispute and fight over the remaining values of the bankrupt company and its assets. In general, bankruptcy risks for companies will likely be exacerbated by the current unstable equity and debt markets. This may reduce the ability of companies to raise badly needed capital to shore up liquidity shortfalls.

Stock market volatility can lead to investor lawsuits

Indeed, reduced economic activity and the uncertainty of future corporate performance have made the stock markets extremely volatile.[18] The last week of February 2020 saw the U.S. equity markets plunge by more than 10%, the largest drop since 2008.[19] These gyrations in the stock markets are potentially fertile ground for another type of litigation: shareholder class action suits against companies and their management. Generally speaking, stock market declines bring investor losses, and investor losses can lead to lawsuits. Of course, the nature of the allegations will vary from company to company.

One possible avenue of investor claims might be allegations that a company failed to adequately disclose risks of geographical concentrations in their supply chains. For example, 10% of the global supply of flat-screen display parts for TVs and other electronics is concentrated at three companies in the Wuhan, China region.[20] As of February 28, 2020, only 606 out of over 4,000 public companies in the U.S. had mentioned the coronavirus as a "risk factor" in their SEC filings.[21] Companies caught off-guard by coronavirus-driven supply or demand woes might also be accused of providing unrealistic guidance regarding future financial performance when those companies fail to meet that guidance.

Reduced business activity may result in increased risk of corporate debt defaults

Equity investors are not the only ones who may feel the pain caused by the coronavirus-induced economic slowdown. U.S. corporate debt is nearly $10 trillion, or a record 47% of the overall economy, and $4 trillion of these bonds are only a single notch above "junk."[22] A substantial portion of this debt has been pooled and securitized in the form of collateralized loan obligations

(CLO) in a process similar to the pooling and securitization of mortgages underlying mortgage-backed securities (MBS).[23]

Although MBS were originally touted as relatively creditworthy instruments because of the theoretical diversification of loan default risk spread across many individual borrowers, the widespread crash in U.S. real estate prices in the late 2000s revealed how vulnerable these financial instruments were to a systemic devaluation. MBS investors incurred significant losses and then sued to recoup their investments from numerous banks and others involved in the manufacture and sale of MBS.

Looking further ahead, a widespread worsening of corporate performance (including reduced revenues and cash flows) could translate into reduced liquidity for many companies. This, in turn, could lead to a systemic wave of corporate debt defaults (if not bankruptcies). Although litigation resulting from the subprime mortgage crisis is finally coming to close, a wave of corporate defaults could start the litigation cycle anew. As in the last financial crisis, substantial economic losses suffered by banks, bondholders, and other investors in debt instruments and complex debt derivatives could bring many to the courtroom.

COVID-19 could result in a cascade of new litigation

McKinsey described their predicted *worst-case scenario* as "global pandemic and recession" in which "East Asia, Middle East, Europe, and western America transmission complexes all see continued case growth until mid Q2…"[24] With incidents of infection popping up in new geographies all over the world on a daily basis, this pessimistic scenario is beginning to seem more and more likely. The World Health Organization officially declared COVID-19 a pandemic on March 11, 2020.[25]

This article highlights only a select few areas of possible litigation. If COVID-19 does bring a worldwide recession, business and investor losses could lead to a cascade of litigation. That is something that cannot be quarantined.

Endnotes

1 The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm or its clients. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

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