

SEC Brings First Enforcement Action Against a Public Company for Misleading Disclosures About the Financial Impacts of the Pandemic

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On December 4, 2020, the Securities and Exchange Commission (“SEC”) announced its first enforcement action against a public company for misleading disclosures about the financial effects of the pandemic on the company’s business operations and financial condition. In a settled administrative order, the Commission found that disclosures in two press releases by The Cheesecake Factory Incorporated violated Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 thereunder. Without admitting the findings in the order, the company agreed to pay a \$125,000 penalty and to cease-and-desist from further violations.^[1] In March 2020, the SEC’s Division of Enforcement formed a Coronavirus Steering Committee to oversee the Division’s efforts to actively look for Covid-related misconduct.

The Company’s Form 8-Ks

On March 23, 2020, the company furnished a Form 8-K to the Commission, disclosing, among other things, that it was withdrawing previously-issued financial guidance due to economic conditions caused by Covid-19. As an exhibit to the Form-8-K, the company included a copy of its press release providing a business update regarding the impact of Covid-19. The press release announced that the company was transitioning to an “off-premise” model (*i.e.*, to-go and delivery) that would enable the company to continue to “operate sustainably.” This press release did not elaborate on what “sustainably” meant. The release also disclosed a \$90 million draw down on the company’s revolving credit facility, and stated that the company was “evaluating additional measures to further preserve financial flexibility.”

On March 27, 2020, in response to media reports, the company filed another Form 8-K, disclosing that it was not planning to pay rent in April and that it was in discussion with landlords regarding its rent obligations, including abatement and potential deferral. The company also disclosed that as of April 1, it had reduced compensation for executive officers, its Board of Directors, and certain employees, and that it furloughed approximately 41,000 employees.

On April 3, 2020, the company furnished another Form 8-K to the Commission that attached a copy of an April 2, 2020 press release. This press release provided a preliminary Q1 2020 sales update, which reflected the impact of Covid-19. The release stated that “the restaurants are operating sustainably at present under this [off-premise] model.”

The SEC found that the March 23 and April 3 Form 8-Ks – but not the March 27 Form 8-K – were materially misleading.

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What the Company Did Not Disclose

The company's disclosures on March 23 and April 3 did not disclose:

1. a March 18, 2020 letter from the company to its restaurants' landlords stating that it was not going to pay its rent for April 2020;
2. that the company was losing \$6 million in cash per week;
3. that it had only approximately 16 weeks of cash remaining even after the \$90 million revolving credit facility borrowing; and
4. that it was excluding expenses attributable to corporate operations from its claim of sustainability.

The SEC's Findings

The SEC found that the company's March 23 and April 3, 2020 Forms 8-K were materially false and misleading in violation of Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 thereunder. These sections require that every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission accurate and current information on its Form 8-K, including material information necessary to make the required statements made in the reports not misleading.

Observations and Takeaways

Although this is the first enforcement action against a public company based on disclosures about the financial effects of the pandemic, the findings against the company are fairly unusual.

Two observations:

- First, the SEC's order focuses on two press releases included as exhibits in Form 8-Ks that are deemed to be "furnished," and not "filed," under the Exchange Act. Specifically, one was filed under Item 7.01 and the other under Item 2.02. Because these Form 8-Ks are not deemed to be "filed" for purposes of Section 18 of the Exchange Act, there is no private right of action under Section 18 that can arise in connection with these Form 8-Ks. So, although "furnishing" reports results in lower liability exposure, it does not mean that the SEC cannot take enforcement action if it believes the disclosure is misleading.
- Second, the language at issue in the two Form 8-Ks is the word of the moment, "sustainably," as in "operating sustainably." It should be noted that, nine months after the disclosures were made, the company remains in business (and did not file for bankruptcy) and, in fact, as of the close of trading on December 4, 2020, its stock price closed near the high of the 52-week range. The concept of sustainability is generally thought to encompass the concept of over the long- or longer term, so it is not self-evident that these disclosures were materially misleading.

Some takeaways:

- In using the word "sustainably" without further qualification or explanation, issuers run the risk of being misunderstood. Sustainably in what sense (as a synonym for liquidity?) or to which degree? Over what period of time? It is not self-evident what sustainability entails.
- Where the subject matter involves the impact of Covid, the Commission's order certainly demonstrates its willingness to take action even if, at worst, the disclosure at issue is vague or unclear. This was not a case in which the company claimed it had no liquidity issues when, in fact, it was experiencing significant liquidity issues.

Put another way, this case raises the question as to whether Covid disclosures are attracting greater scrutiny than other corporate disclosures in the current climate.

- To state the obvious, the Commission brought this action for a reason: to underscore the importance of carefully drafted disclosures with respect to the impact of Covid on issuers' results of operations, financial condition and liquidity; and to signal its willingness to take action if issuers' Covid-related disclosures are not carefully drafted. A quote from the SEC Chair in the press release announcing this action is a further indication of the importance the SEC is placing on this area of enforcement.^[2]

[1] Order Instituting Cease-and-Desist Proceedings, Securities Exchange Act of 1934 Release No. 90565 at 4 (Dec. 4, 2020).

[2] Press Release, Securities and Exchange Commission, SEC Charges The Cheesecake Factory For Misleading COVID-19 Disclosures (Dec. 4, 2020), available at <https://www.sec.gov/news/press-release/2020-306>.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work in the firm's Securities Enforcement or Securities Regulation and Corporate Governance practice groups, or the following authors:

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