



Professional Perspective

How to Avoid Public Company Disclosure Scrutiny After Covid-19

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How to Avoid Public Company Disclosure Scrutiny After Covid-19

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Today's economic crisis, unparalleled in speed and depth, was driven by the global impact of the novel coronavirus. Public companies issuing guidance in the run up to the historic market highs and years of robust economic growth preceding the fall, now face plaintiffs' class actions, shareholder derivative suits, and regulatory inquiries as a result of their disclosures.

The first securities class actions have already been filed. Moreover, the Securities and Exchange Commission has issued "guidance" on adequate public company disclosures during the Covid-19 pandemic.

Moving into this new Covid-19 environment, the duration of which remains uncertain, issuers may expect enhanced SEC scrutiny into their historic and current disclosures, including for Paycheck Protection Program loans. Public company directors, officers, and their counsel, are well-advised to consider whether and how to issue disclosures or guidance in light of new risk factors presented by the virus and continued volatility in the market place.

The SEC on Covid-19

Guidance on Public Company Disclosures

On March 25, 2020, the SEC's Division of Corporation Finance provided [guidance](#) on the adequacy of public companies' disclosures as the full force of Covid-19 was felt on the global economy. While "recognizing that it may be difficult to assess or predict with precision the broad effects of Covid-19," the SEC stated that the effects the virus "has had on a company, what management expects its future impact will be, how management is responding to evolving events, and how it is planning for Covid-19-related uncertainties can be material to investment and voting decisions."

To assist public companies in considering whether the risks presented by Covid-19 or related effects are necessary or appropriate for disclosure, the SEC has provided a detailed set of considerations for assessing and disclosing the evolving impact of Covid-19. The guidance's considerations include, among others:

- How has Covid-19 impacted your financial condition and results of operations?
- How has Covid-19 impacted your capital and financial resources, including your overall liquidity position and outlook?
- How do you expect Covid-19 to affect assets on your balance sheet and your ability to timely account for those assets?
- Have Covid-19-related circumstances such as remote work arrangements adversely affected your ability to maintain operations, including financial reporting systems, internal control over financial reporting and disclosure controls and procedures?

The guidance asks issuers to take a holistic view in considering how Covid-19 has impacted financial results.

Public Statement by SEC Chair and the SEC's Chief Accountant

The SEC recently released a [public statement](#) by Chair Jay Clayton and Bill Hinman, the director of the division of corporation finance. The SEC chief accountant has also issued a [public statement](#), emphasizing how "well-reasoned" judgment will need to be exercised when making decisions about financial statement disclosures. These public statements focused on disclosures in light of Covid-19 and came against the backdrop of broad macroeconomic uncertainty with companies pulling forward-looking projections for the quarter and often times the rest of the year.

The key takeaway is that the SEC is pursuing a "proactive approach" to Covid-19, including engagement with stakeholders across the financial reporting ecosystem. The SEC is placing a heavy emphasis on forward-looking statements and projections—indicating that companies should provide as much forward-looking information as they can. Such disclosures should discuss how quickly or slowly companies believe they will emerge from the crisis. Issuers are also asked to provide meaningful, qualitative detail on how operations have been impacted by Covid-19.

These statements, while not carrying the weight of law, foreshadow the SEC's thinking on whether disclosures are adequate. Implicit is the notion that companies should go above and beyond traditional materiality standards and provide more detail about what is currently impacting their business, and about the future. With respect to forward looking statements, the SEC has said it will not challenge good-faith efforts to provide forward-looking information. While that is seemingly comforting, corporate counsel and litigation/enforcement counsel need to remember there is no guarantee that these forward looking disclosures will not be second guessed, at least by plaintiffs' securities lawyers.

More importantly, the SEC espoused the unusual policy position that robust forward-looking disclosures are important not only for investor purposes, but also for the benefit of the economy as a whole. This was perhaps the first time in history that the SEC placed an onus on public companies to provide qualitative disclosures for the benefit of the market, not simply shareholders. The elevation of the interests of non-shareholders by the SEC, while understandable in light of the current crisis, is a curious development, as it would appear to fall outside of the SEC's jurisdictional ambit and also seems driven by a desire to provide broad macroeconomic stability and confidence. However, this mandate may yet appear during investigation and enforcement.

Disclosure Trends

Anticipating the inevitable surge in Covid-19-related securities litigation, companies have moved quickly to revise and expand their disclosures with specific discussion of the pandemic's impact. There has been a trend among issuers to discuss Covid-19's effect in the management discussion and analysis (MD&A), the accounting policies accompanying their financial statements, risk factors, and Private Securities Litigation Reform Act (PSLRA) safe-harbor statements.

Companies have also provided disclosures regarding aspects of their business that they historically did not discuss. These disclosures—which often begin with a front and center discussion at the lead of issuers' latest 10-Q's—outline the impact of social distancing measures, government-imposed suspensions of business operations, changing social behaviors, and uncertainty and disruption to the global economy. They also stress that the resumption of "normal" economic activities will depend on a variety of factors well beyond their control, including the unilateral decisions of the U.S. and foreign governments.

For instance, in its most recent 10-Q, a large online retailer—which may be impacted less than most companies given its business model—updated its forward-looking statements to note that Covid-19 may magnify many of its already-disclosed risks, such as seasonality, inventory management and delivery. The retailer also disclosed, in its discussion of its financial statements and related risks, that the volatility of financial markets could contribute to defaults in accounts receivable, and included a lengthy discussion of how Covid-19 impacted first quarter operations and how it could create future potential disruptions.

For companies in harder-hit industries like travel, retail, and dining, disclosures have included even more detailed Covid-19 discussions in recent 10-Qs. In its Q1 2020 10-Q, an international airline included a lengthy discussion of Covid-19, noting that the virus and its related impact on travel, including shelter-in-place orders, the use of PPE, and other social distancing rules, have significantly reduced demand. The airline also included a detailed discussion on its financial condition as a result of the pandemic, outlining its reduced capital expenditures and assistance from the federal government under the CARES Act.

Similarly, a retail and consumer products company included a lengthy new Covid-19 discussion in its Q1 2020 10-Q, disclosing the approach the company is now taking with respect to its accounting, the benefits it would receive under the CARES Act, and new risks, such as interruptions to its supply chain and ability to collect receivables. This retail/consumer products company also updated its forward-looking statements, cautioning that future results may be significantly impacted because of Covid-19 related orders, rules, and related new voluntary behavior, as well as the potential for further outbreak.

Not surprisingly, issuers are also adding new risk factors in their Q1 10-Qs. These new risk factors cover a variety of topics, including general discussions about the pandemic and related economic conditions, potential lack of insurance coverage, efforts to preserve or obtain additional liquidity, and new debt and equity offerings. One large conglomerate, for instance, included two new Covid-19-related risk factors in its first quarter 10-Q—one specifically for pandemics and similar events, and another for generally unfavorable economic conditions flowing from the effects of Covid-19. Issuers have also made it a point to discuss the impact of Covid-19 during their earnings call. For instance, during its Q1 earnings call, a tech company executive included a lengthy statement on how the Covid-19 crisis was impacting the company's future outlook. In line with

many other issuers, the company declined to provide specific revenue guidance for its next quarter as a result of the continued uncertainty.

Indeed, quantitative, forward-looking disclosures are now a significant challenge for many companies. Like the tech company just discussed, many are withdrawing projections for the upcoming quarter, and some are even withdrawing projections for the year. As a result, issuers are now focusing on more qualitative disclosures, with candid discussions regarding lost customers, supply chain disruptions, payment delays from customers, and other business challenges arising from the crisis. These qualitative discussions can also be found in companies' management discussion and analysis, which now offer disclosure regarding the impact of Covid-19, such as measures to ensure employee safety, cash flow and liquidity management, and whether they are tapping into CARES Act funds. As these examples from bellwether companies in a variety of different industries make clear, the trend among blue-chip issuers has been to heed the SEC's call for increased—and specific—disclosures on the impact of the pandemic; and, to further limit any forward looking quantitative statements or guidance, until the future becomes more clear.

Lessons from the First Securities Class Action Filings

The first two securities class actions related to Covid-19 have already been filed: [Norwegian Cruise Lines](#) in Florida and [Inovio Pharmaceuticals Inc.](#) in Pennsylvania. Practitioners expect a surge of similar opportunistic coronavirus-related class actions, derivative suits, as well as related SEC investigations and enforcement actions. Public companies, in this environment, present an easy target for the plaintiffs' bar. While the Covid-19-induced economic crisis is unprecedented, the plaintiffs' bar has a well-worn playbook for event-driven securities litigation using Rule 10b-5 and Section 20(a) of the Exchange Act. Moreover, this civil litigation provides a trail of bread-crumbs that could serve to aid an SEC investigation.

For example, taken from the latest filing trend arising from the pandemic, all public companies that obtained a PPP loan can expect possible litigation. In addition, they should prepare for an SEC inquiry as it relates to disclosures in connection to the PPP, including alleged unfair competition in solicitation of PPP funds, representations made in the application, and the availability and use of such funds. This litigation signals that public companies must tread carefully when attempting to put any spin on the impact of Covid-19. To be sure, if there is even the slightest deception or appearance of covering up risk factors or exposure, the truth will come out and hit even harder than a forthright disclosure.

In addition to this litigation risk, there is also SEC enforcement risk, as the SEC continues its investigative mandate, as the economy has begun to re-open and despite lingering restrictions. In fact, the SEC enforcement division has noted that a task force had been assembled to investigate public company disclosure practices relative to their industry group peers as well as issues around valuation and impairments. The SEC also initiated a sweep, seeking information from companies that have received PPP funding and who are seeking forgiveness of the loans under the CARES Act. They are asking that these companies provide information establishing the registrant's qualifications to receive PPP funds, including the impact of Covid-19 on the business and its ability to continue as a going concern.

Avoiding Litigation Scrutiny Post-Covid-19

Amid the chaos and confusion caused by the pandemic, there is a greatly increased risk of fraud, predatory marketing, price gouging, and deception. The SEC Division of Enforcement and the Office of Compliance Inspections and Examinations have warned that they are actively monitoring markets for frauds, illicit schemes, and other misconduct affecting U.S. investors relating to Covid-19. Companies seeking to reduce the likelihood of scrutiny, including litigation, should continue to carefully consider: whether their public filings appropriately disclose coronavirus-related risks, and whether any future disclosures, announcing either positive or negative news about the company, accurately state how the issues related to Covid-19 have driven those results.

Previously issued guidance may also need to be revised or even cancelled. Indeed, a growing number of companies issued revised guidance and, as noted above, even withdrew or canceled earnings guidance for the foreseeable future. In this context, companies may feel it is better to disclose the bad news, allow the market to digest the company's current financial and operational position, in addition to forward looking risk and exposure, then hedge and risk civil litigation and even SEC scrutiny. Such augmented and robust disclosure regarding the impact of the Covid-19 pandemic is particularly critical given the trend of issuers to offer substantive discussion on how their businesses have been affected, and will continue to be affected. Issuers who make minimal efforts to refine and update their disclosures will be the outliers, and they will be the first targets for plaintiff-side security litigators.

Regardless, the next twelve months will likely see a spike in new securities litigation filings and potentially enforcement actions, arising from disclosures companies made, trying to assure shareholders and customers that Covid-19 will have a limited impact on their business, if any. Plaintiffs' securities litigators will be asking what did executives, officers, and directors know, when did they know it, what actions were taken or not taken, and was there any effort to downplay the impact of the virus, cover-up the downside risk, or deceive the public. The plaintiff's bar will also look to question whether the financial losses or operational disruptions which have surfaced in the Covid-19 crisis are evidence of pre-existing issues that were not adequately disclosed in historical filings.

The SEC staff will be asking similar questions, as they try to address investor losses, fraud in the market, and the predatory practices that are sure to emerge as a result of the chaos and confusion of the pandemic. The SEC will likely take a close look at revenue and expense recognition, as well as sham transactions that make no economic sense but are implemented to lower expenses or delay recognition. Another focus of the SEC may be misleading risk factors where companies use hypothetical phrasing such as "may" or "could" to create the false impression that a risk has not yet actually materialized. Meanwhile, the Department of Treasury announced there will be investigations into companies that issued false certifications in connection with obtaining PPP funds from the CARES Act. Public companies would be wise to assess their exposure and litigation risk and consider revising, withdrawing or canceling guidance, before the plaintiffs' bar and the SEC beat them to it.