Professional Perspective

Securities Litigation Trends During Covid-19

Blair Connelly, Colleen Smith, and Cindy Guan, Latham & Watkins

Securities Litigation Trends During Covid-19

Contributed by Blair Connelly, Colleen Smith, and Cindy Guan, Latham & Watkins

Many predicted a wave of securities litigation would follow the stock market plunge during the early days of the pandemic in March 2020, just as it did in the wake of the 2008 economic downturn. But in the months since the onset of pandemic-related economic hardship, only a few cases have been pursued by private plaintiffs, with a roughly equal number of enforcement actions filed by the U.S. Securities & Exchange Commission.

The trend in shareholder litigation is beginning to shift. We are now seeing an uptick in claims challenging public statements made regarding protective measures and financial condition. The SEC has encouraged companies to keep shareholders informed about Covid-19 developments relevant to their businesses throughout the crisis. While this guidance is meant to improve transparency, public companies should not overlook the risk of future shareholder litigation as they adjust to new restrictions on business operations, implement new workplace safety measures, and attempt to best position themselves for success in a period of virtually unprecedented economic uncertainty.

In this article, we examine current securities litigation uniquely associated with the pandemic, predict litigation risks and trends going forward, and offer a summary of best practices for avoiding them.

Securities Litigation Trends

Statements Regarding Purportedly Concealed Risks

In the early days of the coronavirus outbreak, some shareholder firms indicated an intent to focus litigation on companies who relied on misrepresentations to increase share prices, rather than pursue claims based on insufficient risk disclosures prior to the pandemic. At first, this prediction seemed fairly accurate. Early cases seemed relatively unique and focused largely on the cruise industry. Various shareholder lawsuits filed against two large cruise companies are currently pending in federal court in the Southern District of Florida. One of the earliest-filed Covid-19 cases was brought by shareholders against Norwegian Cruise Line for releasing allegedly misleading statements about the threats the virus posed to its business in particular and the cruise industry in general.

News reports later published the company's internal emails, which plaintiffs contend reflect an aggressive sales campaign in response to the pandemic, after which Norwegian's share prices fell dramatically. Starting in late May, shareholders of another cruise operator, Carnival Corporation, commenced similar lawsuits when Carnival's share prices dropped upon the publication of reports that Carnival allegedly concealed its early knowledge of the threats Covid-19 posed to passengers' safety. The allegations against Carnival also assert that the company violated port call regulations and its own health and safety protocols by continuing operations during the pandemic.

Another relatively unique fact pattern is presented in a case against a real estate investment trust, Geo Group, Inc., after multiple Covid-19 outbreaks occurred in Geo Group-operated halfway homes. There, shareholders alleged that the trust made omissions and misstatements regarding the effectiveness and diligence of its Covd-19 response procedures.

Recently, however, there has been an uptick in complaints alleging insufficient risk disclosures regarding Covid-19's impact on operational and financial prospects. These actions have targeted entities including Forescout Technologies, United States Oil Fund, ProShares Trust II/ProShare Capital Management II, and Velocity Financial, and have challenged these companies' statements about the pandemic's potential impact on their respective businesses and industries. These dozen or so cases, while still in the early stages, may be the "test cases" in which courts evaluate the sufficiency of corporate disclosures regarding the expected impact of the pandemic and associated economic conditions on a company or the industry in which it operates.

Statements Regarding Pandemic-Related Treatments or Services

Shareholder Complaints. Many cases have been brought over the last several months focusing on companies that are alleged to have made misleading statements about highly sought after products and treatments designed to address the pandemic. For example, shareholders of Inovio Pharmaceuticals, Sorrento Therapeutics, Chembio Diagnostics, and Vaxart sued the corporations after their statements regarding the companies' developments of a vaccine or cure for Covid-19 were reported false.

Government Complaints. Both the SEC and the U.S. Department of Justice have also been active in this area. In April, the SEC brought an enforcement action against Praxsyn Corporation and its CEO, alleging that the substantial uptick in company share prices was caused by false assertions that Praxsyn had negotiated agreements to buy and sell N95 masks. Shortly thereafter, the SEC commenced two lawsuits against other companies for releasing false statements about the availability and efficacy of Covid-19 supplies, such as testing kits, hand sanitizers, and thermal imaging equipment used to detect individuals with fevers in large crowds. In early June, the SEC indicated its willingness to also target individual defendants. In two separate "pump and dump" complaints filed against individuals, the SEC alleged that the defendants misrepresented investor responses and investment opportunities in order to inflate share prices and dump stock over a short period.

The DOJ has been less active in this realm, but in early June, it filed the first-ever criminal securities action regarding the Covid-19 pandemic against Mark Schena, the president of medical technology company Arrayit Corporation. In its complaint, the DOJ alleged that Schena committed securities and healthcare fraud by, among other things, misrepresenting Arrayit's ability to provide accurate, fast, reliable, and cheap Covid-19 tests in compliance with applicable regulations; inflating Covid-19 test sales numbers by bundling them with allergy tests regardless of medical necessity; and misleading investors about Arrayit's Covid-19 testing capability and future prospects.

Derivative Matters

As of September 2020, there has been a number of derivative cases filed challenging director conduct in fulfilling their fiduciary duties during the pandemic. They include cases filed against Inovio Pharmaceuticals, SCWorx, Chembio Diagnostics, Vaxart, Co-Diagnostics, and United States Oil Funds. They all involve alleged breaches of fiduciary duties stemming from the associated securities class action cases already discussed.

Directors should, however, be mindful of recent Delaware caselaw interpreting the duty of oversight. In *Caremark*, the Delaware Supreme Court recognized that corporate directors have a duty to exercise good faith oversight of key corporate functions. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (1996). To state a *Caremark* claim based on alleged breach of these duties, a shareholder must allege that the directors utterly failed to implement any reporting system or controls, or having implemented such controls, that they consciously failed to monitor or oversee the operation of those controls, rendering them unable to identify risks or problems requiring their attention.

Until recently, *Caremark* was considered an exceedingly high standard to meet, and nearly all such claims failed at the pleading stages. In the past year, however, courts have begun to more carefully examine such claims, relying on a pair of cases—*Marchand* and *Clovis*. *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *In re Clovis Oncology, Inc. Deriv. Litig.*, 2019 BL 373697 (Del. Ch. Oct. 1, 2019).

In *Marchand*, which involved director oversight of food safety issues for Blue Bell Creameries, the court found the shareholders' allegations of improper oversight sufficient because they supported an absence of a system or documentation of board-level oversight of an issue the court deemed key to the business. And in *Clovis*, the court observed that "when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised."

While the alleged facts in both of these cases were somewhat unique, taken together, they provide a framework that some plaintiff shareholders may point to if they are disappointed with a company's response to particular risk areas associated with the pandemic. In the meantime, directors would be well advised to ensure that they have identified the key risk areas for the company and the industry in which it operates, that there is a robust system of management reporting and controls for these risk areas, and that adherence to and execution on these oversight mechanisms is documented in corporate board minutes and as otherwise appropriate.

SEC Guidance

On April 8, 2020, the SEC issued a public statement, reminding public companies of the importance of disclosure as they issue earnings releases and conduct investor calls. In that statement, the SEC urged companies "to provide as much information as is practicable regarding their current financial and operating status, as well as their future operational and financial planning."

The SEC Division of Corporate Finance issued similar guidance on March 25 and again on June 23, 2020, regarding Covid-19 disclosures, instructing companies to provide “as much information as is practicable regarding their current financial and operating status, as well as future operational and financial planning.” This can include: “transition to telework; supply chain and distribution adjustments; and suspending or modifying certain operations to comply with health and safety guidelines to protect employees, contractors, and customers.” Companies are urged to “[p]roactively revise and update disclosures as facts and circumstances change,” and to explain operational changes that have taken place since the pandemic. The SEC staff has indicated that they would not expect to second-guess good faith attempts to provide appropriately framed forward-looking information.

Conclusion

We are starting to see claims against companies that fail to predict how the ongoing pandemic and uncertain regulatory and economic environment will impact their businesses. As companies heed the SEC's advice and disclose hardships to shareholders, plaintiffs will likely point to any optimistic statements that companies could “weather the storm” as materially false or misleading attempts to buoy stock prices in the midst of crisis. Because public company directors and executives do not have a proverbial crystal ball, there is no way to guarantee immunity from such shareholder lawsuits. But adherence to usual good disclosure practices, including robust risk disclosures, should be continued. Implementation, monitoring, and adherence to oversight mechanisms for key risk areas likewise should not be overlooked.

With assistance from Alison Boaz and Devon Diggs