

# Stock Repurchase Considerations in Light of Covid-19

March 27, 2020

In light of recent market volatility resulting from the outbreak of coronavirus disease 2019 (“Covid-19”), responsive measures to address the pandemic, recent shocks in commodity markets and other related events, companies may be considering opportunities to repurchase stock at significantly reduced prices. This memorandum provides an overview of considerations for issuers contemplating stock repurchases, with emphasis on factors of increased importance given current financial, economic and political uncertainty. Specifically, the memorandum outlines: (1) potential restrictions on repurchases (*i.e.*, can you repurchase); (2) fiduciary considerations (*i.e.*, should you repurchase); (3) best practices for repurchases (*i.e.*, how should you repurchase); and (4) other considerations.

## POTENTIAL RESTRICTIONS ON REPURCHASES

Issuers contemplating stock repurchases should ensure that any plan under consideration is permissible under applicable law and the company’s contracts. This should include a review of:

- the laws of the issuer’s jurisdiction of organization, including statutory capital and surplus adequacy provisions, as well as applicable fraudulent transfer and insolvency laws;
- the issuer’s organizational documents, such as its certificate of incorporation, bylaws or other similar documents; and
- any of the issuer’s contracts that may contain restrictions on stock repurchases, including credit agreements, indentures, shareholder agreements and other similar documents.

For example, a Delaware corporation cannot repurchase stock “when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation”, and directors may have personal liability for an unlawful share purchase.<sup>1</sup> Delaware entities are also subject to the state’s Uniform Fraudulent Transfer Act, which would prohibit, among other things, a stock repurchase that leaves an entity with unreasonably small capital.

## FIDUCIARY CONSIDERATIONS

The DGCL does not expressly require that a corporation’s board of directors approve a stock repurchase plan. Nevertheless, for a public company, board approval is a best practice that should be observed, particularly in the current environment. In evaluating a potential stock repurchase plan, the board should exercise due care and inform itself appropriately. In addition to the matters a board would typically consider when evaluating a repurchase plan—such as whether purchases of the issuer’s shares represent a prudent use of corporate resources—a board may consider:

- the issuer’s liquidity requirements in light of economic disruptions that, for some industries, are unprecedented;
- the degree to which the evolving nature of the pandemic requires the issuer to maintain financial flexibility; and
- the risks and benefits of utilizing available liquidity for stock repurchases versus alternative uses.

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<sup>1</sup> Delaware General Corporation Law (“DGCL”) §§ 160, 174. Further, DGCL § 102(b)(7) does not allow a company to indemnify directors for liability under DGCL § 174.

The board should also consider that, under current circumstances, any decision to repurchase stock is likely to receive increased scrutiny from employees, customers or the press, who may contend that repurchasing stock during an economic downturn inappropriately favors shareholders over other stakeholders. In light of unfavorable statements regarding stock repurchases from public figures ranging from President Donald J. Trump to former Vice President Joseph R. Biden Jr., the optics, public relations and public policy considerations surrounding stock repurchases merit increased attention from issuers and their boards.<sup>2</sup>

Repurchasing stock may also impact an issuer's ability to take advantage of government loans or other economic relief programs implemented in response to Covid-19.<sup>3</sup> Even if a company has no intention of participating in such programs directly, it should consider whether industry groups or trade associations of which it is a member are advocating for taxpayer-funded support.

As always, the board process surrounding a stock repurchase should be well documented,<sup>4</sup> as a conflict-free, informed decision reached through the proper procedures should be protected by the business judgment rule.

## BEST PRACTICES FOR REPURCHASES

An issuer's repurchase of its stock implicates the anti-manipulation and anti-fraud provisions of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the rules promulgated thereunder. Issuers can help ensure compliance with these provisions by taking advantage of certain regulatory safe harbors and following best practices developed over time by market participants.

### Manipulation Issues

Section 9(a) of the Exchange Act prohibits transactions that have the purpose of inducing trades in a security by creating actual or apparent active trading in that security or by affecting its price. Section 10(b) of the Exchange Act similarly proscribes manipulative trading practices.

#### Rule 10b-18

Rule 10b-18 under the Exchange Act provides a non-exclusive safe harbor from liability under these provisions to issuers and their affiliated purchasers who purchase stock in transactions that satisfy four conditions:

- *Manner*: The issuer and its affiliated purchasers use only one broker or dealer on any given day to bid for or purchase stock.
- *Timing*: The purchase does not constitute the opening transaction or occur during the last half hour of trading (or the last 10 minutes of trading, if the stock has an average daily trading volume ("ADTV") of \$1 million or more during the four weeks preceding the week in which the purchase occurs and the issuer has a public float value<sup>5</sup> of \$150 million or more).

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<sup>2</sup> On March 20, 2020, former Vice President Biden tweeted: "I am calling on every CEO in America to publicly commit now to not buying back their company's stock over the course of the next year. As workers face the physical and economic consequences of the coronavirus, our corporate leaders cannot cede responsibility for their employees."

<sup>3</sup> On March 25, 2020, the U.S. Senate passed the Coronavirus Economic Stabilization Act of 2020, which, if enacted, would authorize the Treasury Secretary to enter into agreements to make loans or loan guarantees to eligible businesses affected by the pandemic. These agreements must provide that, until the date 12 months after the date the loan or loan guarantee is no longer outstanding, neither the eligible business nor any affiliate of the eligible business may purchase any equity security (as defined in section 3(a) of the Securities Exchange Act of 1934, as amended) that is listed on a national securities exchange of the eligible business or any parent company of the eligible business, except to the extent required under a pre-existing contractual obligation.

<sup>4</sup> Companies may consider obtaining a solvency opinion and a memorandum from outside legal advisors regarding the calculation of surplus under applicable law. If obtained, such documents should be included in the materials the board reviews prior to authorizing the repurchase.

<sup>5</sup> Determined as set forth in the issuer's latest Form 10-K.

- *Price*: The purchase price is not higher than the higher of (1) the greatest independent bid and (2) the last independent transaction price, in each case at the time of the purchase.
- *Volume*: The aggregate amount<sup>6</sup> of the purchases by the issuer and its affiliated purchasers per day does not exceed 25% of the stock's four-week ADTV. Issuers are also permitted to make one block purchase of stock per week outside the volume limit, so long as they do not make any other 10b-18 purchases that day.<sup>7</sup>

The definition of “affiliated purchaser” under Rule 10b-18 includes any affiliate who, directly or indirectly, (1) is acting in concert with the issuer for the purpose of purchasing stock or (2) controls the issuer's purchases or whose purchases are controlled by, or under common control with those of, the issuer. This is a different, narrower definition than that of “affiliate”, particularly because the rule provides that directors and officers are not affiliated purchasers solely because they participate in the decision to conduct the repurchase. Nonetheless, it is best practice to proactively identify any directors and officers who plan to purchase the issuer's stock and determine on a case-by-case basis whether they are affiliated purchasers whose purchases must be taken into consideration to ensure that the issuer does not lose the safe harbor's protection.

The issuer also may need to consider issues raised by any proposed stock sales by insiders on a day when Rule 10b-18 purchases may be made by the issuer, particularly if a director or officer that is trading is affiliated with a major shareholder of the issuer. A conservative approach is to make sure insider sales and issuer repurchases do not take place on the same day, but the need for this will vary based on facts such as the identity of the insider and the size of his or her proposed sales.

The severe market price declines in the wake of Covid-19 have recently triggered market-wide circuit breakers that temporarily halted trading multiple times across equities exchanges.<sup>8</sup> If any such trading halt, or the aggregation of all trading halts, lasts for 30 minutes or more on a given trading day:

- the timing condition of Rule 10b-18 described above does not apply during the remainder of the trading day after the halt is lifted (if the halt is in effect at the closing of any trading day, the timing condition does not apply during the entire following trading day) and
- the volume condition of Rule 10b-18 described above is modified to permit repurchases of up to 100% of the stock's four-week ADTV during the trading session that follows after the halt is lifted.

Finally, the safe harbor provided by Rule 10b-18 is not available for transactions that are subject to Regulation M under the Exchange Act and the Securities Act of 1933, as amended (the “Securities Act”), which prohibits manipulative practices while issuers or their affiliates are engaged in a “distribution” of the issuer's securities outside of ordinary course trading. Whether an offering constitutes a “distribution” depends on several factors, such as the size of the offering (relative to the trading volume and public float of the relevant class of securities) and the method of offer and sale, which companies should evaluate prior to relying on Rule 10b-18.

## **Antifraud Issues**

### **Regulatory Framework**

An issuer that repurchases its securities while in possession of material non-public information risks insider-trading liability under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. The SEC's Division of Corporation Finance underscored this point in guidance issued on March 25, 2020, which reminded issuers and their

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<sup>6</sup> Excluding stock acquired through privately negotiated off-market transactions.

<sup>7</sup> Transactions by an issuer between the time that it has announced a merger, acquisition or similar transaction involving a recapitalization and the earlier of consummation of the transaction or the completion of the vote by target shareholders are excluded from the Rule 10b-18 safe harbor, unless (1) the consideration in such transaction is solely cash and there is no valuation period or (2)(a) the repurchases do not exceed the lesser of 25% of the stock's ADTV and the issuer's average daily Rule 10b-18 purchases and (b) the issuer's block purchases do not exceed the average size and frequency of the issuer's block purchases, in each case, during the three months preceding the transaction announcement.

<sup>8</sup> On a number of occasions since the outbreak of Covid-19, index futures have triggered “limit down” trading stops prior to the opening of a trading session. This alone does not activate the exceptions described above following a halt in trading.

insiders to refrain from trading in a issuer's securities if they are in possession of material non-public information regarding the effects of Covid-19 on the issuer.

Generally, an issuer has two options to address this risk:

- (1) ensure that it is not in possession of any material non-public information while engaging in discretionary repurchases; or
- (2) make repurchases in accordance with Rule 10b5-1(c), which provides an affirmative defense against any assertion of insider-trading liability with respect to purchases effected pursuant to a written trading plan (a "10b5-1 Plan") that:
  - is adopted at a time when the issuer is not aware of any material non-public information;
  - either specifies the date, price and volume of securities to be purchased, includes a written formula, algorithm or computer program to determine such parameters, or otherwise restricts the issuer's influence over the 10b5-1 Plan after adoption; and
  - is entered into in good faith and not as part of a plan or scheme to evade liability under the securities laws.

In practice, issuers implementing a 10b5-1 Plan generally retain an experienced broker dealer to execute the repurchases in compliance with the Rule 10b-18 conditions described above regarding volume, timing and other factors.

An issuer currently considering the adoption of a 10b5-1 Plan to facilitate repurchases in light of Covid-19 should ensure that it does not possess material non-public information at the time of the 10b5-1 Plan's adoption, including with respect to the effect of the pandemic on the issuer's business or prospects.

Issuers with existing 10b5-1 Plans may be considering modifications to such 10b5-1 Plans. Because of SEC guidance, an issuer must ensure that it does not possess material non-public information at the time of the modification.<sup>9</sup> If an issuer chooses to conduct discretionary repurchases outside of an existing 10b5-1 Plan, a 10b5-1 Plan modification may nonetheless be required to ensure that the combined repurchases do not in the aggregate exceed the volume limitations of the Rule 10b-18 safe harbor.

Lastly, issuers with existing 10b5-1 Plans also may be considering terminating such 10b5-1 Plans in light of current conditions. The SEC has indicated that the termination of a 10b5-1 Plan could cast doubt on whether it was initially adopted in good faith.<sup>10</sup> Although issuers should be mindful of this risk, the emergence of the Covid-19 pandemic likely presents a compelling change in circumstances that would justify termination.

### **Black-Out Periods**

Issuers' internal insider trading policies usually impose "black-out periods" during which insiders are prohibited from purchasing or selling issuer securities due to the increased likelihood that the insiders possess material non-public information with respect to upcoming results. These periods typically occur around the close of each fiscal quarter, meaning that issuers with fiscal years ending December 31 currently may be in or nearing their black-out periods as they approach the end of the first fiscal quarter.

Issuers may be contemplating repurchases during their black-out periods. An issuer in this situation should, however, consider the implication of making investment decisions in respect of its own stock—whether by executing repurchases or by modifying or adopting plans to do so—during a blackout period. If an issuer decides to repurchase its stock during a black-out period (other than in reliance on a pre-existing 10b5-1 Plan), the issuer's board should determine that no material non-public information exists, including with respect to the issuer's upcoming earnings.

Issuers may also be considering whether to shorten or waive their black-out periods to allow insiders to purchase (or sell) stock during the current market disruption. Federal securities laws do not require or address black-out periods, but companies looking to shorten or waive their black-out periods should ensure compliance with any listing rules

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<sup>9</sup> See SEC Compliance and Disclosure Interpretations (C&DIs), Exchange Act Rules, Question 120.19.

<sup>10</sup> See C&DIs, Exchange Act Rules, Question 120.18.

addressing insider purchases (such as Section 309.00 of the New York Stock Exchange (“NYSE”) Listed Company Manual, which suggests, but does not require, certain black-out periods).

### **Accelerated Share Repurchases (“ASRs”)**

ASRs are structured as sizable forward purchases entered into with investment banks or other financial institution counterparties. ASRs allow companies to acquire their shares on dramatically abridged timelines when compared with typical Rule 10b-18 repurchases, which involve gradual, open-market acquisitions.

It is best practice to structure ASRs to mirror (to the extent possible) the requirements of Rule 10b-18. Even though—as privately negotiated transactions between an issuer and a financial institution counterparty—an ASR is not covered by the safe harbor, as a matter of market practice the financial institution counterparty typically will conduct its purchases in a manner that is consistent with Rule 10b-18.<sup>11</sup> Further, to avoid anti-fraud liability, companies often ensure that their ASRs also qualify as 10b5-1 Plans by ensuring that the ASR complies with the requirements of Rule 10b5-1(c) described above.

### **Tender Offers**

A minority of stock repurchases are structured as tender offers in which an issuer typically offers to purchase a number of its shares within a range of prices. A tender offer may be appropriate if the issuer wishes to purchase a substantial amount of stock in a short period of time without the potential complexity of an ASR, but it will require the potentially burdensome disclosure and SEC filings requirements mandated by Rule 13e-4 under the Exchange Act. A tender offer must remain open for at least 20 business days, all tendering holders must receive the highest price paid for any share tendered in the offer and the issuer may not purchase securities subject to the tender offer while it is pending and for ten days after its termination.

Any share repurchase program that is not conducted in accordance with Rule 13e-4 must be structured to ensure that it is not inadvertently deemed to be a tender offer (often referred to as a “creeping tender offer”). Under SEC guidance, a tender offer is defined by certain key features, including active and widespread solicitation, a purchase price at a premium to the market price and pressure on the offerees to sell.

## **OTHER CONSIDERATIONS**

- **Disclosure considerations.** Generally, an issuer announces its repurchase plans via press release or current report filed with the SEC. These announcements typically cover the size, timing, method and purpose of the repurchase, though there is no requirement to specifically disclose the adoption of a 10b5-1 Plan. In some instances, public announcements of private off-market transactions may not be required, but companies should keep in mind that Item 703 of Regulation S-K requires disclosure of all repurchases in periodic reports filed with the SEC.
- **Listing rules.** In addition to the insider transaction rules referenced above, exchange listing rules require minimum floats and a minimum number of shareholders. Further, exchanges may require notice of any repurchase announcement prior to its public dissemination or notice of changes in the public float of the stock as a result of the repurchase.<sup>12</sup>
- **Financing considerations.** If an issuer is considering borrowing to fund stock repurchases, it should confirm that the increased debt is permitted under its existing debt agreements and other material contracts.
- **Dividend v. repurchase.** Both cash dividends and stock repurchases are ways of returning a portion of capital surplus to shareholders. The choice is informed by, among other things, an issuer’s current and projected capitalization

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<sup>11</sup> For example, an issuer can set the size of the ASR to be no greater than the aggregate amount of stock the issuer expects to be eligible to repurchase under the Rule 10b-18 safe harbor over a period equivalent to the minimum term of the ASR forward contract, taking into account any right of the investment bank under the terms of the ASR to accelerate the agreed ASR maturity date at its election.

<sup>12</sup> For instance, if a repurchase has the effect of reducing an issuer’s public float by 5%, Nasdaq’s listing rules would require an issuer to notify the exchange within 10 days of the reduction. NYSE does not have an analogous rule.

requirements and the preferences of its investors.<sup>13</sup> Repurchases, however, are generally associated with periods of lower stock prices, such as those prevailing in the current Covid-19 disruption.

- **Post repurchase ownership.** Issuers should review their anticipated pro forma share ownership after giving effect to any planned stock repurchase, as the repurchase may have the effect of putting a large shareholder in a position of control following the reduction in the number of shares outstanding, which could raise additional fiduciary duty concerns.

## CONCLUDING THOUGHTS

The outbreak of Covid-19 and measures taken in response to the pandemic will continue to affect businesses and markets in a number of ways. Issuers considering stock repurchases during this time of uncertainty should weigh the full range of risks and benefits in context. Although Covid-19 has not changed the substantive requirements or best practices for stock repurchases, it has increased the relative importance of certain considerations, including those related to stakeholder relations and public policy.

Please feel free to contact us if we can provide further information on these matters.

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<sup>13</sup> For instance, investors may have tax reasons for preferring repurchases over dividends.