

December 2020

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## *First of Its Kind – SEC Settles Charges Against Public Company for Misleading COVID-19 Related Disclosures*

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On December 4, 2020, the Securities and Exchange Commission announced the settlement of its first ever enforcement action against a public company for misleading COVID-19 related disclosures.<sup>1</sup> The SEC charges centered on alleged misrepresentations the company, a major restaurant operator, made in two press releases during the early days of the pandemic regarding how COVID-19 was impacting the company's business operations and financial condition. The SEC determined that the press releases—attached to Forms 8-K submitted to the SEC on March 23 and April 3, 2020—contained material misstatements and omissions which failed to adequately inform investors of the extent of COVID-19's negative impact on the company.

This enforcement action is important for a number of reasons. First, it is a "message" case from the SEC and suggests that the SEC Enforcement staff is likely to continue pursuing similar investigations and enforcement actions. Second, this action is a clear reminder of the importance of considering a principles-based approach when drafting public disclosures relating to the pandemic. Third, it suggests that the SEC may take an aggressive view when evaluating the materiality of an issuer's statement in similar investigations.

### **The Allegations Focused on Press Releases Made Near the Outset of the Pandemic**

The SEC's action focused on two press releases issued by the company during the early stages of the pandemic. Specifically, the SEC alleged that the company's March 23 and April 3 press releases, both of which were submitted to the SEC on Form 8-K, contained material misstatements regarding COVID's impact on the company's operations and financial condition during the late-March and early-April period. The SEC alleged the company's representation that its transition to a to-go/delivery restaurant model was enabling the company's restaurants to "operate sustainably at present" was misleading. In support, the SEC alleged that the statement did not disclose other information contained in internal corporate documents demonstrating that the company was excluding operational expenses from its claim of "sustainability," was losing approximately \$6 million per week, and had rapidly depleting cash reserves. The SEC further noted that the company separately shared information from the internal documents with private equity investors and lenders in connection with then-ongoing fundraising efforts.

The SEC also alleged that the March 23, 2020 disclosure wrongly omitted any reference to the company's March 18 letter to landlords notifying them that it intended to withhold April rent.<sup>2</sup> As a result, the SEC

alleged that the company's statement that it was "evaluating additional measures to further preserve financial flexibility" in its March 23 press release was misleading.

The SEC charged the company with violations of Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 thereunder, which collectively require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission accurate current reports on Form 8-K that contain material information necessary to make the required statements made in the reports not misleading. Without admitting to the findings in the SEC order, the company agreed to pay a \$125,000 penalty and to cease and desist from further violations of the charged provisions, a penalty which the SEC notes considered cooperation credit.

### **The Allegations Raise Questions about the SEC's Evaluation of Materiality**

The SEC's allegations raise significant questions as to how the SEC might evaluate materiality when considering similar COVID-related corporate disclosures. Materiality is often determined based on whether there is a substantial likelihood the disclosure of the omitted fact would significantly alter the total mix of information available to a reasonable investor. In other words, one must evaluate the alleged misstatement in context with other available facts in order to determine whether it was material.

Here, there is a credible argument that the statement concerning the company's ability to operate "sustainably" was not material. As an initial matter, the statement is somewhat vague. The term "sustainably" can carry a range of meanings, particularly in a volatile COVID-19 market environment. Moreover, it is clear that the company made additional disclosures at the time about its financial prospects and operations that shed light on its overall financial condition. Those other representations, including those that appear below, must be considered when evaluating the context of the alleged misstatement:

- The company "faced an unprecedented challenge to its business arising from the impact of the COVID-19 pandemic";
- The company was "withdrawing previously-issued financial guidance due to economic conditions caused by COVID-19";
- Both the March 23 and April 3, 2020 press releases disclosed that the company's restaurants were transitioning away from their traditional model to an "off-premise model" (*i.e.*, takeout and delivery); and
- The company drew down \$90 million on its revolving credit facility and was "evaluating additional measures to further preserve financial flexibility."

These statements suggest that the company's operational prospects were uncertain. In light of this greater context (and the general context of the pandemic at the time), the SEC's view of materiality seems aggressive. Additionally, the fact that the alleged misstatements occurred at the outset of the pandemic when many issuers were left scrambling as to how to address COVID issues—and that the company's disclosures were apparently evolving as the pandemic evolved—raises the question of why the SEC decided to use this action as an example to send a message to the market.

## Key Takeaways

- We expect the SEC to aggressively pursue COVID-19 related misstatements

The SEC's charging decision here highlights the SEC's scrutiny of COVID-19 related disclosures and signals similar enforcement actions down the road—including actions that reach statements made early in the pandemic where many companies were working to navigate the COVID-19 disclosure environment. As stated by Director of the Division of Enforcement Stephanie Avakin, "When public companies describe for investors the impact of COVID-19 on their business, they must speak accurately . . . the Enforcement Division, including the Coronavirus Steering Committee, will continue to scrutinize COVID-related disclosures to ensure that investors receive accurate, timely information, while also giving appropriate credit for prompt and substantial cooperation in investigations." We do not expect this stance to change with the transition to the new Administration. As such, companies should scrutinize their disclosures and not assume leniency in regulatory scrutiny simply due to the challenging circumstances created by the pandemic.

- Remain vigilant in ensuring clarity and completeness of disclosures

As demonstrated by this enforcement action, it is critical for companies to lessen potential areas of interpretive ambiguity in their disclosures, particularly when describing the financial impact of COVID-19. Here, the company may have held a bona fide belief that its restaurants were "operat[ing] sustainably"—and indeed the company remains operational to this day—but the SEC found that term misleading at the time of the disclosure in light of the undisclosed negative facts about the company's financial condition that painted a more complete, and arguably more negative, financial picture. Remember that any investigation will be judged with the benefit of hindsight, and forward looking information should be accompanied by meaningful cautionary language.

- Ensure that disclosure is made on a timely basis

The SEC's Division of Corporation Finance published its CF Disclosure Guidance Topic No. 9 relating to the Coronavirus<sup>3</sup> on March 25, 2020. While the March 23 statements predated this guidance, by April 3, the issuer should have been aware of the SEC's guidance. In particular, the SEC reiterated that "timely, robust and complete information is essential to functioning markets."

- Consider all available sources of information when developing disclosures

Here, the SEC specifically alleged that, while the company was publicly disclosing that its business was "operat[ing] sustainably," it was at the same time providing more detailed presentations to potential lenders and investors—which the SEC believed painted a more negative financial picture. In the same vein, the SEC alleged that the company was privately informing its landlords that it would not be paying its April rent, an undisclosed fact that the SEC found rendered the company's statements misleading. The SEC's explicit contrast between the public and private disclosures highlights the need to ensure consistency in the flow of information, whether it be to the public, to regulators, or to third parties. It also highlights the need to be extra vigilant in maintaining open lines of communication between corporate departments and divisions to ensure accurate disclosures are made.

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- <sup>1</sup> Order Instituting Cease-and-Desist Proceedings, Securities Exchange Act of 1934, Release No. 90565 (Dec. 4, 2020); Press Release, Securities and Exchange Commission (Dec. 4, 2020), available at <https://www.sec.gov/news/press-release/2020-306>.
  - <sup>2</sup> Following the media report, the company filed another 8-K stating that it was not planning to pay April rent and "it was in various stages of discussions with its landlords regarding ongoing rent obligations, including the potential deferral, abatement and/or restructuring of rent otherwise payable during the period of COVID-19 related closure." The same 8-K disclosure stated that the company had reduced compensation for certain personnel and had furloughed 41,000 employees.
  - <sup>3</sup> SEC Division of Corporate Finance, CF Disclosure Guidance: Topic No. 9 (Mar. 25, 2020), available at <https://www.sec.gov/corpfin/coronavirus-covid-19>.

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