15 OCTOBER 2021

Legal Due Diligence Considerations Through The Lens of COVID-19 Pandemic

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The infectious coronavirus has brought about a global public health and economic crisis like no other. When it hit the shores of Malaysia, the government implemented a nationwide lockdown through the Movement Control Order (MCO), and along with it came dampening of economic activities, drastic change of consumer behaviour and supply chain disruption – all of which have placed companies and businesses in unchartered waters.

However, out of adversity comes opportunity. Despite unprecedented adverse social and economic impacts, forward-thinking leaders are planning proactively and leveraging merger and acquisition (M&A) for the growth and resiliency of their companies under the "new normal" business landscape.

For example, IJM Corporation Berhad, a leading conglomerate in the construction, property, plantation, industry and infrastructure sectors has just recently completed the disposal all of its shares in its plantation arm, IJM Plantations Berhad to Kuala Lumpur Kepong Berhad. Such transaction is envisaged to strengthen the financial position of the whole IJM group and provide them with the financial flexibility to pursue business opportunities during such challenging times[1].

This alert seeks to highlight several pertinent areas of concern which would have to be approached with a different lens during the legal due diligence phase of M&A deals in light of the COVID-19 outbreak.

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[1] IJM Corporation Berhad's Circular dated 28 July 2021 <https://disclosure.bursamalaysia.com/FileAccess/apbursaweb/download?id=210019&name=EA_DS_ATTACHMENTS>, Page 16.

What Is Due Diligence?

Due diligence is an exercise of rigorous and detailed examination conducted on a company before becoming involved in a business arrangement with it to enable informed decision making in respect of the proposed business arrangement. In M&A transactions, a prospective acquirer will typically conduct due diligence on a target company to better understand the fundamentals of the target company's business and the risks that will be involved before signing or closing the deal.

Considering the COVID-19 pandemic, there will be a heightened emphasis on several key areas of concern in a legal due diligence exercise, as discussed below.

Contractual Performance

An integral part of a due diligence exercise is the review of all material commitments and contracts of the target company. Although having a high volume of contracts would point towards a financially healthy company, it is advisable for a prospective acquirer to review and assess the performance of each material contract instead of taking them at face value, as the parties' performance of contractual obligations may be affected by the pandemic.

For instance, the target company or any of its counterparty may terminate some of their existing contracts, or discharge or vary certain obligations under their existing contracts by invoking force majeure clauses or by relying on the doctrine of frustration.

- ***Force Majeure***

Force majeure clauses often exist to protect parties from their inability to fulfil contractual obligations due to certain supervening events. Whether the COVID-19 pandemic constitutes a force majeure event will depend entirely on the scope of the force majeure clause in the contract. Words such as "pandemic", "epidemic", "outbreak" and "government lockdown" in a force majeure clause can be construed to cover the COVID-19 pandemic and the MCO, and several phases of the National Recovery Plan (NRP).

With force majeure clauses typically included in commercial contracts such as purchase agreements and supply agreements, it is crucial for prospective acquirer to identify such force majeure provisions and thereafter, assess if the effects of COVID-19, or any response to it, including government-imposed lockdowns or restrictions affecting the export or import of goods, would fall within the scope of such force majeure provisions.

If affirmative, depending on the construction of the relevant clauses, the prospective acquirer should take into account that the invoking party may discharge itself from the performance of some of its obligations under the contract.

In this case, it is important for the prospective acquirer to understand the target company's and its counterparty's respective rights, obligations, remedies and the relevant timelines or limitations under the relevant force majeure clauses to protect its rights in the event such clause is invoked as it steps into the shoes of the target company.

- ***Doctrine Of Frustration***

In the absence of an express force majeure clause in a contract, the target company and its counterparty may rely on the doctrine of frustration which is encapsulated in Section 57(2) of the Malaysian Contracts Act 1950. Pursuant to Section 57(2), a contract to do an act which, after the contract is made, becomes impossible, or by reason of some event which the promisor could not prevent, becomes unlawful, will be rendered void.

In this regard, in addition to the conventional due diligence questionnaires, prospective acquirer should also inquire the target company on whether the COVID-19 pandemic or any response to it (any standard operating procedures implemented by the government) has rendered the contractual obligations to any contract of the target company or its counterparty either impossible or unlawful to perform, therefore rendering the contract void.

- ***Section 7 Of The COVID-19 Act***

On 23 October 2020, the government of Malaysia introduced the Temporary Measures for Reducing the Impact of Coronavirus Disease 2019 (COVID-19) Act 2020 (the COVID-19 Act). Central to the Act is Section 7, which initially applied retrospectively from 18 March 2020 up to 31 December 2020. The applicability period was subsequently extended to 31 December 2021, and such period may be further extended by the prime minister.

Pursuant to Section 7, a party's right to enforce its contractual rights against the defaulting party will be suspended during the aforesaid prescribed period if the following criteria are satisfied:

(a) there is an inability by the other party to perform a contractual obligation;

(b) the said contractual obligation arises from any of the nine categories of contracts specified in the Schedule to the COVID-19 Act 2020[2]; and

(c) the inability to perform is due to the measures prescribed, made or taken under the Prevention and Control of Infectious Diseases Act 1988.

Accordingly, when undertaking due diligence, prospective acquirer is reminded to review all material contracts and determine if any of the target company's contracts fall within the scope of Section 7. If so, when acquiring the said company, acquirer should take into consideration that the enforcement of the target company's contractual rights will be temporarily barred pursuant to the operation of Section 7.

On the flip side, if the target company is unable to perform its contractual obligation and Section 7 is applicable, prospective acquirer may examine whether the target company has maintained any records of documents pertaining to such inability to perform its contractual

[2] Some examples are lease or tenancy agreement of non-residential immovable property, credit sales contract under the Consumer Protection Act 1999, professional services contract, construction work contract or construction consultancy contract and any other contract related to the supply of construction material, equipment or workers in connection with a construction contract.

obligation, as such documents may determine the outcome of any future disputes.

Employment & Workforce Management

Another essential due diligence item during M&A amid the COVID-19 pandemic relates to matters pertaining to employees and workforce management.

In this regard, prospective acquirer should ascertain the following facets when conducting legal due diligence:

(a) the implementation of any restructuring or retrenchment of workforce by the target company as a result of COVID-19 and the number of employees affected, as well as the compliance with applicable labour legislations (e.g. principle of "last-in-first-out") and the respective affected employees' contracts of employment.

(b) any government relief schemes in response to COVID-19 (e.g. the Wage Subsidy Programme) applied by or granted to the target company and its compliance with the conditions imposed under such relief schemes.

(c) any internal policy or safety measures put in place by the top management of the target company to fulfil their duty as an employer to provide and maintain an environment for employees that is, so far as is practicable, safe, without risks to health, and adequate as regards facilities for their welfare at work.

(d) the target company's collection and processing of any information pertaining its employees' vaccination status and the measures taken by the target company to adhere to the relevant data protection laws in the course of collecting and processing such information.

Competition Law Concerns

In a pandemic, it is more likely for businesses from the same sector or industry to consolidate, as affected companies that bear the brunt of the impact of the MCO or NRP may look to take over competitors or merge/consolidate with other players to combine their strengths and streamline their costs while they steer through the adverse economic conditions.

- ***Anti-trust Counsel***

In such circumstances, it is necessary for prospective acquirer and target company to engage anti-trust counsel to review relevant key documentations prior to circulation to ensure that there is no infraction of competition legislations and regulations by the parties.

For instance, the counsel may, amongst others, remove any wordings in the key documentations which could lead to the impression that the combined entity would not face effective competition in the market.

- ***Clean Team Protocols***

Further, in order to mitigate the risks of competition law concerns being raised in relation to the sharing of market sensitive information between the prospective acquirer and the seller regarding the target company, clearly defined clean team protocol may be put in place.

With such protocol being implemented, access to the target company's competitively sensitive information (including pricing, costing, sales strategies, etc.) will be limited to members of a "clean team" in a separate electronic or physical "clean" data room, which the employees of both buyer and seller cannot independently view.

Conclusion

In any event, there is no one-size-fits-all due diligence approach and the above-mentioned due diligence considerations should be deliberated based on the particular circumstances of each transaction.

Prospective acquirer should engage professional services in this respect prior to inking any business deal to adequately evaluate the impact of COVID-19 on the business, assets, operation and financial performance of the target company, thereby arriving at an informed and sensible commercial decision during such trying times.

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