ALLEN & OVERY

COVID – 19 update

Why The Covid-19 Coronavirus Crisis Might Accelerate U.S. Regulatory Enforcement And Civil Litigation Over ESG Disclosures

Each day we perform the same morbid mathematical calculations. How many total confirmed Covid-19 coronavirus cases? How many new cases? How many new fatalities? But the key indicators of concern, or perhaps hope, is the rate of change. Is there a pattern to the rate of confirmed cases? Is there a pattern to the rate of hospitalizations? Is that rate increasing, flattening or decreasing? The exponent is the focus. Is the rate of exponential change something the social infrastructure can accommodate, or not.

This focus on exponential rate of change is not new, just more acute.[1] Before the Covid-19 coronavirus pandemic, efforts to identify, price and risk manage exponential change became the focus of the so-called ESG (environmental, social and governance) movement and its reaction to the challenges of population, use of resources and emissions from greenhouse gases. One of the focuses concerned global supply chains, which in seeking to optimize efficiency and reduce costs have been shown to be vulnerable to serious potential weaknesses. For example, in October 1998, Hurricane Mitch, a category five storm, destroyed 10 percent of the world's banana crop, cutting off significant sources of supply to the world's largest fruit and vegetable producers. In 2011, historic floods in Thailand shut down factories that made critical parts for the computer hard drive industry and components for major automakers. In 2017, almost 80 percent of the Georgia's peach crop was wiped out by a combination of an overly warm winter and a hard freeze in early spring.

The uncertainty of systemic failure, amplified by exponential impact, have potential serious implications for companies with U.S. reporting obligations and in particular those companies subject to the principles-based approach of Regulation S-K. Item 303 of Regulation S-K requires a set of disclosure items known as the Management's Discussion and Analysis of Financial Condition and Results of Operation, or MD&A. Item 303 includes a broad range of disclosure items that address the registrant's liquidity, capital resources and results of operations. Registrants, for example, must identify and disclose known trends, events, demands, commitments and uncertainties that would have a material effect on financial condition or operating performance. These disclosures should highlight issues that would

[1] Andrew Winston, *Is the COVID-19 Outbreak a Black Swan or the New Normal?*, MIT/Sloan Management Review, March 16, 2020.

cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition.

Item 303 and the SEC's Proposed Amendments

U.S. reporting companies should pay close attention to the Securities and Exchange Commission's January 30, 2020 proposed amendments to modernize, simplify, and enhance certain financial disclosure requirements in Regulation S-K.[2] MD&A Item 303(a)(3)(ii) requires a registrant to describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material impact on net sales or revenues or income from continuing operations. In addition, if the registrant knows of events that will cause a material change in the relationship between costs and revenues, the change in the relationship must be disclosed. The SEC's proposed amendment would require companies to disclose known events that are "reasonable likely" to cause – as opposed to will cause – a material change in relationship between costs and revenues, such as known or reasonably likely future increases in the costs of labor or materials, price increases or inventory adjustments. The proposed amendment conforms the disclosure threshold for this item requirement to other Item 303 provisions, such as Item 303(a)(1) which requires registrants to identify known trends "that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."

In prior guidance, the SEC has explained that the "reasonably likely" standard for disclosures mandated by Item 303 is lower than "more likely than not."[3] In one of its seminal interpretative releases, the SEC also set forth a test concerning the Item 303 disclosure requirements.[4] If a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required; and
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> (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

In addition, for the first time, the 2020 proposed amendments provide guidance about the use of metrics. Metrics may be important to non-linear trends, either pandemics or ESG-related concerns, and their likely trajectory and impact.

In this regard, a company should first consider the extent to which an existing regulatory disclosure framework applies such as

2 Press Release, No. 2020-25, SEC Proposes Amendments to Modernize and Enhance Financial Disclosures (Jan. 30, 2020).

3 Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8056 and 34-45321 (Jan. 25, 2002).

4 SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Exchange Act Release No. 26831 (May 18, 1989).

Generally Accepted Accounting Standards or defined non-GAAP measures. The company also should consider what additional information may be necessary to provide adequate context for an investor to understand the metric presented. For example, in the proposed guidance, the SEC advises that it would generally expect, based on the facts and circumstances, the following disclosures to accompany the metric: (i) a clear definition of the metric and how it is calculated; (ii) a statement indicating the reasons why the metric provides useful information to investors; and (iii) a statement indicating how management uses the metric in managing or monitoring the performance of the business. Critically, according to the SEC proposal, the company should also consider whether there are estimates or assumptions underlying the metric or its calculation, and whether disclosure of such items is necessary for the metric not to be materially misleading.

Item 303 and SEC Enforcement Proceedings

Failure to make the disclosures required by Item 303 can result in SEC enforcement proceedings. For instance, in August 2014, the SEC secured a $20 million civil settlement against Bank of America for failing to inform investors during the 2008 financial crisis about its exposure to repurchase claims on mortgage loans.[5] In particular, Bank of America admitted that it failed to disclose under Item 303 known uncertainties regarding potential increased costs related to mortgage loan repurchase claims stemming from more than $2 trillion in residential mortgage sales from 2004 through early 2008 by the bank and certain companies it acquired. In connection with these sales, Bank of America made contractual representations and warranties about the underlying quality of the mortgage loans and underwriting. The known uncertainties included whether Fannie Mae, a mortgage loan purchaser from Bank of America, had changed its repurchase claim practices after being put into conservatorship, the future volume of repurchase claims from Fannie Mae and certain monoline insurance companies that provided credit enhancements on certain mortgage loan sales, and the ultimate resolution of certain claims that Bank of America had reviewed and refused to repurchase but had not been rescinded by the claimants.

In additon, in June 2017, the SEC secured a cease-and-desist order from two senior executive officers of a multinational freight forwarding and logistics company.[6] The proceedings involved the failure to disclosure serious risks to the company's liquidity and capital resources in its quarterly reporting, which were inadequate under the standards appearing in Item 303 of Regulation S-K.

Item 303 and Private Civil Litigation

In the context of civil litigation, U.S. courts are split on the contentious issue of whether the failure to disclose under Item 303 necessarily gives rise to a private right of action under Section 10(b) of the Securities Exchange Act of 1934, a substantial question the U.S. Supreme Court has declined to resolve.

In January 2015, the U.S. Court of Appeals for the Second Circuit issued a decision holding that a company's failure to disclose a known trend or uncertainty in its quarterly filings, as required by Item 303, can give rise to liability under Section 10(b).[7] In other words, in the Second Circuit's view, Item 303 creates an affirmative duty to disclose, as the court reaffirmed in *Indiana Pub. Ret. Sys. v. SAIC,*

[5] In re Bank of America Corp., Exchange Act Release No. 72888 (Aug. 21, 2014).

[6] In re Kirchner, Exchange Act Release No. 80947 (June 15, 2017).

[7] *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015).

Inc., 818 F.3d 85 (2d Cir. 2016).[8] Despite the Second Circuit's ruling that a violation of Item 303 also gives rise to an actionable omission under Section 10(b), the court nevertheless made clear that a violation of Item 303 does not automatically create such liability, because the materiality standard for Item 303 is not as demanding as Rule 10b-5's materiality requirement. Therefore, under the Second Circuit's analysis, in order for Item 303 to provide a basis for a 10b-5 claim, the omission must also be material under the probability/magnitude test of *Basic v. Levinson*, 485 U.S. 224 (1998).

The Second Circuit's holding is in direct conflict with holdings from the Third and Ninth Circuits, which have rejected the argument that Item 303 imposes a duty to disclose that can give rise to a private right of action for securities fraud.[9] Notably, the Third Circuit's opinion was authored by now-Justice Samuel Alito when he was a court of appeals judge. Judges in the Sixth and Eleventh Circuits, while not reaching the ultimate question, have also expressed skepticism that there is any basis for a private right of action to enforce Item 303.[10]

Cautionary Words, Legal Risk

The Covid-19 coronavirus pandemic has brought into sharp focus the risk-related disclosures about a company's ongoing financial condition. This is especially true for risks than can unleash exponential change. With markets driving into bear territory, securities regulators and private stakeholders will look to press companies on their resiliency in light of remote, yet major, developments. As one court noted, "[c]autionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired."[11] Given the potential for substantial penalties and high damage awards, the SEC, private plaintiffs and corporate management will seek to clarify the scope of Item 303 obligations and the potential risk they pose to imprecise or insufficient disclosures on known trends.

8 The Supreme Court granted certiorari in this action under the caption *Leidos, Inc. v. Indiana Pub. Ret. Sys.*, 137 S. Ct. 1395 (2017), but later dismissed the petition in June 2018.

9 *See In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1064 (9th Cir. 2014); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

10 *See Thompson v. RelationServe Media, Inc.*, 610 F.3d 628, 682 n.78 (11th Cir. 2010) (Tjoflat, J., concurring in part and dissenting in part); *In re Sofamor Danek Grp., Inc.*, 123 F.3d 394, 403 (6th Cir. 1997).

11 *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2002).