

March 5, 2020

## Mitigating Securities Litigation Risks Related to the Coronavirus

Fears over the spread of the coronavirus (COVID-19) have significantly impacted the global economy and businesses' ability to manufacture, distribute and sell their products. These same fears have also caused the most severe US stock market decline since the beginning of the 2008 recession. As recent trends demonstrate, the plaintiffs' securities bar is likely to attempt to convert these (and potential future) drops into event-driven stock-drop litigation. This alert addresses the risks associated with stock-drop litigation related to COVID-19, and the steps companies can take to mitigate these risks, including updating their risk disclosures and financial guidance prior to the filing of their next periodic report.

Yesterday, the SEC expressly reminded "all companies to provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from [COVID-19] to the fullest extent practicable to keep investors and markets informed of material developments."<sup>1</sup> SEC Chairman Jay Clayton explained that the manner in which companies plan and respond to the virus can be "material" to an investment decision, and urged companies "to work with their audit committees and auditors to ensure that their financial reporting, auditing and review processes are as robust as practicable."<sup>2</sup> The SEC also emphasized that COVID-19 may affect companies beyond those that have significant operations in China or other jurisdictions affected by the virus. It may also affect companies that "depend on companies that do have operations in those jurisdictions, including, for example, as suppliers, distributors and/or customers."<sup>3</sup> (See also [SEC Reporting Companies: Considering the Impact of the Coronavirus on Public Disclosure and Other Obligations](#))<sup>4</sup>

### Potential Risks of Event-Driven Stock-Drop Litigation

The last few years have seen a dramatic increase in "event-driven" litigation. These cases follow a familiar pattern: plaintiffs' securities law firms identify public company stock drops resulting from major negative events and then file claims that are largely premised on the theory that the company did not adequately warn of the risk that has now materialized. Event-driven litigation can follow company-specific events such

<sup>1</sup> See <https://www.sec.gov/news/press-release/2020-53>.

<sup>2</sup> *Id.*

<sup>3</sup> See <https://www.sec.gov/news/public-statement/statement-audit-quality-china-2020-02-19>.

<sup>4</sup> An SEC order issued yesterday provides publicly traded companies with an additional 45 days to file certain disclosure reports that would otherwise have been due between March 1 and April 30, 2020, subject to certain conditions. See <https://www.sec.gov/rules/other/2020/34-88318.pdf>. The SEC has also encouraged companies to contact the SEC for guidance on reporting.

---

as data breaches or product failures, as well as larger cultural or societal developments such as the #MeToo movement or climate change. We expect a wave of stock-drop litigation and SEC enforcement actions relating to the business and market impacts of COVID-19.

The plaintiffs' securities bar may attempt to exploit stock drops related to COVID-19 by framing them as the materialization of a known but undisclosed risk that the company was under a duty to warn about. Here, even if plaintiffs cannot argue that a company or executive failed to predict the impact of COVID-19 *specifically*, they may argue that a company's past disclosures failed to adequately warn of the risks from an epidemic *like* COVID-19. This may be a particular concern for companies that experienced supply chain interruptions or customer losses from past global health crises emanating from the same region, like SARS. Additionally, the risk of incurring liability for a securities fraud lawsuit *in the future* may grow as news of the virus and our understanding of its impact continues to accumulate, particularly for companies that fail to address the risk of COVID-19 in a timely manner.

In addition to securities fraud liability, there is also a risk that companies will face stock-drop suits arising under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the '33 Act), which do not require a showing of fraudulent intent. Companies that anticipate issuing securities in the near future should give serious thought to whether COVID-19-specific risk disclosures might be appropriate. Several companies have recently delayed IPOs due to concerns arising from the virus and its impact on the markets. But this disclosure issue applies as well to secondary offerings, which are also the target of '33 Act claims.

We also expect plaintiffs' firms to invoke Regulation S-K in support of claims premised on misstatements and omissions relating to COVID-19-related risks. For example, Item 105 of Regulation S-K requires disclosure in the Risk Factor section of the "most significant factors that make an investment in the registrant or offering speculative or risky." And Item 303 of Regulation S-K requires disclosure in the MD&A section of "known trends or uncertainties" expected to have a "material" impact on "net sales or revenues or incomes." While it remains an open question under the law whether and to what extent these regulations confer duties upon companies that can be actionable in private securities litigation, this theory is often invoked by shareholders in class action litigation.<sup>5</sup>

To mitigate the risk of liability for either securities fraud or a violation of the '33 Act, companies should consider whether they have provided an appropriate level of transparency in their public disclosures into the expected impact of the virus on operations. Companies should consider whether their public filings

---

<sup>5</sup> Importantly, the SEC recently proposed updates to Regulation S-K that would lower the threshold to trigger a company's disclosure obligations. For example, the SEC has proposed changing Item 303 to require disclosure of known events that are "reasonably likely to cause"—as opposed to "will cause"—a material change in the relationship between costs and revenue. The SEC has similarly proposed changing the disclosure standard of Item 105 from the "most significant" factors to "material" factors that make investment in the registrant risky. These changes, if they take effect, may further encourage the plaintiffs' securities bar to pursue event-driven litigation.

appropriately disclose risks related to the virus, and exercise care with any public statements that concern areas of their business that may be affected by the virus, as many public companies have already taken steps to do. Companies should also consider whether their prior forward-looking guidance has been overtaken by subsequent events and should be updated. For example, disclosures about the various risks related to supply chain disruptions may benefit from updates describing any disruptions that are imminent or have actually come to pass. In another example, guidance may need to be revised if management believes that the virus has eroded the underlying assumptions in the prediction. In addition to enhancing the disclosures in scheduled periodic reports, companies should consider whether to provide enhanced or updated disclosures or guidance in an 8-K filing or 6-K submission.<sup>6</sup> More transparency may give the company better tools to defend any future claim of fraudulent intent or issuance of materially misleading statements or omissions. We expect the plaintiffs' bar to be hyper-aggressive in prosecuting these lawsuits.

### **Potential Risks of Derivative Lawsuits**

Plaintiffs may also repackage these theories under the derivative suit rubric. Shareholder plaintiffs may attempt to pin responsibility on a company's board of directors for any damages resulting from the company's response to COVID-19, whether by challenging the sufficiency of oversight over disclosures or business operations, or responses to red flags. Since these lawsuits can often be defeated by relying on a record of sound governance, including exercise of business judgment, boards may wish to consult with counsel about carefully documenting their consideration of, and response to, the impact of COVID-19 on their businesses, and consider establishing a public record of their diligence.

The human impact of COVID-19 has been significant and will continue to grow. The business and financial costs of this pandemic likely will be enormous. And we fully expect there to be follow-on litigation and regulatory activity. Reporting companies should take proactive steps to minimize the risk of regulatory investigations or private securities suits by carefully assessing the likely impact of the virus on their business operations and financial results and, if appropriate, updating their guidance and including COVID-19-specific risk disclosures in future filings. Companies' boards should thoughtfully document their consideration of, and response to, the virus.

We intend to closely monitor the legal and business implications associated with the global fallout from the COVID-19 outbreak, and will continue to report developments.

\* \* \*

---

<sup>6</sup> Notably, several large companies, including Apple, Microsoft, Levi Strauss, and Royal Caribbean Cruises, have already updated prior guidance to warn that disruption to supply chains or other aspects of their business could affect operating results. As of February 28, 2020, 606 companies had already mentioned COVID-19 as a risk factor in SEC filings, including, in some instances, in Form 8-Ks.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buerger  
+1-212-373-3553  
[sbuerger@paulweiss.com](mailto:sbuerger@paulweiss.com)

Andrew J. Ehrlich  
+1-212-373-3166  
[aehrich@paulweiss.com](mailto:aehrich@paulweiss.com)

Brad S. Karp  
+1-212-373-3316  
[bkarp@paulweiss.com](mailto:bkarp@paulweiss.com)

Daniel J. Kramer  
+1-212-373-3020  
[dkramer@paulweiss.com](mailto:dkramer@paulweiss.com)

Richard A. Rosen  
+1-212-373-3305  
[rrosen@paulweiss.com](mailto:rrosen@paulweiss.com)

Audra J. Soloway  
+1-212-373-3289  
[asoloway@paulweiss.com](mailto:asoloway@paulweiss.com)

*Associate Daniel Sinnreich contributed to this Client Alert.*