NAVIGATING TURBULENCE
OPPORTUNITIES AMID A DELUGE OF DISRUPTION

Caitlin Weeks and Peter Watts of Hogan Lovells chart a course through the complex landscape facing businesses, where Brexit and COVID-19 are just the latest additions to the complexity.

For much of the last 20 years it seemed that the disruption facing businesses was confined to the transformational impact of relentless technological innovation. Now it can be seen that growing fractures over trade, climate change and shifting social values reduced an ever more connected world economy to a fragile state by the start of the 2020s. With the arrival of the 2019 novel coronavirus disease (COVID-19) pandemic, disruption is truly the "new normal".

For business this brings a proliferation of risks, but also real opportunities.

CHARTING A COURSE

The role of corporate lawyers is to help companies navigate their most complex challenges. In that role they experience, on a daily basis, the things that distinguish success from failure. For example, the corporate strategy that pays as much attention to regulators and what is really happening in the business as it does to spreadsheets; the restructuring that looks beyond numbers and organisation charts, and considers customers, suppliers and people; or the merger that plans for, and successfully delivers, integration.

Ultimately, what consistently makes the difference is the ability to connect a strategic response to opportunities or threats with the ever-increasing number of individual pieces of the jigsaw that make up the bigger picture.

That is more true than ever in the face of the current deluge of disruption. The businesses that will find opportunities are the ones that are smarter about a whole range of those jigsaw pieces, such as using technology; dealing with the government, sources of capital and other stakeholders; the way in which they organise and manage themselves; engaging with changing cultural and social priorities; and being nimble in doing deals, but always do so as part of a wider strategy.

This is just as true for the legal team as for other aspects of the business. This article explores some of what that means in practice and, in particular, how to:

- Manage some of the risks.
- Grasp some of the opportunities.
- Chart an overall course through disruption.

NEW TAKE ON OLD CHALLENGES

The fundamental business challenges of difficult times are familiar. These include how to juggle short-term financial pressures, long-term strategy and the interests of stakeholders such as owners, governments, talent, suppliers, customers and wider society.

However, some things have changed.

Confronting uncertainty

After the 2016 Brexit referendum and US presidential election, measures of business uncertainty surged. In the midst of the COVID-19 pandemic, with the end of the Brexit transition period approaching, another US election imminent and record falls in economic output, those measures have hit new highs. In Deloitte's survey of UK chief financial officer sentiment, 29% saw uncertainty as high or very high in the first quarter of 2016. By the end of 2016, that number was 50% and, in the second quarter of 2020, it stood at 80% (*www2.deloitte.com/uk/en/pages/finance/articles/deloitte-cfo-survey.html*).

Brexit uncertainty is not confined to the UK's relationship with the EU. It extends to the UK's relationship with the US and other trading partners and, importantly, to the UK's domestic policy priorities and regulatory approach once freed from the constraints of EU membership.

Faced with these unprecedented levels of uncertainty, it is more important than ever for business legal teams to ensure alignment between legal and commercial strategies.

Addressing the future not the past

Since the last global financial crisis in 2008, three linked trends are changing how businesses are organised, with significant implications when storm clouds roll in:

- The increasing sophistication of products and services drives greater complexity in supply and distribution chains, and in other relationships that businesses rely on to deliver those products and services.

- The increasing importance of digital technology to every aspect of the economy drives the increasing importance of data and other intangible digital assets.

- This increasing reliance of businesses on complex networks of relationships, and on data and digital assets, drives a blurring of the line between the assets that a business owns and its reliance on access to assets owned or operated, or services provided, by others.

These changes mean that businesses need to approach the risks and opportunities of today's turbulence in ways that are fundamentally different from the approach to the last crisis. On a practical level, this means that legal teams need to ensure that they are equipped to tackle that new world.

Cutting through complexity

An increasingly connected world in which businesses inhabit complex networks of relationships, and digitalisation breaks down barriers between industries, means that the challenges for businesses are also increasingly complex. A virtual business, whose assets are in the cloud and which outsources swathes of activity, faces the challenge of managing multiple interlocking contracts. As digital technology permeates every industry, regulators race to catch up, setting new challenges for both technology and non-technology businesses.

In addition, as the world changes, so do the perspectives of the governments, funders, customers, suppliers, talent and wider society that constitute the stakeholders critical to business success. This can be seen in the rise of private capital that is transforming the way that potential sources of equity are approaching issues. It can also be seen in everything from increasing scepticism in governments worldwide over certain forms of foreign direct investment, to the pressures for social and political change which find their expression, for example, through the #MeToo, Black Lives Matter and Climate Action movements.

In such a complex landscape, it is important to avoid the temptation to focus on a series of individual opportunities or risks. To cut through the complexity, legal teams (working with their advisers) should pursue an approach as interconnected as the issues they face.

Adjusting to an unprecedented shock

The scale and speed of the contraction in the UK economy resulting from the COVID-19 pandemic was vastly greater and quicker than that in 2008 or any historical recession.

This shock is different in another way. While recessions always have different effects on different businesses, typical downturns apply reasonably consistently across the economy. In this case, some sectors, such as hospitality and travel, shut down almost entirely for a period and are unlikely to have any opportunity to recover fully for many months; other sectors, such as life sciences and telecommunications, have thrived.

This different impact, together with the continuing uncertainty about the pandemic, make it more difficult than in previous recessions to predict the future course. This goes a long way to explain the record levels of uncertainty. It also means that legal teams need to look beyond immediate issues to ensure that they reinforce medium-term resilience.

Constructing a route map

The good news is that disruption creates as many opportunities as it does risks.

While many businesses have been hard hit or are focusing on adjusting to a new world, many others are thriving despite, or because, of the chaos. With much of the initial adjustment process complete, now is the time when many businesses can start to focus on opportunities as well as threats.

To start to map risks and opportunities, and the appropriate legal response, businesses should first ask some basic questions relating to trading, government and stakeholders:

- Whether demand from customers will hold up; how suppliers and business partners might be affected; and whether market prices are positively or negatively affected.

- Whether regulation will change in ways that help or hinder businesses; whether new trade policies will disrupt their supply chain or sales channels; whether government intervention could shape their market and opportunities; and whether government support might be available if needed.

- How events will affect their position with lenders; how they should engage with shareholders; and what the impact is on their staff and on customers' perceptions.

Beyond this, many businesses will look to restructure in response to current events. This may be by disposing of assets to raise capital or acquiring assets in a favourable market. In either case, it will be critical to success or failure for the legal team to ensure that, in such a disruptive context, the business goes about the process in the right way.

The board will have a central role. In times of turbulence, directors are rightly even more focused than usual on their legal responsibilities. For the legal team, providing

Assessing contracts when events intervene

Where one party is prevented or hindered from fulfilling its obligations under a contract because of circumstances outside of its control, businesses should check the following issues:

- Whether there is a contract.
- What obligations the parties have.
- Whether the contract is just a framework.
- What the governing law is.
- If a party cannot perform its obligations:
  - whether it will be in breach;
  - what financial claims will apply;
  - who can terminate; and
  - what limits and exclusions apply.
- Whether force majeure applies and, if so, whether it suspends or terminates the contract, or imposes any obligations.
- Whether there are other contractual triggers that change price or performance, or make a change of control relevant.

practical guidance on how to approach those responsibilities is therefore critical.

Throughout all of this it is important not to lose sight of the impact of change on all the different factors. For example, no analysis of trading risk is complete without an evaluation of the practical impacts of digitalisation on the business and its customers and suppliers.

CONTRACTS

Many legal teams' responses to both Brexit and the COVID-19 pandemic have focused on the specific rules that apply, whether under the contract or applicable law, where one party is prevented or hindered from fulfilling its obligations under the contract because of circumstances outside of their control (*see feature article "COVID-19 disputes: good faith to the rescue?", www.practicallaw.com/w-026-1736 and News brief "Covid-19 coronavirus: impact on contractual obligations", www.practicallaw.com/w-024-1611*).

Brexit and COVID-19 have encouraged many businesses to revisit the terms of "standard" force majeure clauses (*see feature articles "Force majeure in a changing world: predicting the unpredictable", www.practicallaw.com/w-019-2821* and *"Terminating for breach of contract: look before you leap", www.practicallaw.com/w-016-9676*). Businesses should bear in mind that force majeure is just another way to allocate commercial risk between the parties to a contract. In effect, it is a form of exclusion clause. In many situations a force majeure provision may be appropriate but that will not always be the case. A business should consider whether to include a force majeure clause in a contract and, if so, on what basis. It should not assume that it is merely boilerplate.

However, the way in which contracts deal with Brexit and the COVID-19 pandemic goes beyond force majeure. It is important to look at the situation in the round (*see box "Assessing contracts when events intervene"*). For example, the question of force majeure is likely to be largely academic unless: a contract exists; there are clear obligations that are not being performed; and the party is one of substance. The governing law may also fundamentally affect the position.

Similarly, even if a potential breach exists, a business should not lose sight of the fact that many factors beyond force majeure will determine the consequences of that breach.

Future-proofing contracts

There is no magic "Brexit clause" or "COVID-19 clause". Every individual contract reflects the nature of the parties' relationship. Inevitably, the impact of disruptive events will vary by reference to the nature of the contract and the ways that the events affect the contract.

Future-proofing therefore needs to be considered for individual contracts or categories of similar contract. However, there are some key points that a business should always consider particularly carefully if a disruptive environment means that the risk of intervening events is heightened, including:

- Whether the contract should be structured to be flexible in the face of unanticipated events, bearing in mind that flexibility will normally come at a price.
- How contract pricing will respond in various scenarios, for example, if duties or taxes are imposed, either directly or at another point in the supply or distribution chain.
- Whether contractual risk allocation, particularly under a force majeure provision, can be aligned with insurance cover.
- How contractual provisions will operate in a situation of financial distress and, in particular, whether it is possible to build in protections with respect to key assets, whether tangible or intangible.
- The fact that situations where potential force majeure events occur, such as an interruption of supply or the imposition of new checks at borders, do not necessarily prevent a party from performing its obligations but do require it to prioritise competing contracts.

Preparing those on the front line

Every business has countless contracts. Day-to-day, most will be dealt with outside of the legal department.

In many cases the outcome when a problem arises will be determined by the parties' immediate response or the way that the

relationship is managed day-to-day. By the time it reaches the legal department, the best chance of securing the best outcome will often have passed.

To navigate turbulent times, it is particularly important to prepare people in the business teams who deal directly with customers and suppliers (*see box "Practical anticipatory steps"*). The legal team should remember that, when educating the business, it will have more impact if it focuses on a small number of key points rather than trying to cover too much ground.

Some of the key practical points with which to equip non-legal colleagues when dealing with customers or suppliers that are affected by events include the following:

- Unless a relationship is already broken, there is a delicate balance between exercising legal rights and damaging a relationship. If something is impossible, getting angry will not fix it.
- It will often be better to talk to customers or suppliers as early as possible to identify workarounds or mitigate the impact of events but before doing so, it is important to write to the customer or supplier to confirm that informal talks do not affect the legal position and that the business is reserving its legal rights.
- If a customer is struggling with cash flow, even if extreme unexpected events have intervened, it will still probably have a legal obligation to pay.
- Where a supplier is unable to perform a contract, the business should think about making it explicitly clear that it is only prepared to forgive a breach if payments under the contract are appropriately adjusted. This is particularly important where payment is not directly linked to performance; for example, if there are regular periodic payments.
- If the business is supplying goods that have been delivered to a customer before payment is received, there may be provisions which mean that it still owns the goods and can recover them. These may be helpful, although they are typically difficult to enforce in practice.
- If it looks like a customer or supplier is in serious financial difficulty, the business needs to balance the need to put a claim on record at an early stage of the insolvency process against the risk that doing so might precipitate insolvency.

Practical anticipatory steps

A business that becomes concerned that a party with whom it has a contract may face financial challenges should consider:

- Seeking new payment terms but take care not to fall foul of the rules on preferences (*see box "Preferences"*).
- Seeking extended arrangements to retain title to assets pending payment, taking formal security over relevant monies or assets, and obtaining third-party guarantees or letters of credit.
- Undertaking an enhanced level of diligence on capacity to pay and examining rigorously the risks to which the counterparty is exposed.
- Scaling down the relationship with the other party, even if this means reducing sales in the short term, and minimising "take-or-pay" style commitments with suppliers.
- Avoiding granting exclusivity to a customer as this can inhibit the business's ability to reduce dependency if that customer gets into difficulty.
- The potential impact of falling market prices, price review or most favoured nation clauses.
- Identifying any liabilities that the business shares directly or indirectly with other parties where it might be the "deep pocket" if the other party gets into financial difficulty.

Where events are affecting the business and risk putting it in breach of its contracts, business teams should, wherever possible:

- Try to avoid expressly admitting the breach of a contractual obligation and, instead, try to talk about the practicalities of rescheduling or suggest changes.
- Try to avoid acknowledging that a customer or supplier has suffered particular loss or damage as a result of something that the business has done or failed to do. It is better to simply note what they say and try to agree to sit down with them to talk when the dust has settled.
- If a customer or supplier tells the business "not to worry about it in the circumstances" or uses other language suggesting that they accept that the business cannot do anything about the breach and will live with it, note the statement down and try to have it confirmed in writing.

Seeing the whole chain

There is a key difference between managing a discrete contract, and managing a supply or distribution chain. Unlike with discrete contractual relationships, looking across an entire chain requires an understanding of complex interdependencies. This has both legal and practical implications.

If a supplier falls into insolvency, it may leave the business unable to meet its commitments to its own customers. Many standard force majeure clauses will not provide adequate protection, leaving the business liable to its customers for failures to perform contracts with them, even though the cause of those breaches was the insolvency of a supplier.

On the other hand, where a new tariff is imposed directly on a supplier, the contract may require the supplier to carry that cost. By contrast, if the tariff falls further up the supply chain, it may flow through to the business's pricing as a cost-plus adjustment.

It is also important to consider any exposure to risk that comes from third parties with whom a direct supplier deals but on whom the business ultimately depends. If a business's financial covenant is strong, it may be drawn into giving comfort to those third parties so that they keep dealing with the supplier. This can be a dangerous strategy but may be necessary to fulfil the commercial imperative of keeping the whole supply chain going.

In this scenario, businesses should keep a constant eye on the situation and assess whether it may be better to cut out the middleman and deal directly with the ultimate third-party supplier.

DEALING WITH DIGITAL

Technology is no longer confined to its own sector. Every corner of the global economy is now increasingly defined by digital technologies and is dependent on digital assets.

This has fundamentally changed the financial and operational risks for businesses in difficult trading conditions and the practical steps that businesses can take to manage risk in a number of ways.

Data are increasingly seen as a critical asset for many businesses (*see feature articles "Data use: protecting a critical resource", www.practicallaw.com/w-012-5424 and "Data assets: protecting and driving value in a digital age", www.practicallaw.com/w-019-8276*). However, there is no clear concept in most legal systems of ownership of personal data. As a result, value is heavily dependent on the basis on which it can be used.

The value of insights and, therefore, of the data will frequently drop rapidly if the data are not kept up-to-date and regularly refreshed.

"Big data" is generally the product of combining data from a variety of sources meaning that if access to some of those sources is interrupted the overall value of all of the data, individually and when combined, may be significantly diminished (*see feature article "Big data: protecting rights and extracting value", www.practicallaw.com/1-595-7246*).

The overall impact of these factors is that the value of data as an asset is frequently far more ephemeral than might first appear. If contractual or practical sources by which data streams are accessed are jeopardised, for example, where a data provider or intermediary becomes insolvent, this can have a disproportionate impact on the value of the data asset.

As the value of the data depends fundamentally on the basis on which it is held, it is vital to understand the basis on which it has been gathered and transferred. These processes can become increasingly opaque in extended supply chains, particularly where players in those chains suffer financial distress.

Data storage

The way in which data are held presents a further challenge. The old saying "possession is nine-tenths of the law" is no less true for data as it is for other forms of valuable asset.

Just as a business needs to pay attention to the risks when its physical assets are held in a warehouse owned by a logistics provider, or by a supplier or business partner that becomes insolvent, the same issues are relevant to the holding of data. Two similar but distinct risks need to be managed (*see box "Data storage risks"*).

Firstly, there are the risks associated with the way in which the business stores its data. There are a variety of options ranging, at one extreme, from a business holding all of its data within its own physical environment within its own premises to, at the other extreme, using a range of potential offsite data centre options through the use of cloud service providers where it may be difficult for a business to physically identify its data.

It is important to consider the risk associated with storing data offsite or in the cloud. If the service provider runs into financial difficulty, the business may face both practical and legal challenges in recovering its data.

Secondly, there are the risks associated with the way that customers, suppliers or business partners store a business's data. Increasingly frequently, data that a business regards as critical to its value are being collected or processed by a service provider or a business partner. It is important to be mindful of the potential risks of that provider or partner running into financial difficulties.

If a provider stores a business's data in data centres or the cloud, the business is likely to find it even more difficult to recover business-critical data than in the situations outlined above.

In addition, many cloud contracts provide that the cloud service provider is entitled to delete

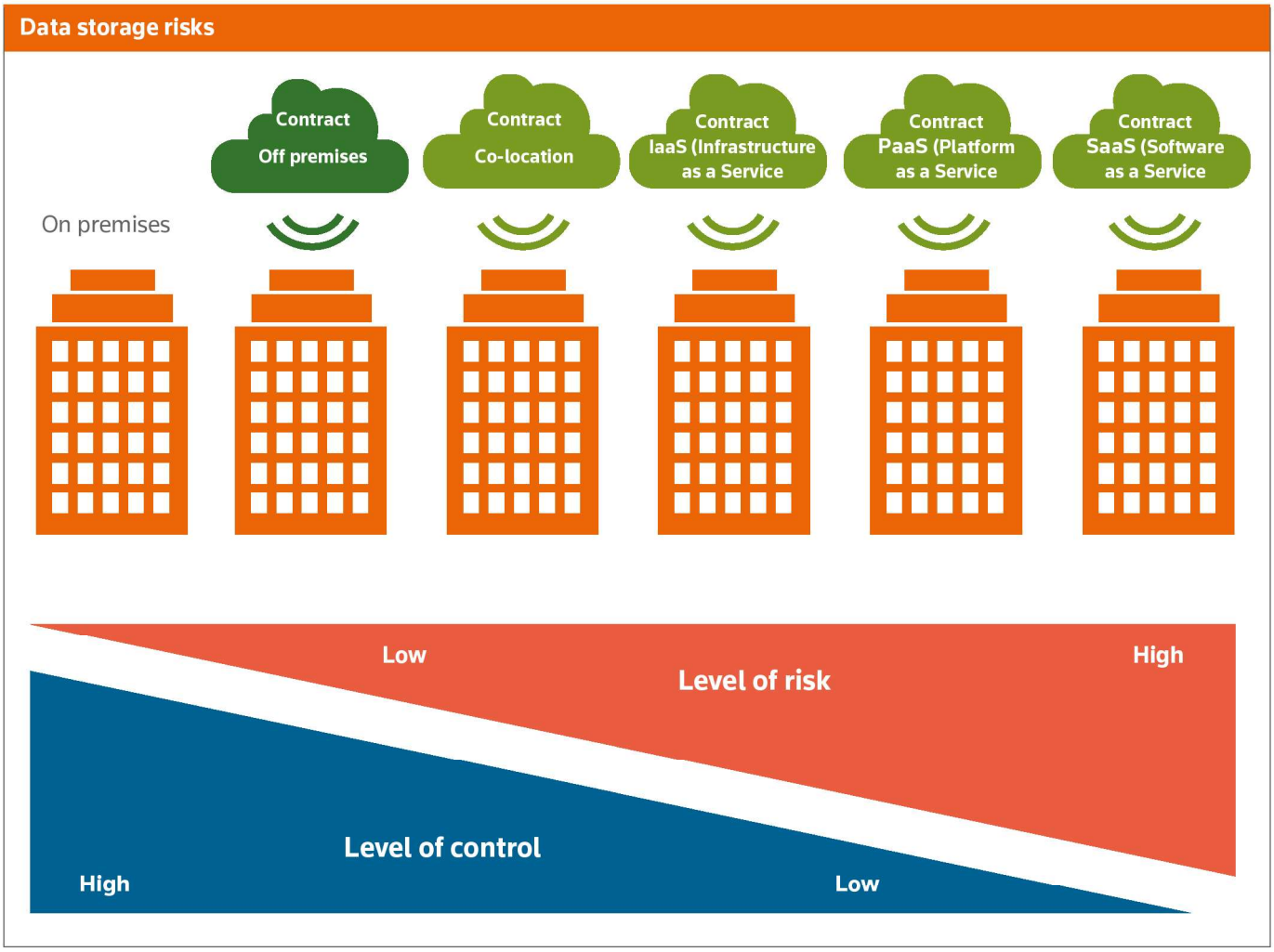
Preferences

Transactions may be set aside if they involve a company giving a preference to an existing creditor (*section 239, Insolvency Act 1986*). A company gives a preference if it does anything that has the effect of putting the recipient in a position that, in the case of an insolvent liquidation, will be better than the position it would have been in without that action and, in so acting, it was influenced by a desire to produce this result.

For a transaction to constitute a preference, it must be entered into within six months before the onset of the insolvency (or two years, if the parties are otherwise connected) and the selling company has to be unable to pay its debts at the time of the transaction or become unable to pay its debts as a consequence of the transaction.

Every case will be judged on its own circumstances, and the intentions and motivations of the seller will be relevant, as there has to be a clear desire to put someone in a better position. Paying off one creditor before others in an attempt to keep the company afloat, rather than because of a desire to prefer the creditor, will not normally amount to a preference.

From the creditor's perspective, there is little to lose by accepting a payment or a change in terms and conditions that may constitute a preference unless, in return for that payment or amendment, the creditor incurs costs or supplies services that it would not have been prepared to incur or provide without the certainty of payment.



the data if the customer becomes insolvent or does not pay. Therefore, if a business partner runs into financial difficulty, the business may not simply find it difficult to recover its data; those data may no longer exist.

Digital issues are not confined simply to the value of big data. This is also increasingly the age of artificial intelligence (AI) (*see feature article "Artificial intelligence: navigating the IP challenges", www.practicallaw.com/w-015-2044*). The foundation stones of AI are algorithms and the data sources that are used to train those algorithms; that is, to enable machine-learning systems to learn.

In the face of turmoil, neither of those foundation stones is consistently as stable as it might first appear since:

- Algorithms are rarely capable of patent protection in the UK.
- Training data are frequently sourced from third parties, with their availability dependent on contracts that will be at risk if the business partners from whom the business sources those data run into financial difficulty.

From digital to virtual

The digital revolution has not simply created new assets and associated risks, it has also reshaped many business models.

Digital business models, whether in the technology sector or beyond, can be flexible and often relatively "asset-light". This often involves replacing pure capital transactions that involve buying or owning assets outright with service-based relationships set out in contracts.

In many scenarios this can be a strength. However, it creates a complex value chain that can generate real risks if any of the links in that chain become financially weakened and brings all of the issues regarding contracts into play in new ways (*see "Contracts" above*).

INSURANCE

A highly disruptive environment means that it is important to carry out more frequent risk audits and reviews of existing insurance cover to make sure that the cover is sufficient and appropriate, both in scope and limit, and reflects increased and changing risks that have emerged or may emerge. Key questions to consider are whether:

- The existing insurance provides the necessary scope of cover, particularly in evolving areas like business interruption, the resulting loss of access to data or the consequences of cybersecurity incidents.
- The level of cover is appropriate in the face of potentially shifting risk profiles.
- The risks that the business faces are non-standard and complicated, requiring bespoke policy wording to ensure the appropriate cover.
- The policy effectively transfers risk from the business to the insurer, in particular whether standard exclusion clauses contained in the insurance, which may exclude, for example, direct or indirect consequences of a pandemic-related risks, are still fit for purpose.

Many of the risks against which insurance should provide protection have a legal angle to them and many of the challenges in ensuring that insurance protection is adequate are fundamentally legal. Therefore, even where the legal team does not have primary responsibility for the insurance function, it can make an important contribution to overall risk management.

LENDERS

The relationship with lenders is key to navigating turbulence. There should be an emphasis on the value of active management of those relationships with a particular focus on:

- Practical and operational challenges arising in the context of that turbulence, such as pressures on cash flow or changes to the business or operational structure.
- Key requirements in finance arrangements, including the testing and repeating of covenants and representations specifically including information and reporting requirements.

With the legal responsibilities of directors in mind, it is important to ensure planning for the short, medium and long term and that those plans are consistently updated and aligned (*see "Governance" below*). For example, if the business will struggle to meet repayments in the near future under an existing facility agreement, the short-term financing options available to it may be a useful stop gap but could end up putting more pressure on its finances in the long term.

Prudent governance in a disruptive environment also means that the business should consider scenarios where it will need to access working capital quickly. This is likely to include:

- Identifying any pre-emptive steps that it could take now to help to avoid potential issues crystallising, for example, making voluntary pre-payments, exercising cure rights or posting more collateral.
- Taking particular care where financing arrangements contain forward-looking covenants, which are difficult to assess in the current environment.

In the era of COVID-19, lenders have come under political pressure not to call a default too early, but there are real risks in leaving lender management to the broader political environment. Being open and co-operative will give a business additional flexibility. This could help to avoid a cliff-edge and put the business in the position to take advantage of opportunities that others are less well equipped to seize.

Directors' duties

Directors' statutory duties are set out in sections 171 to 177 of the Companies Act 2006 (2006 Act).

Section 172 of the 2006 Act requires directors to promote the success of the company for the benefit of the members as a whole (*see feature article "Directors' liabilities in a downturn: navigating the road ahead", www.practicallaw.com/4-386-6803*). The 2006 Act lists matters that directors are to have regard to in so doing, including:

- The likely long-term consequences of decisions. Directors should be aware that they are not just working on short-term, expedient considerations.
- The need to foster business relationships with suppliers and customers, and to maintain high standards of business conduct. Trying to put pressure on counterparties or force them by commercial means to accept less advantageous terms may run counter to this.

SHAREHOLDERS

It is crucial for a business to understand and regularly engage with its shareholders, bearing in mind that not all of them will be concerned about the same things or will approach risk in the same way. This is true whatever an organisation's corporate structure.

Keeping up-to-date on what shareholders are sensitive to is key to understanding what a business should be disclosing to the market. The business's broker or investment bank may be able to help with this.

Markets

For listed companies, keeping up to date on what shareholders are sensitive to is important in understanding what a business should be disclosing to the market. A broker or investment bank will frequently be key to this, but the legal team should not underplay its role.

Having robust and appropriate corporate governance systems and controls in place will be critical (*see feature article "Corporate governance reforms: widening responsibilities", www.practicallaw.com/w-016-1385*). Often, these are put in place during stable periods, so it is essential that these structures are fit for purpose during volatile times.

Listed businesses must also carefully consider their disclosure obligations as these continue to apply even when the market is generally aware of tough trading conditions, for example, the downward pressure on share prices in general as a result of COVID-19.

A particular feature of disrupted times is that it may be difficult to deliver financial reports of the requisite quality where these contain a forward-looking assessment. Viability disclosures were introduced following the 2008 financial crisis to provide investors with a better view on the longer-term prospects and viability of a company's future (*www.practicallaw.com/3-584-9227*). The COVID-19 crisis is a test of the value of those viability statements. A viability statement with realistic scenarios and clear assumptions provides boards with an opportunity to communicate their longer-term prospects, even when the short-term outcome is less certain.

The legal team can help in thinking laterally about disruptive influences and their potential implications for the business. The customer and investor reaction to recent allegations of modern slavery in Leicester was a good example of how one source of turbulence (in this case, COVID-19) led to scrutiny in an otherwise unrelated area of corporate governance.

REGULATORY AND POLICY ISSUES

In a disrupted world, government regulation, intervention and support are particularly

critical elements of the business environment. As the impact of technology-driven disruption continues, disruptive businesses are becoming established players and historical sectoral boundaries continue to evolve. This is shifting the focus of regulation and political attention. Regulators that have difficulty in keeping up with change often struggle to find the appropriate response and this can be a risk but also a significant opportunity for a business that can get ahead of the game.

Brexit creates a completely new domestic environment for policy and regulation, the shape of which is far from clear. In addition, the exceptional current conditions created by both COVID-19 and Brexit magnify the opportunities for policy to drive structural reform. A government with a large majority and a mandate for change will be, and will need to be seen to be, active in supporting business and driving change.

An upsurge in social and political activism associated with social media use puts new pressures on business and on the government to intervene in issues that affect businesses, as well as amplifying the response to issues as they arise.

These factors will have direct consequences for any business. They also shape the attitudes of stakeholders, with important indirect implications for everything from customer engagement to the availability of capital. If a business responds by building new long-term strategic relationships or making new acquisitions or investments, the policy and regulatory environment will be a critical determinant of success or failure. Indeed, it is now difficult to remember doing a deal where this was not the case.

As a result, these factors are of such importance that they need to be at the heart of any business's strategic planning and its evaluation of, and response to, disruptive risks and opportunities. Successful risk and opportunity management go beyond passively responding to events. Proactive, sustained and constructive engagement with policy stakeholders can help a business to build trusted relationships, understand the direction of travel and shape it.

These issues permeate everything a business does. For a legal team this means providing input into the strategic thinking but it also means ensuring that legal input in areas such as mergers and acquisitions (M&A), contracts and the business structure are informed by the policy context.

In industries with established patterns of high regulation and political sensitivity, these trends mean that it is more important than ever that legal and policy teams work successfully together and are effectively aligned with business strategy and implementation. The implications are, if anything, more significant in traditionally less highly regulated industries where businesses often do not have experience in the policy environment and where a legal team should be evaluating the level of engagement that is going to be needed going forward.

GOVERNANCE

Robust corporate governance is more important than ever in a world of disruption.

Board and risk management

Monitoring risks and opportunities is a core function of the board. Experience suggests that many boards have a good record in assessing the risks associated with issues of which they already have some personal experience. However, boards are not necessarily as good at planning ahead effectively for risks which lie outside their experience. This can leave some boards with blind spots. Few directors will have had experience of the impact of a pandemic, leaving a disproportionate number of companies ill-prepared for the possibility.

While the history of the past 15 years might prompt boards to increase their focus on potential systemic risks, the risks of blind spots and optimism bias persist. It is important to constructively help directors explore whether their evaluation of risks takes sufficient account of those that they have not encountered before.

Being appropriately equipped

Every business should be actively considering whether it has the right mix of skills and experience for the current disruptive environment.

This starts with the board (the UK Corporate Governance Code, for example, recommends that companies think carefully about the optimal board composition). However, it also extends to professional advisers. The best advisers in fair weather are not always the best advisers when times are hard, and the nature and diversity of current disruption means that the need for new or different skills is likely to arise more frequently.

Transactions at an undervalue

A transaction at an undervalue should be fairly easy to spot. It is where a company sells an asset either for no consideration or for significantly less than the asset itself is worth. Transactions at an undervalue can be set aside under section 238 of the Insolvency Act 1986 if the transaction took place at any time in the two years before the onset of insolvency. Therefore, the risk arises if, at the time the seller entered the transaction, the seller was insolvent or it became insolvent as a consequence of the transaction.

However, there is some assistance for an unwary buyer:

- The tests for constituting a transaction at an undervalue must be satisfied on the balance of probabilities: it may be possible to prove that there was no undervalue, that the company was not insolvent or, even if it was, that the transaction at an undervalue did not cause the insolvency.
- The buyer may have a defence where the seller entered into the transaction in good faith for the purpose of carrying on the seller's business and at the time there were reasonable grounds for believing that the transaction would benefit the seller. If, for example, a seller sells stock or assets, or provides services, at a reduced price to help its cash flow and genuinely believes this to be necessary for its continued survival, the buyer may be safe.

It may also be commercially realistic or pragmatic for a business to accept that a good bargain does not come without risk or strings attached and to accept the bargain in the knowledge that there is a risk that it could be set aside at some stage in the future.

Be prepared

In a fluid and confused environment in which financial, operational and regulatory uncertainty is high, businesses can successfully navigate the risks by taking the following steps:

- Look ahead for signs of trouble; for example, a customer who starts to pay late or whose corporate housekeeping deteriorates.
- Be practical as the best legal protections will be wasted if they are not operated effectively.
- Think about reputation and build trust, and ensure that the business's legal, public relations and government affairs strategies are aligned.
- Be proactive since a fluid environment provides the opportunity to set the agenda.
- Ensure that risks, including legal, commercial, political and reputational risks, are tested properly and bear in mind that if something looks too good to be true, it probably is.
- Check the business's insurance cover as it can be a surprisingly useful risk management tool but may not hold all the answers.
- Be able to move fast since circumstances can change fast, so businesses need to ensure that they are in a position to respond quickly to whatever happens.

Sometimes, businesses do not realise that they need something different until they are in the middle of a particularly difficult event. There is a role for the legal team in proactively ensuring that this is high on the agenda.

The board and financial stress

A period of short-term financial stress can trigger several different potential liabilities. In the authors' experience, it is often difficult, at the time, for directors to distinguish between a rough patch and forthcoming insolvency. This often complicates the legal support that the board requires.

As a starting point, it is always essential to ensure that:

- Directors understand their duties. In practice, this means that, if conditions look tough, the board should be proactively briefed on its responsibilities.
- Decisions are made properly and full consideration is given to all issues. In practice, this means the legal team being more actively involved to ensure that the appropriate level of discipline is being applied to the provision of information and discussion of matters at the board.
- There is a clear paper trail evidencing the directors' consideration of the issues. In practice, this means preparing and checking minutes of meetings with greater rigour than is sometimes the case in ordinary trading conditions.

Directors' duties

When trying to negotiate sharper deals or use commercial pressure to change the terms of an existing deal, directors should consider carefully their overall success duty under section 172 of the Companies Act 2006 (section 172) (*see box "Directors' duties"*).

That duty is subject to any enactment or rule of law that requires directors to consider or act in the interest of creditors. In ordinary trading conditions where the board expects to be able to pay all creditors in the ordinary course, the duty to creditors can largely be ignored in practice. However, if the risks of insolvency grow, directors need to increase their focus on the duty act in the best interests of the company's creditors.

Avoiding wrongful trading

More specifically, if the financial situation starts to deteriorate, directors need to consider potential wrongful trading.

A director or former director of a company that goes into insolvent liquidation may be ordered to contribute personally to the company's assets if, at some time before the commencement of the winding-up, they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation and they failed to take every step to minimise the potential loss to the company's creditors (*section 214, Insolvency Act 1986*).

For this purpose, a director will be judged both by reference to their actual knowledge, skill and experience and by the general knowledge, skill and experience that may reasonably be expected of a person carrying out their functions. For example, in relation to financial matters, a finance director will be judged by a higher standard than the HR director.

The risk will apply to directors who are formally appointed but also anyone else whose directions the company often follows, including de facto directors and shadow directors.

A director can avoid liability for wrongful trading by showing that they took steps to minimise the potential loss to creditors. This illustrates the importance of the paper trail. Directors must not simply make the decisions on the right grounds but must also demonstrate that is what they have done.

Joint venture governance

Particular issues arise for directors of joint venture (JV) companies, who are typically appointed by different shareholders whose funding is often critical to continued trading.

For example, a director who is aware that their appointing shareholder does not want to provide further funding and that this might jeopardise the viability of the JV will have to consider the implications of potential wrongful trading.

To provide practical mitigation against the problems this may cause, shareholders in a JV should consider insulating directors from shareholders' decisions. This can mean, for example, ensuring that a director can take a decision based solely on their duties to the JV unaware that their appointing shareholder is in the process of withdrawing financial support.

It can also be helpful if key decisions relating to the business of the JV are taken by shareholders rather than by the board. The advantages of this are that a shareholder does not have a section 172 duty to promote the success of the company or any duty to other shareholders. Unlike a director whom they have appointed, a shareholder is generally entitled to take decisions, exercise negative vetoes or refuse to give consent in a way that fits in with their own commercial imperatives, without regard to the interests of creditors. Given that JV agreements typically provide for key decisions to be escalated to shareholders, it is generally not too difficult to accommodate this approach.

DEAL OPPORTUNITIES

In a fluid business environment characterised by activist governments and regulators, in many countries the focus has been on reshaping their economies, and the ongoing march of technology means that deal opportunities are not confined to distressed assets. However, while in many cases, these have the look and feel of M&A, increasingly other deals combine features of classic M&A with different and distinctive characteristics.

Making the most of these opportunities increasingly requires a combination of old-fashioned deal-making skills, an acute sensitivity to the underlying business drivers and a proactive approach to the political and regulatory environment.

Doing M&A

Even in the most stable of times with the clearest of commercial strategies, negotiating an acquisition or a disposal can be complex and time-consuming.

In the current landscape, the risks inherent in M&A are magnified, adding pressure when there is a compelling need to get a deal done quickly because a target business is in, or is approaching, financial distress (*see box "Transactions at an undervalue"*). Focusing on getting the basics right will be key but, for businesses able to navigate the uncertainties of the current climate and move quickly, this presents opportunity.

Deciding what to buy

If a business is considering acquiring a target business that is, or will shortly be, in financial difficulty, time will be of the essence so it is crucial for it to determine swiftly what it actually wants to buy (*see Briefing "COVID-19 and M&A: key issues between signing and completion", www.practicallaw.com/w-025-6449*).

If it is clear about the assets or parts of a business that it does and does not want, a cherry-picking exercise should enable a more targeted and quicker due diligence exercise. On the other hand, if a reorganisation is required to create a "clean" entity (that is, one that does not carry historic liabilities), this is likely to take time and will need to be properly documented. This balance needs to be considered carefully when designing the structure of a transaction.

Allocating risk

In any deal, allocating risk between the buyer and the seller is a key point of contention. This is even more important when the buyer is considering acquiring a distressed target as:

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- A priority for the seller will be to ensure that the deal will complete, so it will be even more difficult than usual for the buyer to include in the purchase agreement termination rights that are triggered by, for example, a material adverse change.

- A package of warranties or indemnities, or both, is only as good as the person standing behind those warranties. Warranty and indemnity insurance products can prove useful where a seller is unwilling or unable to provide the level of warranty protection required by a buyer, particularly with the growth in popularity of so-called "synthetic" warranty or tax covenant packages (*see feature article "Covering the risks: warranty and indemnity insurance", www.practicallaw.com/5-382-3120*). However, this protection will come at a cost and will inevitably exclude a number of liabilities from the coverage offered.

- Sellers of distressed assets will be particularly keen to maximise immediate cash proceeds. However, a well-placed buyer may be able to use its leverage to obtain a more balanced consideration package, for example, part-deferred or part-paid in equity to limit some of the risk.

Moving quickly

For a business that is able to move quickly, a challenging market creates opportunities to make acquisitions at favourable valuations. Executing a transaction within a seller's aggressive timetable driven by financial distress requires careful stakeholder management. This starts with having a clear M&A strategy and monitoring potential targets closely.

It is valuable to extend a strategy agreed with relevant stakeholders, including the board and key shareholders, to cover the practical steps to be taken if it becomes clear that a potential strategic target is up for sale and have delegated authorities and other approvals lined up in advance. This will not simply enable the business to move fast, it will also give confidence to a seller that the business has the support, motivation and ability to get the deal done quickly. Private capital, including private equity, frequently finds this level of agility more straightforward than companies. In practice therefore, it is particularly important for potential strategic investors that want to compete for the most strategic assets to develop an approach that enables them to move quickly.

The point at which most M&A fail is integration after the merger. That risk can be heightened where the acquisition is undertaken opportunistically and at speed. This means it is even more important than in a non-distressed deal for a buyer to plan for integration from the earliest possible stage of the process and, for example, to plan its approach to due diligence with integration in mind.

SECRETS TO SUCCESS

Experience indicates that there are some secrets to success in a fluid and confused environment in which financial, operational and regulatory uncertainty is high (*see box "Be prepared"*). Among other things, businesses should:

- Ensure that they are in a position to respond to issues quickly and, where possible, be proactive.

- Bear in mind that engaging with non-legal business colleagues is key as they, not legal technicalities, will often be the difference between success and failure.

- Remember that the human dimension is central; people are critical to the way in which any business navigates turbulence.

Each of these factors is individually important but it is essential to take a rounded perspective. In 2020, no business can navigate turbulence in a series of silos; it needs to see the bigger picture and find a holistic approach that encompasses the opportunities as well as the threats. Above all, businesses should think and act ahead, not wait for things to go wrong.

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