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Business Law Update

Summer 2020

Business Perspectives

Frank D. Chaiken, Practice Group Leader, Corporate Transactions & Securities

In our last issue I wrote about trying to maintain "business as usual" in the face of a global pandemic and unprecedented government efforts to control it, primarily by shutting down most commercial activities. Now we are facing another crisis, one unfortunately all too familiar. While many are eager to get back to work, the recent nationwide spotlight on systemic racism, discrimination and bias against people of color makes clear that, as it relates to equity, inclusion and social justice, we cannot return to business as usual.

What is the proper response for companies, and for us as your lawyers, to the injustice emanating from hatred, racism and bigotry that affects many people with whom we live and work every day? As lawyers generally, we have a special responsibility to society to promote justice and the rule of law. As business lawyers, we are oriented toward solving problems and helping to alleviate the inevitable frictions that arise in human interactions. A fair and level playing field for everyone in our society is a baseline condition for progress and prosperity. We must devote our problem-solving skills and passion for justice to the achievement of that ideal.

Social justice calls for more action than words. As noted by our Managing Partner Debbie Read in a statement on our website, as a firm we are committed and stand together with those suffering from the evils of racism. It affects us all, and in particular our diverse partners, associates and staff. We recognize that we cannot be silent; we cannot be bystanders. We have taken and are taking concrete actions to combat injustice. We are focused on increasing the diversity of our personnel, ensuring equitable access to leadership opportunities in our organization for underrepresented minority professionals, and

Recent News & Related Articles

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For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or David R. Valz, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

supporting organizations that promote social justice in our local communities and beyond. These are not new commitments, but we are rededicating ourselves to them. We need to and shall do more.

We work hard to keep our *Business Law Update* focused on legal issues and information of interest to our clients. But I do not need to apologize for taking some of your time to reflect on social justice before you delve into the range of topics covered in this quarter's edition. Businesses can truly thrive only in an environment where stability and the rule of law prevail. Firms will succeed in the long run only if they are adapted and oriented to the needs of the diverse communities they serve, reflecting that diversity in our organizations. Apart from such practical considerations, our common humanity demands it. It is important to keep these fundamental values in mind as we go about our daily affairs.

Please enjoy our current edition of the *Business Law Update*. As always, we invite and appreciate all your comments, suggestions and ideas for how we can improve it, and make it more relevant and useful.

Frank Chaiken leads the firm's highly regarded Corporate Transactions & Securities practice, which comprises more than 100 professionals who represent clients of all sizes across virtually every industry. If you have questions or would like to share your thoughts, please contact Frank at 312.998.4249 or Frank.Chaiken@ThompsonHine.com.

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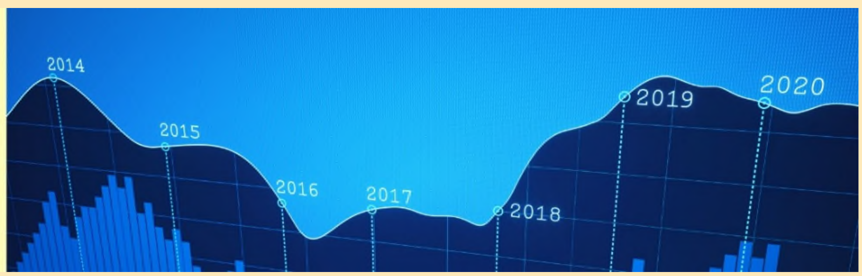


Securities Quarterly – Summer 2020

Please visit our website for the latest edition of *Securities Quarterly*, our publication that provides updates and guidance on securities regulatory and compliance issues. In this edition, we look at ongoing disclosure developments related to COVID-19 in the first half of 2020 that public companies should consider as they prepare their Form 10-Q filings for the second quarter of 2020, as well as other general updates in securities laws and regulations.

M&A

Into the Unknown: Purchase Agreement Considerations in the Time of COVID-19

By Jim Brown and William M. Henry

The effect that the COVID-19 pandemic has had on M&A transactions already in progress merits significant attention—and indeed, many articles have been written about the subject—including the interpretation and invocation of material adverse effect clauses and, less commonly, force majeure provisions, on deal closing certainty. However, as society at large emerges from the pandemic in the coming months and years, and new M&A transactions take shape, we will need to turn our focus to considering other essential aspects of the purchase agreement negotiations affected by the impacts of COVID-19.

Representations and Warranties and Disclosure Schedules

A seller would be well advised to pay particular attention to any direct or indirect effects that the COVID-19 crisis has had on its business and the resulting effect on its ability to make the standard representations and warranties in the purchase agreement, including warranties relating to the absence of material changes and those related to employees (in the latter case, to the extent head count, compensation and/or benefits have been affected). Accordingly, a seller should proactively seek to schedule pandemic-related impacts where possible to avoid indemnification claims from the buyer. A buyer, conversely, should require specificity with respect to COVID-19-related disclosures so that the seller cannot use such disclosures as blanket exceptions to literally any event or circumstance that would have otherwise ordinarily resulted in a breach, absent a tangential or strained connection to COVID-19. In that regard, the disclosure schedules then have the potential to become a battleground. For example, when scheduling against a customer and supplier representation, a seller may seek to include a broad exception that customer and supplier relations have been adversely affected by COVID-19 (in part because a seller would contend it has not yet been able to ascertain the specific impacts), whereas a buyer should seek detail as to which specific customer and supplier relationships were harmed, and to what extent. Additionally, in both the representations and warranties and the disclosure schedules, a buyer should be wary of ordinary course exceptions or references, as a seller may argue, particularly as we move further into 2020, that the ordinary course includes operations as impacted by the pandemic. For instance, would it be ordinary course for a seller to shut down factories for two months? Certainly not. But during a pandemic? Entirely possible.

Earn-Outs and Working Capital Adjustments

Earn-outs and working capital adjustments, because they are by their nature forward-looking, demand at least modest predictability in terms of business operations in the ordinary course (again, what is ordinary course?) to minimize conflict between a buyer and seller at the time of their determination and settlement. In the present world, however, a seller that agrees to an earn-out construct in the near term may be in an increasingly volatile position given the considerable economic uncertainty that may occur in the coming months (and potentially longer) during the earn-out measuring period. As such, a wise and wary seller should consider negotiating a lengthier earn-out measuring period during which the parties can assess the required thresholds, a tolling of certain earn-out requirements if the particular earn-out metric fails to reach a floor in certain time periods, or even an exclusion for EBITDA downturns attributable to the fallout from COVID-19 (the “hurricane” effect—short-term deleterious effects on output). (The latter argument may not hold water, but it’s worth asking for!)

Likewise, the COVID-19 pandemic's effect on working capital calculations can (and should!) challenge the standard assumptions on which a working capital target is determined. A savvy buyer simply must attempt to inoculate itself against wild fluctuations in current assets or current liabilities due to the pandemic, especially in a scenario where its sole recourse for a working capital shortfall is access to a working capital escrow.

Interim and Post-Closing Considerations

A transaction structured as a separate ("two-step") sign and close poses further complications for a buyer and seller to consider, primarily relating to each party's responsibility for occurrences between signing and closing and to the seller's need for closing certainty. First and foremost (and an article unto itself), the material adverse effect clause, an already hotly contested provision of the purchase agreement, will now have added to its complexity the core question of whether a buyer can include effects attributable to COVID-19 (or, really, from any pandemic) in the clause. How that question is answered may give a buyer considerable latitude to walk away, and leave the seller with only the prospect of arguing in court whether such material adverse effect truly was a result of the effects of COVID-19. As such, a seller should only accept such a carve-out if it includes a disproportionality exception.

There are also practical and logistical items to consider, such as whether a seller will even be able to abide by a reasonable access covenant (i.e., providing access to its facilities for the buyer as part of the continuing diligence process). As offices or facilities may be closed or employees may be working remotely, the parties will need to be more specific as to the access requirements contemplated at the time of signing or perhaps provide that a lack of any such access would not delay closing. As a related point, the parties should consider whether the effects of COVID-19 could make it impossible for certain third party consents, governmental notices or payoff letters to be delivered or provided without undue delay (if at all) in connection with the closing, and build in protections such as potentially starting the third party consent process early or extending the outside date.

Lastly, the parties should build in additional time for post-closing transition services covenants or agreements to create a buffer for particularly turbulent weeks or months. This additional time may be needed as a result of potential operational or logistical hurdles, such as limited access to facilities or decreased head count. A seller may also need to charge a higher fee to account for such adverse circumstances.

The COVID-19 crisis has had a substantive and far-reaching effect on businesses all over the world, and in many instances created (and continues to create) an uncertain marketplace. Despite this, buyers and sellers, as always, will still be looking to find mutually beneficial transactions in the months ahead, and will look to their counsel to protect their respective interests and anticipate risks. The purchase agreement for an M&A transaction is a complex and multifaceted document constructed to address myriad possible outcomes and uncertainties, some of which have an element of predictability, and some of which do not. By focusing on how to allocate risk and account for those unknowns, we can provide value and negotiate dynamic agreements well-positioned to anticipate what may lie ahead.

Please contact Jim Brown or Will Henry with any questions.

Corporate Governance

Managers and Controllers Owe Fiduciary Duties to LLC Members and Limited Partners – What Does That Mean for Fund General Partners Moving Forward?

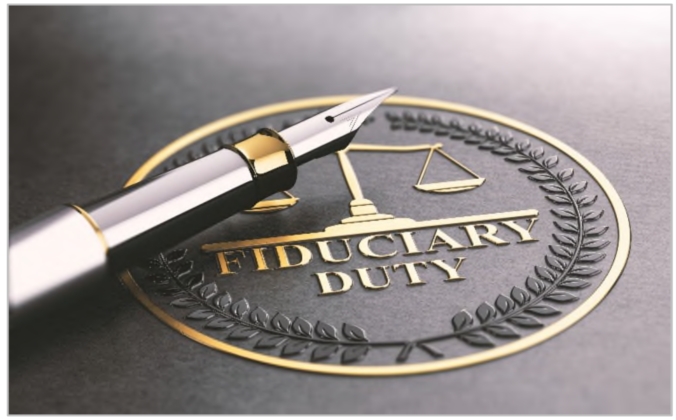
By Megan McClung and Lindsay Karas Stencel

Under Delaware law, controlling affiliates that exert control, even indirectly, over an entity's assets owe limited fiduciary duties to that entity and its stakeholders. This holds true even when the controlling affiliates are not parties to the controlled entity's governing instruments.

Controllers, in the limited liability company (LLC) and partnership context, are the individuals and entities with authority to cause the LLC or partnership to act. Delaware law imposes a limited fiduciary duty on remote (or indirect) controllers to not use control over an entity's assets to benefit the controller at the expense of the entity.

Unlike corporations, whose directors must be "natural persons," LLCs and partnerships may appoint individuals and/or entities to serve as managers or general partners (GPs). As organizational hierarchies develop, identifying which individuals and entities owe fiduciary duties to a controlled entity becomes more difficult. When determining whether the manager of an LLC's manager owes fiduciary duties to the LLC and its members, the answer depends on whether the upstream controlling affiliate (i.e., the manager's manager) has exerted control over the assets of the underlying LLC. For example, if upstream individuals or entities have exerted control, even if indirectly or through other controlling affiliates, then those individuals or entities owe a limited fiduciary duty to the underlying LLC and its members.

Delaware's flagship case, *In re USACafes, L.P. Litig*., establishes a framework for determining when upstream controllers owe fiduciary duties to a controlled entity. 600 A.2d 43 (Del. Ch. 1991). In *USACafes*, limited partners brought breach of fiduciary duty claims against the general partner and its controlling stockholders (who also served as the general partner's directors) because the general partner had approved a sale of substantially all the assets of the limited partnership. The Chancery Court denied the motion to dismiss brought by the controlling stockholders, holding that directors of a general partner owe fiduciary duties to the limited partnership and its members. In subsequent



cases, Delaware courts have applied *USACafes*-type liability to remote controllers of LLCs, finding that indirect controllers will owe limited fiduciary duties if they exert control over the assets of a controlled entity.

In a recent case before the Delaware Chancery Court, breach of fiduciary duty claims were brought by 77 Charters, Inc. (77 Charters) against Jonathan D. Gould (Gould), the individual at the top of an organizational hierarchy, involving three groups of investors that acquired a shopping center (Mall) through a holding company (Holding Company). *77 Charters, Inc. v. Jonathan D. Gould, et al. and Stonemar Cookeville Partners, LLC, et al.*, C.A. No. 2019-0127-JRS, memo. op. (Del. Ch. May 18, 2020). The Holding Company was formed by a special purpose vehicle (SPV) as managing member and one preferred investor (Preferred Investor). 77 Charters, a non-managing member of the SPV, was a passive investor in the Holding Company, while Gould and the entities under his control oversaw the Mall's operations. Under the Holding Company's original operating agreement (to which the SPV and Preferred Investor were parties), distributions from the Holding Company would first be allocated to the membership interests of the Preferred Investor (Preferred Interest) until it had received a 9% return, and thereafter the excess returns would be distributed to the SPV and its members (including 77 Charters). Six years into the investment, the Preferred Investor sold its entire Preferred Interest in the Holding Company to an entity controlled by

Gould. Thereafter, Gould, as manager of the Holding Company's manager, amended the Holding Company's operating agreement to increase the Preferred Interest's annual returns from 9% to 12.5%. Gould then sold the Mall. The sale proceeds were insufficient to provide any distribution to the SPV or its members. In reviewing the breach of fiduciary duty claims that 77 Charters brought against Gould, the Chancery Court found that the circumstances under which Gould amended the Holding Company's operating agreement could reasonably support a finding that Gould had breached his fiduciary duties by engaging in a self-dealing transaction that was not entirely fair to 77 Charters.

The court observed that as for Gould, although he was neither a member nor manager of the SPV or Holding Company, under certain circumstances, second-tier controllers (such as Gould) will owe limited fiduciary duties if they "exert control over the assets of that entity." The court denied Gould's motion to dismiss, holding that 77 Charters adequately pled a remote controller scenario by alleging that Gould personally undertook the acquisition of the Preferred Interest and then used his total voting control over the Holding Company to amend its operating agreement in a self-dealing transaction (to increase the Preferred Interest's economic value for his own benefit, and shift economic value away from 77 Charters).

So, What Does This Mean for Managers and GPs Moving Forward?

Based on the Chancery Court's most recent holding, intermediary entities and complex organizational hierarchies cannot be relied on to reduce or eliminate liability between control groups with respect to fiduciary duties owed to any controlled entity and its stakeholders. *USACafes*-type liability requires a practical fiduciary analysis focused on control, as one would commonly see in a GP-limited partner relationship within a fund structure. If upstream individuals or entities have exerted control, even if indirectly or through other controlling affiliates, then those individuals or entities owe a limited fiduciary duty to the controlled entity and its members. Transactions that unfairly benefit the controller to the detriment of the controlled entity and its stakeholders will subject investors and control groups to potential claims for breach of *USACafes*-type liability.

While this type of restriction on unfair benefit may be captured in limitations placed on a general partner or the members or managers thereof in a traditional fund structure through the requirements to seek approvals from either a limited partner committee or the limited partners themselves, the language in the limited partnership agreement is often narrowly tailored to be limited to the GP or management entity itself and may not always carry through to the ultimate controllers of those entities. The 77 Charters decision now places even greater scrutiny on the actions of controllers, like general partner decision-makers and managers, to ensure that no conflicts or potential conflicts are occurring or could be perceived to be occurring which may be reflected in the future by way of stricter drafting of conflict transaction limitations and amendment rights for controllers.

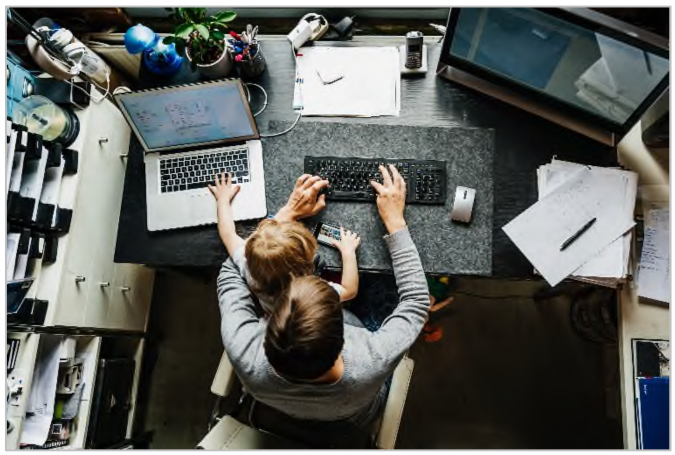
Please contact Megan McClung or Lindsay Karas Stencel with any questions.

General Corporate

Navigating the New Frontier of Working Remotely: An Overview of Legal Resources Available to Facilitate Virtual Business Operations

By Lauren A. Davis and Emma Off

The spread of the novel coronavirus disease (COVID-19) has changed the way that businesses operate, forcing many businesses to implement remote work environments. While the use of virtual meetings, electronic signatures and electronic notarization existed prior to the COVID-19 pandemic, the stay-at-home orders issued by governmental authorities have increased reliance on these resources. This article offers recommendations and highlights legal resources available to corporations to facilitate working remotely.



I. Authorize Virtual Meetings

Corporations are required to hold annual shareholders' meetings pursuant to statutory law. However, due to government mandates prohibiting large gatherings and requiring physical distancing, corporations will likely be unable to host large gatherings for the foreseeable future. As such, corporations should review and amend their bylaws to include language regarding the ability to conduct shareholders' and board meetings telephonically or virtually, if permissible under state law. For example, Ohio allows (i) the board of directors to authorize the shareholders' meetings to be held solely by means of communications equipment rather than in a physical space, if provided in the articles or code of regulations (Ohio Rev. Code §1701.40(B)) and (ii) that the board of directors may hold meetings through any communications equipment (Ohio Rev. Code §1701.61(B)). For shareholders' meetings, state statutes typically require, among other things, that the attending shareholders have an opportunity to participate in the meeting and to vote, including an opportunity to read or hear the proceedings contemporaneously (Ohio Rev. Code §1701.40(C); Del. Gen. Corp. Law §211(a)). While the requirements vary state by state, Delaware maintains similar requirements, but in California, there is an additional prerequisite that the prior consent of the shareholders be obtained to hold a virtual meeting (Del. Gen. Corp. Law §211(a); Cal. Corp. Code §600). As such, a corporation should verify the applicable state law and any relief available as a result of COVID-19 prior to amending its bylaws.

II. Revise Commercial Contracts to Expressly Authorize Use of Electronic Signatures

While working remotely, designated signatories may not have the necessary tools to sign and return a document in "wet ink." Generally, an electronic signature will be given the same legal effect as an original wet-ink signature so long as the parties have agreed to conduct the transaction by electronic means.[1] Under Ohio law, whether the parties have agreed is determined by the "context and surroundings, including the parties' conduct" (Ohio Rev. Code §1306.04(B)). For avoidance of any doubt and to establish such agreement in writing, the parties should provide an explicit consent in their commercial contract authorizing the use of electronic signatures and the delivery of signature pages by fax, PDF or other electronic

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[1] Ohio Rev. Code §1306.04(B). See also Electronic Signature in Global and National Commerce Act (E-Sign Act), adopted June 30, 2000; Uniform Electronic Transactions Act, for which date of adoption depends on the state. Where federal law does not exist, 47 states have adopted the Uniform Electronic Transactions Act and the three other states (Illinois, New York and Washington) have a form electronic signature law. See Uniform Electronic Transactions Act, *Thomson Reuters Practical Law*, last accessed on June 8, 2020. However, electronic signatures will not be accepted for certain documents. In Ohio, an electronic signature may not be used for wills, codicils, trusts and those additional documents included in Ohio Rev. Code §1306.02 (including commercial paper, title documents, and others).

transmission (including, but not limited to, electronic signature platforms or technologies).

III. Use Remote Online Notarization

Signatories should utilize remote online notarization when traditional face-to-face notarization is either undesirable or infeasible in the face of COVID-19.

a. Difference Between E-notarization and Remote Online Notarization

Electronic notarization and remote online notarization are not the same thing. Electronic notarization or "e-notarization" is the notarization of documents signed with an electronic signature and seal in the physical (face-to-face) presence of a certified notary public. Remote online notarization, on the other hand, is the notarization of documents signed with an electronic signature and seal over a two-way audiovisual communication (such as webcam), as opposed to physically. The notary and the signatory are not required to be in the same room. Remote online notarization can be used so long as the notary can see and hear the signatory through video and audio conferencing. Currently, 25 states have enacted a version of remote online notarization, including Ohio.[2] However, upon the issuance of stay-at-home orders in response to COVID-19, several states have issued emergency orders temporarily allowing remote online notarization.[3]

b. Identification of Signatory When Using Remote Online Notarization

Similar to the traditional notary process, the remote online notary is required to obtain satisfactory evidence of the identity of the signatory (Ohio Rev. Code §147.64(E)(1)). While it varies depending on the state requirements, in Ohio, satisfactory evidence of identification requires (i) review of government-issued ID, (ii) credentialing analysis of the signatory, which uses an automated process to verify the security elements and information on the ID presented, and (iii) identity proofing of the signatory, which is a means of knowledge-based authentication that creates computer-generated questions based on public or private data sources (such as the signatory's personal history, financial or credit information) that only the signatory is expected to know, each of which must be reviewed by the notary or by one or more credible witnesses.[4] Further, each notary session is recorded and remote online notaries are required to keep electronic records for a period of time evidencing the transaction to help prevent fraudulent transactions and to help prove the identity of the signatory should a future issue arise (Ohio Rev. Code §147.65).

Conclusion

Virtual resources are available to help businesses navigate the world in which they currently find themselves. Businesses should consider these practices to create efficiencies in their business operations (now and in the future) and ease any burdens felt by government mandates preventing face-to-face interaction.

Please contact Lauren Davis or Emma Off with any questions.

[2] Remote Electronic Notarization, *National Association of Secretaries of State*, last updated May 21, 2020.
[3] *Id.*
[4] Thun, David, "How Do You Identify Signers For A Remote Online Notarization?" *National Notary Association,* April 15, 2020; Ohio Rev. Code §147.64(E)(2); Ohio Admin. Code §111:6-1-05.

Commercial Contracts

Think You've Drafted an Airtight "No Oral Modifications" Clause? Think Again!

By Marla R. Butler and David Castillo Gocher

I. Introduction

A core tenet of contract law is that the contracting parties are masters of the agreement. Parties negotiate and ultimately agree upon terms – terms that each party expects to be bound by and hold the other side to. Most commercial agreements include an "integration clause" or "merger clause" which states that the written and executed contract is the complete and final agreement between the parties, and supersedes any and all prior agreements on the same subject matter between those same parties. Most commercial agreements also include a provision that states any future modifications to the agreement must be in writing and executed by the parties. In other words, there will be no oral modifications to the contract. These provisions make sense. After all, the parties engaged counsel who spent countless hours negotiating the terms of the agreement. The parties deliberated, debated and ultimately compromised until they reached terms that both sides could live with. The time and attention that resulted in these final, agreed-upon terms was substantial, as was evident from the legal fees each party paid its lawyers.

So, what happens when the parties have an ongoing working relationship and the subject matter of the agreement is a regular topic of discussion between the parties? Perhaps the parties are jointly developing a product and, as the development work proceeds, the teams from each company realize that one company is going to have to contribute more than was originally anticipated. Because the parties have worked so closely on the project, the relationship takes on an informality that leads to the teams deciding – orally – that the terms of the written agreement should change.

This is exactly why that "no oral modification" provision is in the contract. The lawyers anticipated this and similar scenarios and included the provision to make sure that the contract is not modified without careful consideration and without buy-in from the highest levels of the companies. But these lawyers might be surprised to learn that, in many states, that "no oral modification" provision is worth hardly more than the paper it is written on, and that oral modification to the contract between the joint development teams might actually be enforceable.

II. State-by-State Analysis

This article examines the law from several states around these "no oral modification" provisions to help lawyers draft provisions that will stick and advise their clients to avoid conduct that might undermine the written agreement. For each of these states, we explore the extent to which these provisions are generally enforceable and any equitable considerations a court will apply.

California

The California Civil Code (§ 1698(d)) provides that "[a] contract in writing may be modified by an oral agreement to the extent that oral agreement is executed by the parties." This statute, however, does not preclude waiver of a provision of a written contract, including a "no oral modification" provision, by words or conduct. Accordingly, California courts will look to the course of dealing and all actions between the parties. The issue of whether a "no oral modification" provision has been waived is a question of fact and requires a party asserting an oral modification to prove it by a preponderance of the evidence.

Delaware

Delaware courts have held that a contract provision deeming oral modifications unenforceable can be waived orally or by course of conduct. However, Delaware courts require a party attempting to prove the existence of an oral modification to do so by clear and convincing evidence. The party asserting the existence of the oral modification must prove the modification with "specificity and directness as to leave no doubt of the intention of the parties to change what they previously solemnized by a formal document." *TWA Resources v. Complete Production Services, Inc.* (Del. Super. Ct. 2013). Where the parties have reduced a modification to writing on a prior occasion, Delaware courts are less likely to enforce an oral modification.

Florida

Florida law provides that a "no oral modification" provision is generally enforceable. However, "[a] written contract or agreement may be altered or modified by an oral agreement if the latter has been accepted and acted upon by the parties in such manner as would work a fraud on either party to refuse to enforce it." *Professional Ins. Corp. v. Cahill* (Fla. 1956). Interpreting Florida law, the Eleventh Circuit has held that, despite the existence of a "no oral modification" clause, an oral modification will nevertheless be effective where clear and unequivocal evidence of a mutual agreement is presented. Further, Florida courts require the plaintiff to prove that (1) the parties agreed upon and accepted the oral modification, (2) both parties performed consistent with the terms of the alleged oral modification, and (3) due to the one party's performance under the contract as amended, the other party received and accepted a benefit that it otherwise was not entitled to receive.

Georgia

In Georgia, contractual provisions requiring all modifications to be in writing are valid and enforceable. However, such a provision may be waived by the course of conduct between the parties. For example, where the oral modification has been acted upon by one party and accepted by the other, that modification is likely to be enforced.

New York

In New York, "no oral modification" clauses are enforceable by statute. General Obligations Law § 15-301(1) provides: "A written agreement or other written instrument which contains a provision to the effect that it cannot be changed orally, cannot be changed by an executory agreement unless such executory agreement is in writing and signed by the party against whom enforcement of the change is sought or by his agent." Accordingly, when a written contract indicates that any modification must be in writing and signed by all parties, such a provision will be enforced. Nonetheless, the statute can be avoided where there is partial performance of an oral modification and such partial performance is "unequivocally referable to the oral modification." *Rose v. Spa Realty Associates* (N.Y. 1977). In addition, New York courts will apply the doctrine of equitable estoppel and enforce an oral modification if the subsequent oral agreement is coupled with substantial reliance.

Ohio

In the commercial transactions context, the Ohio Revised Code (O.R.C. § 1302.12(B)) provides, "[a] signed agreement which excludes modification or rescission except by a signed writing cannot be otherwise modified or rescinded … " However, this same statute (O.R.C. § 1302.12(D)) also provides, "[a]lthough an attempt at modification or rescission does not satisfy the requirements of division (B) or (C) of this section, it can operate as a waiver." In other words, "no oral modification" provisions may be waived by the parties, like any other contractual provision. Such a provision is waived when: (1) the oral modification has been acted upon by the parties; and (2) "refusal to enforce the oral modification would result in fraud or injury to the promisee, i.e. detrimental reliance." *Fields Excavating, Inc. v. McWane, Inc.* (Ohio Ct. App. 2009). The waiver must be clear and unequivocal.

Pennsylvania

Pennsylvania law provides that a "no oral modification" provision can be waived, and a subsequent oral agreement enforced, if the parties' conduct clearly shows an intent to waive the "no oral modification" provision. The party seeking to prove a subsequent oral modification must do so by clear, precise, and convincing evidence. In determining whether to enforce the oral modification, Pennsylvania courts will also take equitable considerations into account. Such considerations may include unjust enrichment and subsequent reliance.

III. Statute of Frauds

In addition to the law described above specific to the enforceability of "no oral modification" provisions, parties should also keep in mind any applicable statute of frauds, which may also have the effect of limiting the enforceability of an alleged oral agreement. These statutes vary by state, but generally require contracts for the sale of land, contracts for the sale of goods over a certain dollar amount, and contracts that are not to be performed within a year to be in writing. If not in writing, the contract will not be enforceable. In most states, the statute of frauds not only applies to original contracts, but also typically applies to contract modifications. There are exceptions to when the statute of frauds will apply to contract modifications. For example, in some states, if the oral modification relates only to the manner of performance, and not the substance of the contract, the statute of frauds may not apply. Additionally, even where the statute of frauds might apply to an oral modification, if the modification has already been performed by one party and accepted by the other, the modification may be enforced.

IV. Conclusion

There is significant variation among the states with respect to the enforceability of "no oral modification" provisions in written contracts. What we know for sure is that drafters should not assume such a provision will be enforced. Where the risk of attempted oral modifications is high, drafters should consider using choice of law provisions to achieve the parties' intended contractual goals. For example, under California law, a party asserting an oral modification need do so only by preponderance of the evidence. States like Delaware, New York and others, however, require more exacting proof.

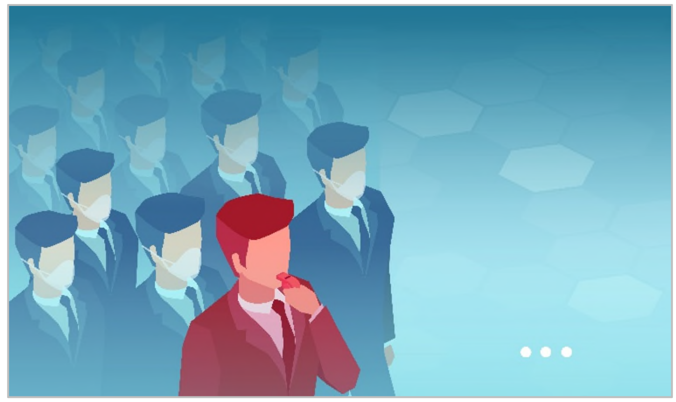
Please contact Marla Butler or David Castillo Gocher with any questions.

Corporate Compliance

Both Whistleblowing and Whistleblower Awards Are on the Rise

By David A. Wilson

Whether attributable to the pandemic effect of remote work, layoffs and furloughs, or the slew of recent substantial awards, the SEC's whistleblower tip line is lighting up with greater frequency. Companies are understandably focused on the panoply of challenges to their businesses posed by the pandemic and its economic impacts, but they ignore heightened whistleblower risks at their peril.



Since April 1 of this year, the SEC has announced five large awards in rapid-fire succession totaling $104 million, bringing the total awarded since the beginning of this fiscal year in October 2019 to more than $114 million. This total includes an award of $50 million announced on June 4, which is the largest award to a single individual under the agency's whistleblower program. The amount awarded so far in this fiscal year is more than the SEC has distributed in any full year.

The whistleblower program, created under the Dodd-Frank Act, authorizes bounties to be paid to individuals who provide original information that leads to successful enforcement actions that result in monetary sanctions of over $1 million. Since the program's inception in 2011, the SEC has awarded more than $500 million to 83 individuals. Individuals who receive awards and the companies on which they "blow the whistle" are not disclosed and remain confidential. Announcements of awards, including multiple orders in which the Claims Review Staff declined to make awards to those who believed they were entitled to one, are available on the SEC's whistleblower website.

The rate of tips coming into the SEC has soared. According to co-director of the Enforcement Division, Steven Peikin, in the first two months since remote work arrangements began spreading across the country in mid-March, the Commission received approximately 4,000 tips—35% more than it received in the same period last year. Lawyers close to the program speculate that as employees work away from the prying eyes and ears of their colleagues or have been furloughed or laid off, the reluctance to risk being ostracized or to just step forward may be easing. Another possibility is that the publicity about large awards has provided an incentive for employees to come forward to the SEC. Finally, because (according to co-director Peikin) many of the tips are COVID-19-related, it may be that there has been an uptick in the kind of conduct that employees believe is unlawful or inappropriate. The SEC's Office of the Whistleblower is still getting tips in traditional areas such as accounting fraud, insider trading, money laundering and other types of alleged securities law violations.

So, what should companies do about this heightened risk? The answer is that they should make sure that the policies and procedures they have in place to encourage employees to report internally are well known within the company, and that when concerns are raised internally, they are responded to and acted upon. The SEC's April 16 report about the $27 million award announced that day stated that the whistleblower had repeatedly tried to get management's attention about his or her concerns before going to the SEC. Pronouncements by SEC Enforcement Division senior leadership this year make clear that companies will not be able to use the COVID-19 crisis as an excuse for misconduct or for failing to follow compliance policies or failing to commit adequate resources to compliance.

Of course, with travel restrictions currently in place at many companies, conducting meaningful internal investigations of internal complaints poses particular challenges for companies with multiple sites, especially those with international operations. Several of the recent Whistleblower Program awards have had international dimensions, and with foreign governments regulating business openings and engaging in stimulus programs, the risks of bribery are likely heightened. Internal reports of serious misconduct should generally be investigated with careful document collection and in-person interviews, which may be challenging to undertake in the current environment.

Among the many challenges companies face in this new era is maintaining a strong commitment to compliance by making sure their policies and procedures are up to date based on best practices in the present reality. As always, prompt attention to internal reports or complaints about misconduct or fraud is a must in order to address misconduct promptly and convey to employees that the culture of compliance at the company remains strong.

With any questions, please contact David Wilson.

Applying Lessons Learned to Address EH&S Concerns During the COVID-19 Pandemic and Beyond

Thursday, July 16 – Webinar

1:00 - 2:30 p.m. ET

We invite you to a discussion of best practices and risk mitigation strategies identified by EH&S professionals as facilities reopen during the COVID-19 pandemic. Topics will include:

- Managing OSHA compliance in the wake of COVID-19: Best practices to protect employee health and safety; OSHA injury and illness reporting and enforcement.
- Adjusting to the new normal of environmental compliance: Conducting effective "virtual audits"; EPA post-pandemic enforcement strategies; developing effective contingency plans and new technologies to prepare for future business interruptions.
- Site investigations and remediation: Field work best practices, force majeure and health and safety plans.

Presenters:

- Scott Stoner, Stanley Black & Decker
- Carrie F. Ramirez, General Motors Company
- Stephen J. Axtell, Thompson Hine
- Andrew L. Kolesar, Thompson Hine
- Theodore J. Schneider, Goldenberg Schneider, LPA
- Rajib Sinha, P.E., Trihydro Corporation

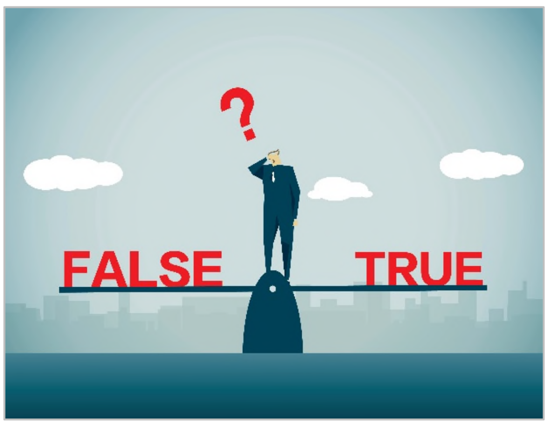
Please register online to receive the webinar login information. CLE credit will be requested.

Investment Management

In This Time of Great Change, Steer Clear of Becoming an "Inadvertent Investment Company"

By Owen J. Pinkerton and Brian Doyle-Wenger

In connection with the initial public offering of a well-known services company (Company) in April 2019, the U.S. Securities and Exchange Commission (SEC) issued an exemptive order that confirmed that the Company was not required to register as an investment company and be subject to the provisions under the Investment Company Act of 1940 (1940 Act).



To the casual observer, this may seem like an obvious point, but a closer look at the Company's financial statements explains why this order was needed. Section 3(a)(1)(C) of the 1940 Act defines an investment company as an entity that is "engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer's total assets." The audited balance sheets for the years ended December 31, 2018 and 2017 showed that the Company had slightly over 40% of its total assets in short-term investments, which are considered to be "investment securities" under Section 3(a)(2) of the 1940 Act. While the nature of the Company's business would seem to fall outside the realm of investment companies, an issuer is presumptively considered to be an investment company if it trips the 40% threshold unless such issuer obtains an exemptive order from the SEC, as the Company did, or can rely on another exemption under the 1940 Act. Issuers that are impacted by the 40% threshold are commonly referred to as "inadvertent investment companies."

The Company's business generated large amounts of cash (cash is not an "investment security"), but by investing such cash in investment securities, it tripped the 40% threshold. Other situations where an issuer may inadvertently be an investment company include:

- New issuers that have raised capital but have not yet fully commenced operations;
- Issuers that have devoted significant capital to research and development;
- Issuers that conduct a large portion of their operations through minority-owned subsidiaries or joint venture vehicles; and
- Issuers that sell a portion of their assets or a division and invest sales proceeds in investment securities.

Operating companies that have a large portion of their total assets in investment securities for any of the above reasons should either take steps to ensure that they do not trip the 40% threshold or be aware of the exemptions found in the 1940 Act and the rules thereunder. Operating companies that fail to do so run the risk of being required to register as investment companies. Investment companies are subject to a myriad of rules that limit their ability to conduct normal operations, including but not limited to (i) prohibitions against transactions with affiliates, (ii) a requirement that their securities be held by a qualified custodian, (iii) significant limits on the ability to incur leverage and (iv) significant restrictions on the entity's capital structure. Since the 1940 Act was not designed to apply to operating companies, for most operating companies, fully complying with such rules and regulations is virtually impossible.

The Company was apparently unable to rely on any of the statutory exemptions set forth below, so it was forced to obtain an exemptive order from the SEC. However, with awareness of the exemptions and a little bit of planning, many issuers can rely on such exemptions and avoid the pitfalls associated with being an investment company.

The most common exemptions are summarized below.

Rule 3a-1

Rule 3a-1 was adopted to codify previously issued exemptive orders and set forth a bright line test as to what issuers are definitively not investment companies based on the composition of their assets and sources of income. In order to rely on Rule 3a-1, an issuer must satisfy both of the requirements below:

- No more than 45% of the value of its total assets (exclusive of government securities and cash items) may consist of securities other than government securities, securities issued by employees' securities companies, securities of certain majority-owned subsidiaries, and securities of certain controlled companies; and
- The issuer must receive no more than 45% of its income after taxes (over the last four fiscal quarters combined) from such securities.

The adoption of this bright line test removed the burden of having to submit an exemptive application and provided additional certainty as to what issuers are conclusively not considered to be investment companies by the SEC.

Rule 3a-2

Rule 3a-2 under the 1940 Act was adopted to exclude issuers that are "transient investment companies." Specifically, Rule 3a-2 allows issuers that qualify as investment companies due to an unusual corporate occurrence to exceed the 40% threshold for an interim period, not to exceed one year, so long as they meet certain requirements. The one-year period is calculated from the *earlier* of:

- The date on which an issuer owns securities and/or cash having a value exceeding 50% of the value of the issuer's total assets; or
- The date on which an issuer intends temporarily to invest the proceeds pending the acquisition of new operating assets to acquire certain investment securities representing more than 40% of its total assets.

Rule 3a-2 further requires that the issuer's board of directors adopt resolutions evidencing the issuer's intent to rely on the Rule 3a-2 exclusion, and an issuer may not rely on such exclusion more than once during any three-year period.

Rule 3a-8

Rule 3a-8 was adopted in order to codify previously issued exemptive orders obtained by research and development companies in response to the recognition that certain companies may trip the 40% threshold by virtue of the fact that the value of their intellectual property assets are not reflected on their balance sheets. Rule 3a-8 includes a number of quantitative tests that must be met in order to rely on such exclusion.

Conclusion

In the current environment where issuers may be exploring new business lines, changing their operating focus or investing in new joint venture vehicles, it is important to be aware of the 40% threshold and take the necessary steps to avoid inadvertently being treated as an investment company under the 1940 Act.

With any questions, please contact Owen Pinkerton or Brian Doyle-Wenger.