WINSTON & STRAWN LLP

WEBINAR

Stock Price Nosedives: Securities Litigation and Enforcement in COVID-Churned Markets

June 22, 2020

Overview of Topics

- COVID-19's Impact on Federal Securities Class Actions
  - Recent Filings
  - Defense Considerations
- Loss Causation Defenses and Damages Mitigation Based on Resulting Market Volatility
- SEC's Response to COVID-19 Pandemic
- Implications for Accountant and Auditor Liability

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COVID-19’s Impact on Federal Securities Class Actions

COVID-19 Federal Securities Trends

- Notable increase in securities case filings
  - 50% year-over-year increase for April according to Lex Machina
    - Some filings are expressly related to COVID, while others are not
      - Q1 2020: 77 filings referenced COVID
      - Q2 2020: 76 filings referenced COVID (through June 1)

  - Securities class actions are outstripped only by filings in product liability cases

Securities Litigation in the COVID-19 Era

- Class actions related to the pandemic have generally involved allegations that the company made misstatements or omissions ***either***:

  - Downplaying the negative impacts on business
    - *E.g.:*
      - *Norwegian Cruise Lines*
      - *Carnival Cruise Lines*
      - *Elanco*
      - *Phoenix Tree*

Securities Litigation in COVID-19 Era (cont.)

- ***Or*** overstating an anticipated upside business opportunity (pharmaceutical/healthcare products/technology). *E.g.*:
  - *Inovio Pharmaceuticals, Inc.*
  - *Sorrento Therapeutics*
  - *Praxsyn Corp.*
  - *SCWorx Corp.*
  - *Chembio Diagnostics*
  - *Co-Diagnostics Inc.*

- Other COVID-19-related securities litigation filings of note
  - *iAnthus*
  - *Zoom*

SEC Encourages COVID-Related Disclosures

- Views reflected in SEC Division of Corporation Finance Disclosure Guidance, Topic No. 9 (Mar. 25, 2020)
  - "The Division encourages disclosure that is tailored and provides material information about the impact of COVID-19 to investors and market participants"
  - "We also encourage companies to provide disclosures that allow investors to evaluate the current and expected impact of COVID-19 through the eyes of management, and that companies proactively revise and update disclosures as facts and circumstances change"

Defense Considerations

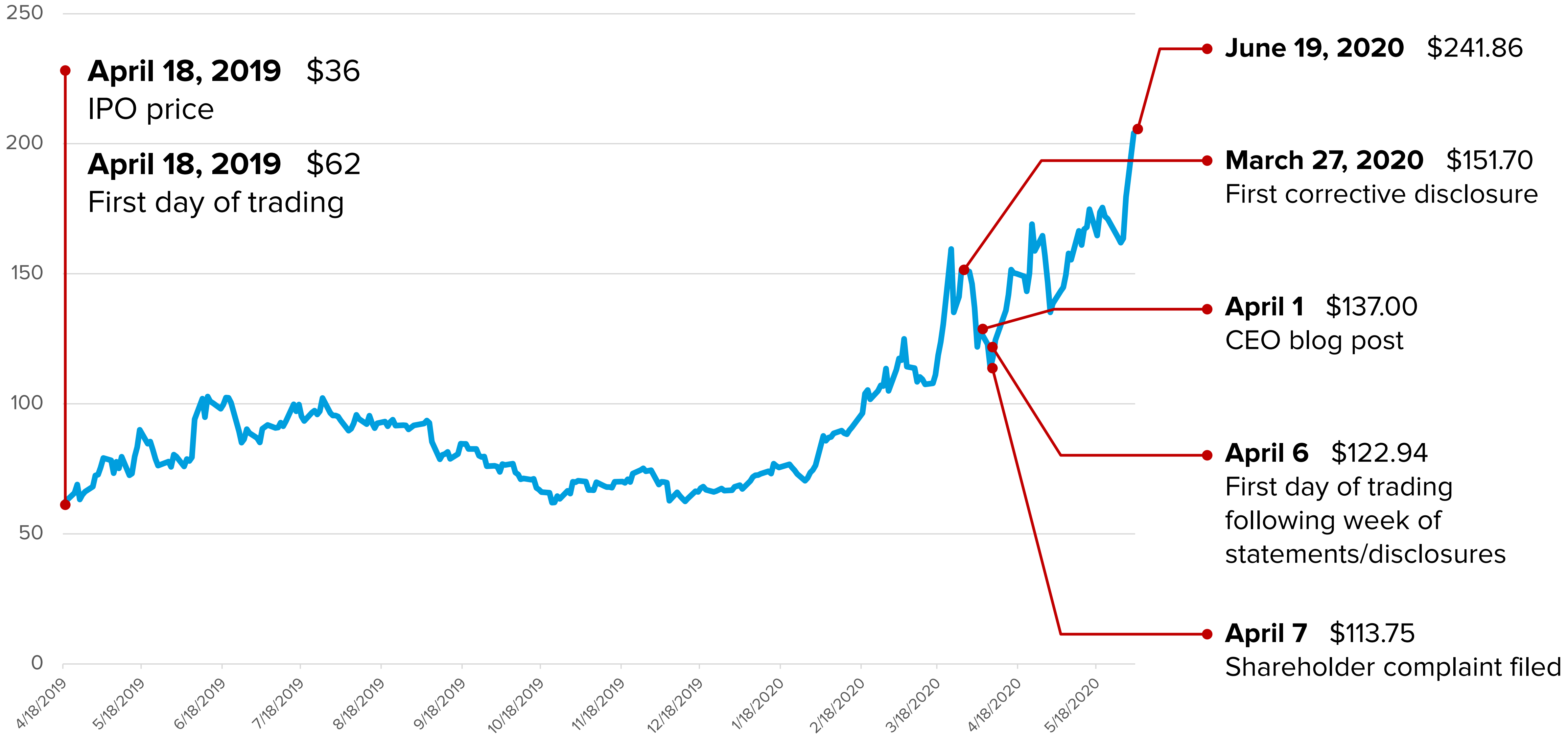
- Safe harbors for forward-looking statements
- Statements of opinion
  - *Omnicare*
- Scienter
- Loss causation and damages

PSLRA's 90-Day "Bounce-back" Rule

- Limits plaintiff's damages to the difference between purchase price and mean trading price of the security during the 90 days following a corrective disclosure (or, if the plaintiff sells before the 90 days, the mean trading price between the corrective disclosure and the date the plaintiff sold).

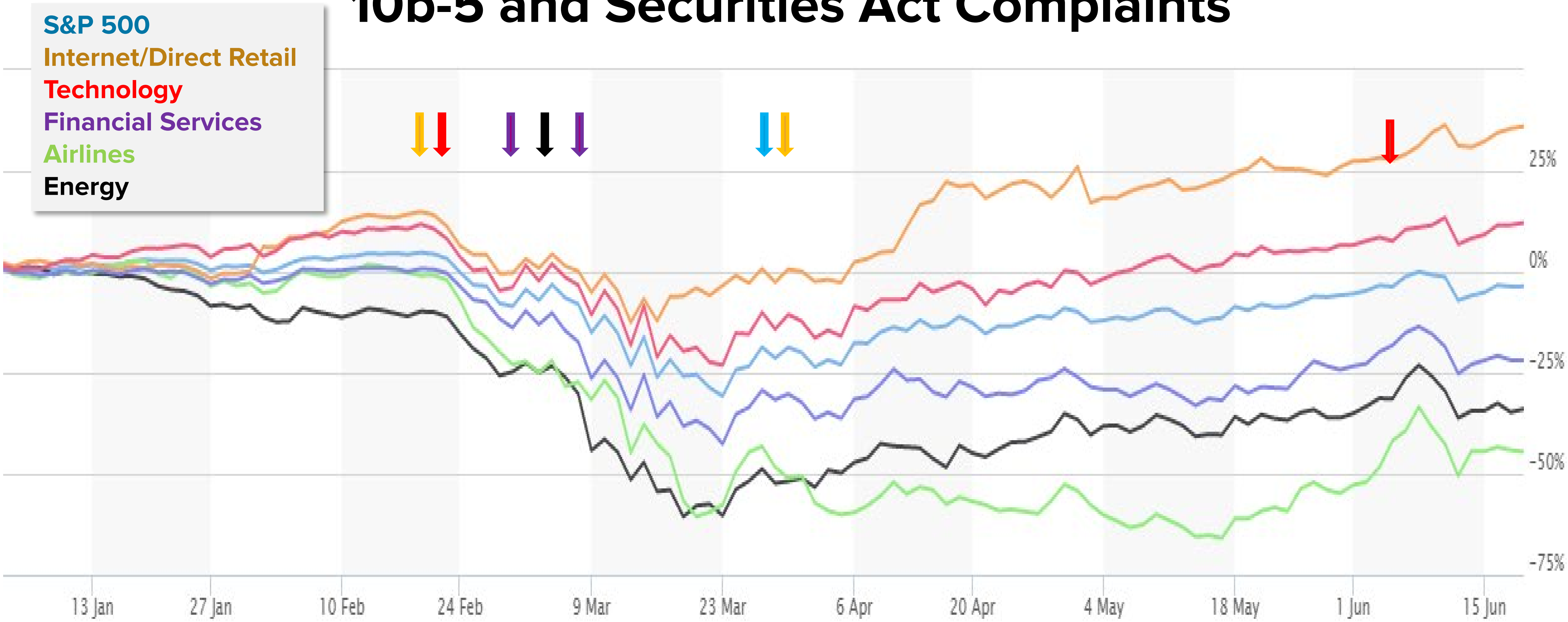
- Acts as rescissory cap on out-of-pocket damages by allowing the security an opportunity to recover.

Zoom Video Communications, Inc. (ZM)



Loss Causation Defenses and Damages Mitigation Based on COVID-19 Market Volatility

Alleged Corrective Disclosures in Recent 10b-5 and Securities Act Complaints



"Loss causation is a fact-based inquiry and the degree of difficulty in pleading will be affected by circumstances."
***Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 174 (2d Cir. 2005).**

Loss Causation as a "Fact-Based" Inquiry?

- "If the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation … is a matter of proof at trial …." *Lentell*, 396 F.3d at 174; *see also McCabe v. Ernst & Young, LLP*, 494 F.3d 418, 427 n.4 (3d Cir. 2007) (loss causation is "highly factual" and "becomes more critical at the proof stage").
- PSLRA imposes on 10b-5 plaintiffs the burden of proving loss causation, 15 U.S.C. § 78u–4(b)(4).
  - Potential "negative causation" defense in Securities Act claims.
- *Dura Pharms.* requires pleading of "the relevant economic loss" and "causal connection" between "that loss and the misrepresentation" under Rule 8—i.e., satisfaction of the fact-based plausibility standard.

Two Facets of Loss Causation: (1) Revelation; and (2) Disaggregation

- *Dura Pharms.*: Non-fraud factors can affect price: "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."
  - The resulting two facets of loss causation: (1) revelation of the "truth"; and (2) disaggregation of non-fraud causes. Both should be required to satisfy the Court's cautionary instruction that the federal securities laws are not intended to "provide investors with broad insurance against market losses …."
- Courts have generally emphasized the alleged reveal—a correction or materialization of risk—with less emphasis on disaggregation.
  - *Compare Lattanzio v. Deloitte & Touche LLP,* 476 F.3d 147, 158 (2d Cir. 2007) (complaint failed to "allege[] facts that would allow a factfinder to ascribe some rough proportion of the whole loss to" the alleged fraud) *with Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC*, 797 F.3d 160, 189 (2d Cir. 2015) ("While Plaintiffs did not plead that the alleged fraud caused their losses *independently* of the larger financial events of 2007 and 2008, they were not required to do so under our precedents.").

Taking Disaggregation Seriously in the Aftermath of a Major Event

- *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 568 F. Supp. 2d 349 (S.D.N.Y. 2008) ("the Complaint does not assert facts that distinguish between the alleged fraud and the market-wide collapse of Internet stocks as the cause of Ventura's losses")
- *Fulton Bank, N.A. v. UBS Sec., LLC*, 2011 WL 5386376 (E.D. Pa. Nov. 7, 2011) ("intervening macroeconomic phenomena, namely, a decrease in ARS demand ultimately stemming from a global credit crisis, which had its roots in the subprime mortgage crisis")
- *Cent. States v. Fed. Home Loan Mortg. Corp.,* 543 F. App'x 72 (2d Cir. 2013) ("the housing bubble bust")
- *City of Westland Police & Fire Ret. Sys. v. MetLife, Inc.*, 129 F. Supp. 3d 48 (S.D.N.Y. 2015) (S&P downgrade of U.S. credit rating)

Alleged Corrections of Pre-COVID Statements in the Post-COVID World

"The loss causation inquiry typically examines how directly the subject of the [omission] caused the loss, ... while also taking into account issues such as the presence of intervening causes and the lapse of time between the behavior complained of and the loss." *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001).

Securities and Exchange Commission’s Response to the COVID-19 Pandemic

SEC's Orders and Guidance Regarding the COVID-19 Pandemic

- Public Company Filing Relief: SEC extends Exchange Act filing deadlines
  - March orders providing for 45-day extension to file certain Exchange Act filings otherwise due between March 1 and July 1, 2020
  - Conditions:
    - Registrant unable to meet a filing deadline due to circumstances related to COVID-19
    - File Form 8-K or Form 6-K stating, among other things:
      - (1) a brief description of the reasons why it could not file the report on a timely basis;
      - (2) the estimated date by which the report is expected to be filed; and
      - (3) a company-specific risk factor or factors explaining the impact, if material, of COVID-19 on its business

SEC's Orders and Guidance Regarding the COVID-19 Pandemic

- Division of Corporation Finance Disclosure Guidance, Topic No. 9 (March 25, 2020)
  - Provides guidance to evaluate impact of pandemic on business operations and whether separate disclosures are warranted.
    - How has COVID-19 impacted financial condition and results of operations? How might COVID-19 impact future operating results and near- and-long-term financial condition?
    - How has COVID-19 impacted capital and financial resources, including overall liquidity position and outlook? Ability to meet covenants in credit agreements?
    - How will COVID-19 affect assets on balance sheet and ability to timely account for those assets (e.g., fair value determinations)?
    - Assess possibility of material impairments (e.g., with respect to goodwill, intangible assets), increases in allowances for credit losses, restructuring charges, or changes in estimates.
    - Assess impact of remote workplace on internal controls.
    - Assess impact of COVID-19 on demand for products and on supply chain.

SEC's Orders and Guidance Regarding the COVID-19 Pandemic

- Disclosure changes to MD&A, risk factors, business description, notes to financial statements, among other sections
- Consider the need to disclose known trends and uncertainties as they relate to ability to:
  - Service debt or other financial obligations
  - Access debt markets, including commercial paper or other short-term financing arrangements
  - Maturity mismatches between borrowing sources and the assets funded by those sources
  - Changes in the valuation of collateral
  - Counterparty or customer risk

SEC's Orders and Guidance Regarding the COVID-19 Pandemic

- Insider trading considerations
  - Refrain from trading prior to dissemination of material non-public information related to COVID-19.
- Non-GAAP Considerations
  - If a final GAAP financial measure is unavailable at time of earnings release because measure may be impacted by COVID-19-related adjustments, companies can reconcile a non-GAAP financial measure to preliminary GAAP results.
  - A non-GAAP financial measure should not be disclosed more prominently than the most directly comparable GAAP financial measure or range of GAAP measures.
  - Companies should reconcile to GAAP results in 10-K and 10-Q filings.

SEC's Orders and Guidance Regarding the COVID-19 Pandemic

- April 8, 2020 SEC Statement on Importance of Disclosure
  - Company disclosures should reflect (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.
    - Provide as much detailed information as possible regarding future operating conditions/resource needs. SEC recognizes this is challenging because response strategies are likely to change.
    - Companies should avail themselves of the safe harbors for forward-looking statements.

SEC Trading Suspensions

- Trading Suspensions, Procedurally
  - Federal securities laws permit the regulator to suspend trading for any stock for up to 10 business days, typically because of lack of information about the issuer, questionable trading activity for the security, or questions about accuracy of issuer's statements.
  - SEC Enforcement recommended trading suspensions related to COVID over accuracy of:
    - Statements about manufacture/sale of test kits
    - Development of virus treatments/vaccines
    - Production/sale of PPE
  - Trading suspensions <u>not</u> enforcement action and <u>not</u> finding of wrongdoing, but can lead to SEC investigations and enforcement actions.

SEC Trading Suspensions Related to COVID-19

- Sample Trading Suspensions
  - Since February, SEC temporarily suspended trading in more than 30 securities due to concerns about virus-related statements from issuers.
    - February 7: Aethlon Medical Inc. – concerns about claims from third-party promoters about the viability of a product to treat the coronavirus
    - February 24: Eastgate Biotech Corp. – concerns over statements about company's purported marketing rights to an approved treatment for COVID
    - March 25: Zoom Technologies – concerns about adequacy and accuracy of publicly-available information concerning its financial condition, confusion with Zoom Video Communications
    - March 25: Praxsyn Corporation – concerns about statements regarding Praxsyn having large quantities of N95 masks

SEC Trading Suspensions Related to COVID-19

- Sample Trading Suspensions (cont.)
  - April 23: Decision Diagnostics Corp. – concerns about statements including claims to have technology to manufacture and sell COVID test kits that would provide results "in 15 seconds, based on a small finger prick blood sample"
  - April 30: Nano Magic Inc. – concerns about statements claiming the Company has a patent for a disinfectant that kills "coronavirus" and the Company's involvement in the fight against COVID
  - May 1: Moleculin Biotech, Inc., CNS Pharmaceuticals Inc., WPD Pharmaceuticals, Inc. – concerns about statements regarding status of development of a drug for potential application to COVID, and the ability to expedite regulatory approval of treatment
  - May 5: Custom Protection Services, Inc. – concerns about statements regarding development of screening solutions for COVID and its estimate that it would earn gross revenue from new contracts for the screening solutions of $10,000 per day
  - May 26: Micron Waste Technologies Inc. – concerns about claim to have acquired Covid Technologies Inc. and the acquisition's ability to manufacture PPE to meet global needs

SEC Enforcement Actions in COVID-19 Environment

- Enforcement actions generally begin as investigations
  - SEC inquiry
  - Evidence gathering and analysis
  - Pre-Wells and Wells process
  - SEC approves/rejects enforcement recommendation
  - Parties settle or SEC files litigated action (federal court or administrative proceeding)
- Investigations and enforcement actions occurring on accelerated basis due to COVID
  - In many cases, Enforcement division continues to investigate after trading suspensions to determine whether issue engaged in fraud or other misconduct
  - Spike in COVID-19-related tips, complaints and referrals, many of which are leading to new investigations

SEC Enforcement Actions Related to COVID-19

- Recent COVID-Related Enforcement Actions
  - Praxsyn Corporation (April 28, 2020, S.D. Fla.)
    - March 25: Trading suspended over concerns about statements that Company had large quantities of N95 masks
    - April 28: SEC filed lawsuit alleging fraud
  - Turbo Global Partners, Inc. (May 14, 2020, M.D. Fla.)
    - April 9: Trading suspended over concerns about statements of Company's entry into an agreement to be an exclusive U.S. distributor of temperature screening and facial recognition technology and the Company's ability to quickly ship technology to customers
    - May 14: SEC filed lawsuit alleging fraud against Company and CEO
      - Complaint alleges that Company had no agreement to sell equipment, there were misrepresentations regarding partnerships with governmental entities, and there were inaccuracies about technology
      - SEC seeking civil money penalties and an officer/director bar for CEO

SEC Enforcement Actions Related to COVID-19

- Recent COVID-Related Enforcement Actions (cont.)
  - Applied BioSciences Corp. (May 14, 2020, S.D.N.Y.)
    - April 13: Trading suspended over concerns about statements regarding Company’s sale of coronavirus test kits for home use
    - May 14: SEC filed lawsuit alleging fraud against Company
      - Complaint alleges Company’s test kits not intended for home use and were not authorized by the FDA
      - SEC seeking civil money penalties
  - Microcap Fraud Scheme (June 9, 2020, D. Mass.)
    - Trading suspended in four offshore entities from January to May 2020 over concerns about accuracy of statements about entities’ stock
    - June 9: SEC filed lawsuit against five individuals and six offshore entities
      - Complaint alleges illegal stock sales were boosted by promotional campaigns that, in some instances, included false and misleading information designed to capitalize on COVID pandemic
      - SEC seeking injunctions, disgorgement, civil money penalties, and penny stock bars

Implications of COVID-19 Pandemic on Accountant and Auditor Liability

Impact of Pandemic on Accountant and Auditor Liability

- Pandemic presents potential challenges to and constraints on auditors
  - Access to company personnel
  - Delays by management in responding to auditor inquiries
  - Changes to audit execution: inability of auditors to be on site at company
  - Need to obtain new types of audit evidence
- Changes to planned audit strategy and audit risks
  - Business has changed, so need to relearn the business
  - Use heightened professional skepticism when evaluating reasonableness of companies' estimates
  - Increased risk of fraud: pressure to meet earnings or covenants
  - Increased opportunities for misappropriation of assets due to weaker internal controls

Impact of Pandemic on Accountant and Auditor Liability

- Accounting and audit areas of focus due to COVID:
  - Non-recurring expenses: what expenses are being deducted as COVID-related?
  - Late adjustments
  - Changes to internal controls (impact of remote workplace)
  - Management estimates, including goodwill and asset impairment
  - Going concern considerations
- COVID-19 may impact what constitutes a Critical Audit Matter (CAM)
  - COVID may not be a CAM, but may be a principal consideration in the auditor's determination as to whether one or more CAMs exist

Impact of Pandemic on Accountant and Auditor Liability

- Likelihood for increased auditor litigation resulting from:
  - Challenges to companies' use of estimates and judgment
  - Scrutiny over auditors' identification of CAMs
  - Alleged liability for companies' COVID-related misrepresentations
  - Failure to identify going concern considerations

Thank You!

Speakers

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