Covid-19 Creates New Risks Of Shareholder Litigation And Regulatory Actions

The impact of COVID-19 continues to evolve, yet we already have seen securities class actions and regulatory activity regarding the pandemic. As with previous economic downturns, we are likely to see a continuing rise in the number of securities class actions, stockholder derivative suits, and regulatory activity over company representations concerning the outbreak on a business's performance, the adequacy of risk disclosures of COVID-19 on the business, compliance with government required or recommended protocols, or the company's own policies, or mitigation efforts concerning the virus. These actions may be filed even long after the pandemic subsides when stockholders "discover" the basis for suit. As companies grapple with challenging decisions for their businesses, this remains a crucial time to remain vigilant and committed to fulsome public reporting addressing the current impacts of COVID-19 and expected continuing risks of the pandemic to the business, all the while adhering to corporate governance best practices in company decision making. Reviewing company insurance policies, indemnification, and advancement obligations also may be a prudent step for a complete picture of the company's risks.

Key Takeaways

- Public reporting. New guidance from the Securities and Exchange Commission ("SEC") counsels public companies to disclose the impact of COVID-19 on their current business status and financial condition, and the risks and impact of COVID-19 on future operations and finances. Companies should report details of the already known impacts on their business, such as revenues, or whether the company has received or applied for relief under the "Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"). To discuss the impact on future operations, companies should avail themselves of the safe harbor protections for forward-looking statements under the Private Securities Litigation Reform Act ("PSLRA"). Companies may start by examining current risk disclosures and consider if and how the pandemic has affected those risks. A hypothetical risk in a supply chain may have become turned into a reality, and has compelled the company to seek alternative sources, redesign products, or adapt other strategies. Companies also should consider any new risks posed by the pandemic and how those might uniquely affect them, such as retention of furloughed employees or training of new employees.

- Corporate Governance. In this extraordinary time as in any other time, companies should remain steadfast and embrace the best practices in corporate decision making. Board members should proactively engage with management about challenges posed by the pandemic and receive frequent reports and updates as those challenges evolve. In preparing to take action, board members should have a deliberative process to arrive at decisions in the best interests of the company that includes considering alternatives, consulting with management and reliable, outside consultants, and engaging in open discussions. Video conferencing, telephonic meetings, and other communications will enable companies to meet the new challenges in real-time. As always, corporate records should accurately reflect the decision making process.

- Flexibility. Companies need to be flexible and adapt to new regulations, news, and threats affecting the business as they adopt to cope with COVID-19. Federal, state, and local orders and recommendations affecting businesses have been rapidly changing and evolving; the pace will only increase as governments begin to relax shelter in place restrictions with new guidance on safe workplaces. Companies need to remain current

on those orders and recommendations, and consider any adjustments to existing policies and practices to ensure compliance. Companies may wish to establish working groups to rapidly digest new information and provide recommendations to senior management and the board for government regulations and other new or different threats. For example, cybersecurity threats for remote work are increasing, particularly, as more employees, customers, and partners use video conferencing. Based upon those new threats, companies should consider and ensure that other measures are taken to mitigate new threats, such as using security features to protect confidential information in video conferencing.

- A complete picture. To fully understand risks and obligations in event of regulatory action or lawsuits, companies may wish to review indemnity and advancement obligations, and insurance policies, including D&O policies, for coverage pertaining to possible COVID-19 related claims.

Fulsome Public Reporting To Minimize Securities Class Actions And Regulatory Actions Arising From COVID-19

As companies began to issue earning releases, on April 8, 2020, SEC Chairman Jay Clayton, encouraged companies to provide as much information as practicable about their current financial status and operations, and projected operations. Chairman Clayton stressed "high quality disclosures," including: "(1) where the company stands today, operationally and financially, (2) how the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and its customers, is progressing, and (3) how its operations and financial condition may change as all our efforts to fight COVID-19 progress." The Chairman recognized that prior results and historical information may have less significance to stockholders and public markets as companies cope with and develop their plans to move forward amid the pandemic. The Chairman's statement came on the heels of an advisory on April 3, 2020 from the SEC's Chief Accountant, Sagar Teotia, recommending high quality disclosures for accounting estimates and judgments affected by the pandemic.

Just a month earlier, on March 4, 2020, Chairman Clayton had reminded companies that they should "provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable to keep investors and markets informed of material developments." He reiterated that companies "providing forward-looking information in an effort to keep investors informed about material developments, including known trends or uncertainties regarding coronavirus, can take steps to avail themselves of the safe harbor in section 21E of the Exchange Act for forward-looking statements." Further, the SEC has long made clear that "its disclosure requirements can apply to a broad range of evolving business risks even in the absence of a specific line item requirement that names the particular risk presented[1]."

This will be an environment for SEC investigations, Financial Industry Regulatory Authority ("FINRA") inquiries, and possibly state level enforcement. Already, there has been an uptick in SEC activity, including suspending trading for a total of 20 companies so far, mostly over their respective public statements concerning COVID-19 testing and possible treatments. This regulatory scrutiny only stands to increase as companies issue earnings results and guidance.

With stock prices declining, officers, directors, and companies are certain to face stock drop securities lawsuits asserting that the company disseminated false or misleading information or omitted material facts on a company's performance, projections, and the potential impact of COVID-19. Indeed, the first suits for COVID-19-related securities fraud suits

[1] For example, the Commission has highlighted that although no existing disclosure requirement specifically refers to cybersecurity risks and cyber incidents, a number of requirements may impose an obligation on companies to disclose such risks and incidents. See Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release No. 33-10459 (Feb. 26, 2018), available at https://www.sec.gov/rules/interp/2018/33-10459.pdf.

under section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 have already been filed.

For example, in March 2020, Norwegian Cruise Lines received its first complaint challenging the company's statements concerning COVID-19 and the virus's effect on the cruise business. Just before the lawsuit, Norwegian had been offering various specials to encourage new cruise bookings despite the pandemic. According to the lawsuit, the company did not disclose to the public markets that those sales tactics included "unproven and/or blatantly false statements about COVID-19 to entice customers to purchase cruises" rendering the company's statements of business and operations false and misleading. As is often the situation for securities fraud suits, a second lawsuit has been filed, targeting Norwegian and its executives for "underplaying the danger of COVID-19" on the business, including in their statements about cruise bookings and revenues.

Also in March, a putative stockholder filed suit against Inovio Pharmaceuticals, Inc. and its CEO, J. Joseph Kim, questioning the CEO's ambitious plan to develop a COVID-19 vaccine "within three hours" and to start trials in April 2020. Inovio's shares soared within a few trading days upon the statements. On March 9, 2020, Citron Research, a purported short seller, went to Twitter encouraging the "SEC [to] immediately halt [the Company] stock and investigate the ludicrous and dangerous claim that they designed a vaccine in 3 hours. This has been a serial stock promotion for years. This will trade back to $2." In response to Citron's Tweet, Inovio's stock price plummeted by 71% (but the stock has rebounded upon news that Inovio is testing a possible COVID-19 vaccine). The putative stockholder filed suit shortly after the stock price dropped.

It is too early to predict the results of the Norwegian and Inovio lawsuits. The pandemic has reached far across the U.S., but it has not affected the significant protections against securities fraud lawsuits, ranging from the heightened pleading requirements of imposed by the PSLRA and rule 9(b) of the Federal Rules of Civil Procedure, original jurisdiction in federal courts, and the stringent requirements for loss causation and other elements of such claims.

To avoid the crosshairs of regulatory action and securities suits, companies should continue to diligently and thoughtfully manage their earnings releases and other public statements. Based upon Chairman Clayton's guidance, a company should disclose the obvious impacts the pandemic already has had on the company – revenues, offices or other location shut downs, employees furloughs, layoffs, or working from home, customers and partners changing orders or plans, and impacts on necessary suppliers and vendors. A company should also disclose if it has received or applied for loans or other relief under the CARES Act. These are difficult, but identifiable details.

In assessing the future impacts of the pandemic, the company should avail itself of the safe harbor for forward-looking statements referenced by Chairman Clayton in disclosing the additional risks presented by the pandemic and the impact upon future operations. That will involve considering the impact of the pandemic upon a company's suppliers, employees, customers, and others; undoubtedly, these are the same considerations companies are undertaking to deal with the pandemic. As a starting point, a company should review its existing risk disclosures and, then, consider how a particular risk is heightened or altered by the pandemic. For example, a manufacturer may normally discuss threats to its supply chain as a risk disclosure, but that risk may become more palatable if one of its suppliers has already cut production or the supplies of raw materials necessary for production are from an area heavily affected by the pandemic. A company also should evaluate new risks posed by the pandemic. Most companies face new considerations for employees, ranging from expenses of enhanced safety protocols (sanitation, new workplace configurations, possibly different employee shifts, and the like), to challenges of retaining furloughed employees or hiring and training new employees to fill the void for furloughed employees who do not return, or challenges of employees tasked with caring for their children while schools and daycare are not in session. These new challenges are common to many companies, but the risks and impacts to each business will be unique.

Deliberative Decision Making To Avoid Stockholder Derivative Litigation Arising From COVID-19

The COVID-19 outbreak also brings new risks of stockholder derivative suits against officers, directors, and their companies as the plaintiff's bar examines companies' responses to the pandemic. While public companies face securities fraud suits, derivative suits may target public and privately held companies for their response to COVID-19. Companies may have a heightened risk where there is an existing dispute or disgruntled stockholder, who may look to benefit from the pandemic. Often times the first sign of an impending derivative action is a stockholder's written demand to inspect the company's records to investigate purported wrongdoing.

Derivative suits may question the board or company's decision making in developing policies and practices in compliance with evolving health requirements and guidelines, particularly if there is a loss stemming from a COVID-19 closure of an essential business that could possibly have been prevented, or infections jeopardizing employees or the public traced to a company facility. With many businesses seeking loans and other relief under the CARES Act, the failure to use the loan properly or unforgiven indebtedness could become a possible area for derivative suits. Litigation with major customers and suppliers for non-performance and business interruptions may spawn derivative litigation, particularly if a company's losses are attributable to a lack of protection from force majeure clauses.

Other areas for derivative suits abound. A failure to implement a sufficient infrastructure for remote workers could also expose directors and officers to liability for cyberattacks and/or loss of critical company data, particularly if a company continues using technology for video conferencing or remote data access with known security risks. Other suits are possible if a company favors certain related or interested party vendors or contract partners. Adverse regulatory action may also beget piggy-back stockholder actions.

With derivative lawsuits, there are procedural safeguards, including a pre-suit demand upon the company's board of directors to investigate claimed wrongdoing, or requirement for a plaintiff to allege in a complaint why such a demand is excused. There may also be opportunities for independent directors to form a special litigation committee wrest control of the lawsuit away from a stockholder. The business judgment rule and other substantive defenses are formidable in many instances.

As companies continue to deal with the pandemic, they should continue to follow best practices for their corporate governance to address the evolving challenges and take appropriate actions in the best interest of their companies. The board of directors should be proactive in engaging management about the impacts of the pandemic on the business and future operations, and receive frequent updates on operations and new risks and challenges as they arise. As a board considers taking actions, its members should actively deliberate on the benefits of a proposed action and consider alternatives, and consult with management and other relevant advisors, including counsel. Board agendas, minutes and other contemporaneous materials should reflect this deliberative process, and ultimately record the reasons why the board believed an action was in the best interests of the company. For example, as some government and public health officials begin to announce new directives to re-open businesses, a company should consider how to implement those directives in a safe, responsible manner for its particular business.

Because the challenges to businesses are evolving, companies will need to remain flexible to adapt to new regulations or recommendations from government authorities, and new marketplace challenging to business operations. Companies should make use of readily available technology to make real-time decisions. Companies also may wish to task specific working groups to address particular areas, such as public health compliance, and make recommendations to management and the board.

D&O Insurance Coverage For COVID-19-Related Lawsuits And Regulatory Action

Mounting procedural and substantive defenses to stockholder suits, or responding to regulatory action, can impose significant financial burdens on businesses, beyond the impact of COVID-19. D&O insurance policies offer protection from defense costs and settlements when a company's directors and executives are named as defendants in stockholder claims or are the subjects of certain regulatory action. Public company policies tend to provide extensive coverage for securities class actions and derivative suits, and many policies also cover costs of an investigation into a stockholder's pre-suit demand for a derivative action. As with all insurance policies, it is important t to review the actual policies and consider the potential types of claims a particular company or industry may experience.

D&O policies offer coverage based upon the type of claim, such as one alleging fraud or breach of fiduciary, and the plaintiff or adversary, such as a non-employee stockholder. These policies often exclude coverage where one insured sues another insured. The so-called "insured v. insured" exclusion only applies in narrow circumstances, usually for closely held companies where the plaintiff is an officer or director and sues the company or its other insureds.

D&O policies do not generally contain "communicable disease" exclusions that are sometimes found in commercial liability policies. For example, a company might face a customer claim over the company's interrupted or non-performance due to COVID-19, but commercial liability coverage may be unavailable due to a communicable disease exclusion. However, a stockholder may file a related claim, alleging that any losses from the original customer claim are attributable to mismanagement, and D&O coverage often will be available to defend this second claim. Coverage under these policies will vary depending on the nature of the claim and the individual terms and conditions of the policy.

D&O policies often have bodily injury exclusions. Yet, in practice, those exclusions generally are limited to situations where a director or officer directly caused a bodily injury to a plaintiff. Stockholders filing securities or derivative suits have claims for economic losses – not for their own bodily injuries – and thus D&O policies cover such claims even where the alleged underlying conduct may have caused bodily injury to customers or others.

In addition to these limitations, many D&O insurance policies also include various "conduct exclusions" that exclude coverage for certain misconduct by the insured, including deliberate fraud, dishonesty, and willful violations of the law. The language of these exclusions becomes more important if the basis of the lawsuit is a company's response to the risks or impact of COVID-19. The language of the conduct exclusion should also be reviewed to determine whether its application requires a final adjudication exhausted by appeal or only "in fact" confirmation of such conduct.

As more companies and their directors and officers turn to their D&O insurance policies for coverage for claims arising from COVID-19, D&O carriers may try to limit coverage by adding warranty statements and/or new exclusions for new policies, or by interpreting existing exclusions to exclude certain COVID-19 claims. This will be a developing area, likely for years to come as companies renew their policies.

Indemnification and Advancement For COVID-19-Related Lawsuits

Indemnification or advancement may also be available to officers and directors for defense costs associated with stockholders suits or regulatory action related to COVID-19. Company bylaws or governing documents often require a company to fully indemnify and advance defense costs for those officers and directors sued for their actions undertaken in their corporate capacities, consistent with corporate law. The scope of the obligation often varies amongst privately held companies. Whether a director or officer has a right to advancement or indemnification depends on the statutes governing the business and the company's charter and bylaws. D&O policies often pay those costs, subject to the policies applicable retention.

Remaining Vigilant

In light of these risks, companies should remain committed to corporate governance and public reporting best practices, which may feel cumbersome but are the first and often times the best defense to litigation. Companies should review their insurance policies and organizational documents to understand their coverage and potential obligations for COVID-19 related claims. While the scope of coverage will depend upon the specific terms of each insurance policy, a number of policies will cover the types of COVID-19 claims that companies may experience.

Please feel free to reach out to us with any questions you have about any of the above issues.

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