Coronavirus Implications For Securities Litigation

The coronavirus disease known as COVID-19 and a related oil price war have delivered a one-two punch to global markets, sending stocks plunging in the largest point fall ever for major indices. As of March 27, 2020, the Dow Jones Industrial Average had dropped more than 7,914 points (over 26%) in a matter of weeks, and the future of any investment remains uncertain.

Hundreds of public companies have already issued statements about the effect of COVID-19 on their earnings and other business metrics, and many have downgraded prior forecasts as COVID-19 spreads and yet more customers, supply chains, and work environments are affected.

Where markets crash, litigation follows. We anticipate an increase in securities litigation, driven by COVID-19-related losses, in the coming months and years. Although the spread of COVID-19 is an unusual and unexpected event, the usual legal standards for securities litigation will apply. Thus, although only a handful of such cases have been filed at this early stage of the outbreak, SEC guidance and existing caselaw provide insight into the types of securities cases we expect to see in the future.

I. What Guidance Has The SEC Provided That Is Relevant To COVID-19 Litigation?

Earlier this month, SEC Chairman Jay Clayton reminded companies that disclosures relating to COVID-19-related risks could be material to investment decisions, and stated that businesses should provide investors with insight regarding their "assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus."[1] Relevant information might include reliance upon suppliers, customers, or employees located in affected areas, along with known trends or uncertainties relating to COVID-19.[2] The SEC's guidance further stated that issuers should consider whether it was necessary to "revisit, refresh, or update previous disclosure to the extent that the information becomes materially inaccurate," and indicated that issuers providing updates regarding COVID-19 should "take steps to avail themselves of the safe harbor in Section 21E of the Exchange Act for this information."[3]

It is easy to see how the failure to follow the SEC's recent instructions could result in a securities claim. For example, an issuer that reaffirmed guidance without disclosing the risks to its business from COVID-19 would be vulnerable to a lawsuit if it later reported disappointing earnings due in any part to the virus.[4] Even

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[1] SEC Provides Conditional Regulatory Relief and Assistance for Companies Affected by the Coronavirus Disease 2019 (COVID-19), U.S. Securities & Exchange Commission (Mar. 4, 2020), *available at* https://www.sec.gov/news/press-release/2020-53

[2] *See* Item 303 of SEC Regulation S-K (requiring disclosure of "any known trends or uncertainties … that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations"). Notably, on January 30 the SEC proposed updates to Regulation S-K that, if adopted, would require disclosure of known events "reasonably likely to cause" a material change in a registrant's financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources, thus lowering the current standard of disclosing known events that "will cause" such a change.

[3] *Id.*

[4] *See, e.g.*, *Plymouth Cty. Ret. Ass'n v. Advisory Bd. Co.*, 370 F. Supp. 3d 60, 89 (D.D.C. 2019) (ruling that reaffirmation of guidance was materially misleading where corporate event "made it more likely that

if the issuer did not reaffirm, its failure to withdraw prior guidance might trigger litigation. Although no federal statute or regulation imposes a duty to update forward-looking statements, courts in multiple jurisdictions have ruled that, depending on the circumstances, including whether subsequent events render an existing forward statement misleading, an update may be required. In particular, if the statement has "a forward intent and connotation upon which parties may be expected to rely" (in the First Circuit)[5] or "contains some factual representation that remains 'alive' in the minds of investors" (in the Second, Third and Eleventh Circuits),[6] it is likely a court will rule that an update should have been provided. Thus, many large companies, including Apple Inc. and Microsoft Corp., have already updated prior guidance to warn that disruptions to their businesses may affect results. Similarly, other companies have modified or discontinued the practice of disclosing expected 2020 earnings in their year-end reporting. In an example of one such modification, United Airlines Holdings Inc. recently rescinded its annual revenue guidance for 2020, saying the effects of COVID-19 were too unpredictable to ensure that the forecast would be accurate. A diverse array of companies, including Nordstrom Inc., H&R Block, and Ford Motor Co., have made similar announcements in recent days.

Even companies that withdraw guidance and warn merely that COVID-19 *might* affect results could face securities liability, because "[a] generic warning of a risk will not suffice when undisclosed facts on the ground would substantially affect a reasonable investor's calculations of probability."[7] Thus, if the risks to a company's business from COVID-19 have already materialized, a company would likely face a securities suit if it discloses those risks as merely hypothetical.[8]

II. What Kinds Of COVID-19-Related Securities Cases Can Be Expected?

We anticipate an increase in COVID-19-related securities litigation within at least four categories: (a) defective products and overstatements of position; (b) materialization of known but undisclosed risks related to the virus; (c) data breaches; and (d) Blue Sky and Securities Act claims.[9]

[Defendant] would ultimately underperform guidance" even though "Defendants may not have been able to quantify the . . . impact" at the time they reaffirmed the guidance.).

5 *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990).

6 *Finnerty v. Steifel Labs, Inc.*, 756 F.3d 1310 (11th Cir. 2014); *In re IBM Corp. Secs. Litig.*, 163 F.3d 102 (2d Cir. 1998); *In re Burlington Coat Factory Secs. Litig.*, 115 F.3d 1410 (3d Cir. 1997).

7 *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245, 251 (2d Cir. 2014); *but see re Plains All Am. Pipeline, LP Sec. Litig.*, 307 F. Supp. 3d 583, 621, 626 (S.D. Tex. 2018), *aff'd*, 777 Fed. App'x 726 (5th Cir. 2019) ("generalized, top-level statements" about a company are generally not actionable).

8 *See In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 400 (S.D.N.Y. 2005) ("[T]o caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit.") (internal citation and quotations omitted).

9 In the event a company is served with a securities class action, its first steps should include confirming whether it has D&O insurance coverage and informing its carrier of the lawsuit. For more information on D&O coverage, see Quinn Emanuel's recent article, Insurance Coverage Questions Amid CVOID-19 Outbreak, available at https://www.quinnemanuel.com/the-firm/publications/covid-19-insurance-questions/#page=0&byNewsType.

a. Defective Products And Overstatements Of Position

As the pandemic moves forward, certain companies, such as those in the medical, telework, and delivery industries, may claim they are particularly well-positioned to weather the outbreak. History tells us these companies will be susceptible to securities class actions if there are any indications their products are defective or the businesses have overstated their ability to confront the pandemic. For example, in one case stemming from an outbreak of Ebola, a manufacturer was forced to defend a securities lawsuit after it allegedly failed to disclose that the surgical gowns it touted as safe for the Ebola crisis were defective.[10] In another case, a putative securities class action—which resulted in a seven-figure settlement—the complaint alleged that a company falsely claimed it was involved in developing an Ebola vaccine.[11] Notably, one of the two COVID-19-related securities class actions plaintiffs have filed so far is likewise premised on allegations that a company falsely "claim[ed] unequivocally that the company had successfully developed a vaccine against the spread of COVID-19 and that it anticipated rapidly bringing that vaccine to market."[12] Purportedly, once a third party exposed these claims as misstatements, calling for an SEC investigation into the "ludicrous and dangerous claim that they designed a [COVID-19] vaccine in 3 hours," the company's stock price plunged from its March 9 opening price of $19.36 per share to $5.70.[13] Companies that publicly state they have developed products to combat the virus must ensure those products exist and that there is factual support for the claimed efficacy.

b. Materialization Of Known But Undisclosed Risks Related To The Virus

History suggests we will also see an increase in securities fraud litigation that is tangentially related to COVID-19. These cases will focus on companies that have suffered material stock price declines, and many will allege that the virus resulted in the materialization of a known but undisclosed risk about which the company had a duty to warn investors, such as the risk from epidemics generally, or from reliance on vulnerable supply chains, markets, customers, or geographic areas. For example, plaintiffs have previously stated claims for violations of the federal securities laws based on allegations that a company made ambiguous statements suggesting it had engaged multiple contract manufacturers to produce its products when in fact it had hired just one, which subsequently "experience[ed] difficulties" in the manufacturing process.[14] Here, we can expect similar claims if a company's primary supplier or customer is impacted by COVID-19 and the company failed to disclose the extent to which it relied on that supplier or customer.

Indeed, one of the two COVID-19-related securities class actions plaintiffs have filed so far is likewise premised on purportedly misleading statements in connection with virus-related risks to customers. Shareholders filed suit against a cruise line and certain of its officers and directors alleging that—although company publicly disclosed that the "spread of the COVID-19 coronavirus, particularly in North America,

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[10] *Jackson v. Halyard Health, Inc.*, 2018 WL 1621539, at *4, *8 (S.D.N.Y. March 30, 2018)(dismissing action for lack of scienter where desire "to take advantage of the Ebola pandemic scare" was insufficient to allege motive), *leave to amend denied*, *Jackson v. Avanos Medical, Inc.*, 2019 WL 1437517, at *4 (S.D.N.Y. March 31, 2019) (denying leave despite additional proposed allegations of scienter, including that "presentations [regarding compliance failures] were presented to 'senior management'"), *appeal filed* May 1, 2019.

[11] *Varapu v. iBio, Inc.,* Case No. 14-1344 (D. Del. Dec. 18, 2015) (Stipulation and Agreement of Settlement).

[12] *McDermid v. Inovio Pharmaceuticals, Inc., et. al.*, Case No. 2:20-01402 (E.D. Pa. March 12, 2020) ¶ 15.

[13] *Id.* ¶ 6.

[14] *Karth v. Keryx Biopharmaceuticals, Inc.,* 2018 WL 3518497 (D. Mass. July 19, 2018); *See also* Subpart 229.100 of SEC Regulation S-K (issuer must set forth the "[t]he name of any customer and its relationship, if any, with the registrant or its subsidiaries … if sales to the customer by one or more segments are made in an aggregate amount equal to 10 percent or more of the registrant's consolidated revenues").

could exacerbate its effect on us"—this and other statements were false or misleading in light of various undisclosed facts, including declining sales and an alleged campaign to lie to potential customers about the dangers of the virus.[15] According to the lawsuit, when the truth about the company's sales and tactics were revealed to the market, shares fell by 35.8%.[16] Thus, businesses that claim to have insulated their operations from the effects of the virus must have factual support for the claimed insulation, and the statement that a company has not experienced a decline in customer demand probably cannot safely be made without qualification if there are signs of declining demand.

c. Data Breaches

As companies increasingly require or suggest that employees work from home and move their businesses online, there is an increased risk of data breaches.[17] This too can result in securities litigation (as well as consumer litigation). For example, Equifax was sued for securities fraud following the its high-profile data breach.[18] The Equifax securities case recently resulted in a $149 million settlement.[19] Given the size of that settlement, any company touting the efficacy of its cybersecurity or its ability to operate remotely will likely face a securities suit in the event that it suffers a material breach.

d. Blue Sky and Securities Act Cases

In addition to 10(b) securities fraud actions, investors are likely to bring stock-drop suits when possible under state Blue Sky laws and Sections 11 and 12(a)(2) of the Securities Act of 1933, which do not require a showing of fraudulent intent or loss causation (although the absence of loss causation may be an affirmative defense for certain of these claims).[20] Companies that anticipate new offerings of securities in the coming months should closely evaluate their disclosures that may relate to COVID-19-related risks, including any public statements that concern areas of their businesses that may be affected by, or vulnerable to the effects of, the virus.

III. Will The COVID-19 Securities Actions Be Successful?

The success of the expected securities lawsuits will depend on a number of factors. First, plaintiffs will need to prove scienter for any actions alleging securities fraud. Under the Private Securities Litigation Reform Act, a 10(b) action must plead a "strong inference of scienter" that must be more than merely "reasonable" or

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15 *Douglas v. Norwegian Cruise Lines, Ltd., et al.*, Case No. 1:20-21107 (S.D. Fla. March 12, 2020).

16 *Id.*

17 *See* Cyber Risk Implications of the Coronavirus Outbreak, AON, *available at* https://www.aon.com/getmedia/fc789882-0d2c-4ed9-bfdb-1a5d22cf274f/Cyber-Risk-Implications-Of-The-Coronavirus-Outbreak-COVID.aspx.

18 *In re Equifax Inc. Sec. Litig.*, 357 F. Supp. 3d 1189, 1205 (N.D. Ga. 2019).

19 *In re Equifax Inc. Sec. Litig.*, Case No. 17-034063 (N.D. Ga. Feb. 13, 2020) (Stipulation and Agreement of Settlement).

20 Although plaintiffs may be unable to bring state Blue Sky claims on a class-wide basis due to the Securities Litigation Uniform Standards Act, which prohibits "covered class actions" alleging misrepresentations in connection with the purchase or sale of securities from bringing claims under state or common law, 15 U.S.C. § 78bb(f)(1)(A), "[t]he Act does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist," *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 87 (2006).

"permissible."[21] The allegation must be "cogent and compelling" "and at least as compelling as any plausible opposing inference."[22] Plaintiffs asserting claims based on forward-looking statements will likely need to show that such statements were made with "actual knowledge" of falsity, as opposed to with "recklessness."[23] These points have proven difficult to allege in similar cases. For example, in *Jackson v. Halyard Health, Inc.*, in which a plaintiff claimed that a business failed to disclose that its surgical gowns were defective, the court ruled that the complaint failed adequately to plead scienter, because—despite stating that there were independent studies confirming flaws in the company's surgical gowns—the complaint did not provide sufficient allegations that the individual defendants were aware of those reports.[24] Here too, it may be difficult to plead that defendants were aware of the falsity of any alleged misstatements, whether related to the safety of the company's medical products, disruptions connected to key customers or suppliers, or otherwise. However, officers and directors should not attempt to insulate themselves from knowledge of potentially negative reports about the effect of COVID-19, lest they face liability for failing to fulfill their fiduciary duties to the company. As the Delaware Supreme Court recently confirmed in *Marchand v. Barnhill*, a fiduciary must confront and address issues that, like the virus, are "intrinsically critical to [a] company's business operation."[25]

Second, defendants in fraud, Securities Act, and Blue Sky cases will likely attempt to seek refuge in the claim that projections and other forward-looking statements that were frustrated by fallout from COVID-19 were opinions rather than facts. However, this assertion may not provide a complete defense if the companies failed to provide an adequate basis for the underlying projections or other statements of opinion. For example, in the well-known *Omnicare* decision, an issuer that had engaged in unlawful practices had stated in its disclosures that it "believe[d]" various conduct was in compliance with federal and state laws.[26] The Supreme Court recognized in the ensuing securities litigation that the statement was an "opinion," subject to a lesser standard of liability than a statement of fact, but remanded for further proceedings to determine whether the issuer had omitted material facts about how it had formed its belief.[27] These would include whether the issuer had adequately investigated the matter or recognized that there were serious questions about its conduct.[28]

Similarly here, lawsuits focused on disclosures about business risks and opportunities related to COVID-19 that ultimately resulted in underperformance are likely to examine whether companies conducted adequate diligence about their reliance on vulnerable supply chains, specific geographic areas or products, or other virus-related matters before making related disclosures to investors. Thus, although an issuer would not have been expected to have predicted the COVID-19 outbreak itself, the issuer would likely have needed to have disclosed whether a material portion of its business might falter under the pressures of an event like an

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21 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 310 (2007).

22 *Id.*

23 *Slayton v. Am. Exp. Co.*, 604 F.3d 758, 773 (2d Cir. 2010) ("Moreover, because the safe harbor specifies an 'actual knowledge' standard for forward-looking statements, 'the scienter requirement for forward-looking statements is stricter than for statements of current fact. Whereas liability for the latter requires a showing of either knowing falsity or recklessness, liability for the former attaches only upon proof of knowing falsity.'").

24 *Jackson v. Halyard Health, Inc.*, 2018 WL 1621539, at *8 (S.D.N.Y. Mar. 30, 2018) (finding allegations of scienter insufficient were plaintiffs failed to "specifically plead facts demonstrating or supporting plausibly an inference that [any of the individual defendants] was personally informed or would reasonably have been informed about any alleged issues with the MicroCool gowns, their failure to meet industry standards, or the ability of the manufacturing process to be validated to ensure it complied with AAMI Level 4 criteria.").

25 212 A.3d 805, 821-22 (Del. 2019).

26 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 575 U.S. 175, 182-83 (2015).

27 *Id.* at 182-97.

28 *Id.*

outbreak, whether in the form of geopolitical disruptions centered around critical just-in-time suppliers, on a particular type of consumer spending, or otherwise.[29] The company would also need to have investigated the factual basis for any claims it made relating to COVID-19 itself. For example, if a company publicly touted that it had taken steps to insulate itself and its customers from the effects of the outbreak, it would need to have examined and disclosed the factual support for the claimed insulation, or risk the allegation that the statements were materially misleading. Courts have regularly ruled that where such disclosures are both "specific and tailored," they render estimates and forward-looking statements non-actionable.[30]

As may be obvious, any historical facts the company did disclose in support of its opinions would need to be true. For example, if the company stated it had developed a product to combat the virus, that product would need to exist and there would have to be factual support for the claim that it was effective. Similarly, if the company claimed it had not yet experienced a decline in customer demand as a result of COVID-19, that statement would need to be true, and probably could not safely be made without qualification if there were signs of declining demand.

As in other areas, selective disclosures will not satisfy the required standard. For example, the Supreme Court has made clear that plaintiffs may state a claim under Rule 10b-5 when a company fails to disclose reports it has received about adverse effects associated with its products (even where no statistically significant association between the products and the effects is shown).[31] Numerous other cases likewise caution that generic warnings of risks will not suffice when undisclosed facts would substantially affect a reasonable investor's calculations of probability."[32] With respect to COVID-19, for example, a disclosure about business exposure to China that omits risks relating to other regions to which the virus has spread or is expected to spread, such as Europe or the United States, probably would be vulnerable under the relevant standards. Similarly, generic warnings of potential risks relating to COVID-19 might be considered false or misleading if not accompanied by descriptions of related adverse facts of which a company was aware. For example, generic statements that COVID-19 might have an adverse effect on a business might be considered misleading if a company failed to disclose that its sales were, in fact, already softening.

Finally, securities fraud lawsuits arising from market downturns in response to COVID-19 may be vulnerable to the challenge that plaintiffs cannot show the required element of loss causation, which requires proof that the investor's losses were caused by the company's alleged misconduct and not by an unforeseeable

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[29] *See* Subpart 229.100 of SEC Regulation S-K (issuer must set forth the "[t]he name of any customer and its relationship, if any, with the registrant or its subsidiaries … if sales to the customer by one or more segments are made in an aggregate amount equal to 10 percent or more of the registrant's consolidated revenues"); *Karth v. Keryx Biopharmaceuticals, Inc.*, 2018 WL 3518497 (D. Mass. July 19, 2018) (plaintiffs stated claim where defendants had made ambiguous, misleading statements regarding the number of manufacturers with which they had contracted, and production from the actual sole manufacturer was subsequently disrupted).

[30] *Paradise Wire & Cable Defined Benefit Pension Plan v. Weil*, 918 F.3d 312, 322 (4th Cir. 2019)(statements were not actionable where, among other things, issuer disclosed "a page and a half of context including specific and tailored cautionary language regarding the estimates").

[31] *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 30-31 (2011).

[32] *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) ("Cautionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired."); *see also Meyer v. Jinkosolar Holdings*, 761 F.3d 245, 251 (2d Cir. 2014) (vacating dismissal of action and ruling that although the issuer had disclosed a "financial risk to the company from environmental violations, the failure to disclose then-ongoing and serious pollution violations would cause a reasonable investor to make an overly optimistic assessment of the risk"); *In re Hi-Crush Partners L.P. Sec. Litig.*, 2013 WL 6233561, at *14 (S.D.N.Y. Dec. 2, 2013) (omissions regarding the deterioration of a relationship with a business partner were actionable because the issuer continued to tout that relationship).

crisis itself. In this context, the Supreme Court has ruled that there may be a "tangle of factors affecting price," thus signaling that investors must show that their loss was caused by the alleged misstatements themselves, not by an unexpected event.[33] This issue has been litigated frequently in cases stemming from the 2008 financial crisis, in which defendants often claimed that outside economic forces, and not fraud, caused investors' losses. The Second Circuit has interpreted the element of loss causation to require investors to "disaggregate those losses caused by 'changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events from disclosures of the truth behind the alleged misstatements."[34] However, as litigation stemming from the 2008 financial crisis confirms, it is difficult for defendants dispose of an action on the pleadings based upon this defense; rather, courts have found that allegations providing at least "some indication of the loss and the causal connection that the plaintiff has in mind" are sufficient to withstand a motion to dismiss.[35] Thus, defendants who rely heavily upon the absence of loss causation in COVID-19-related securities litigation can expect to proceed to summary judgment or trial, where expert witness event studies have proved to be a critical tool in performing the required disaggregation.[36]

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

Harry A. Olivar, Jr.
Email: harryolivar@quinnemanuel.com
Phone: (213) 443-3176

Julia M. Beskin
Email: juliabeskin@quinnemanuel.com
Phone: (212) 849-7482

Danielle Shrader-Frechette
Email: daniellefrechett@quinnemanuel.com
Phone: (213) 443-3710

Jesse Bernstein
Email: jessebernstein@quinnemanuel.com
Phone: (212) 849-7036

Mike Lyle
Email: mikelyle@quinnemanuel.com
Phone: (202) 538-8166

Karl Stern
Email: karlstern@quinnemanuel.com

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[33] *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343 (2005).

[34] *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29, 36 (2d Cir. 2009)

[35] *Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC*, 783 F.3d 395, 404 (2d Cir. 2015); *see also Federal Hous. Fin. Agency v. JPMorgan Chase & Co.*, 902 F. Supp. 2d 476, 498-99 (S.D.N.Y. 2012) (whether "'losses … sustained were attributable to fraud, rather than the systemic and market-wide decline in the housing market'" was question of fact not to be resolved on motion to dismiss).

[36] *See, e.g., In re Xerox Corp. Sec. Litig.*, 746 F. Supp. 2d 402, 410-15 (D. Conn. 2010) (event study was reliable to prove loss causation and thus was admissible).

Phone: (713) 221-7171

Jonathan Bunge
Email: jonathanbunge@quinnemanuel.com
Phone: (312) 705-7476

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