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COVID-19: A Second Look at Securities Act Litigation Amid COVID-19

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This article follows an earlier Client Alert titled *COVID-19: An Early Look at Securities Act Litigation Amid COVID-19.*[1] In that alert, we anticipated that there would be an increase in Securities Act filings involving claims directly related to COVID-19 and its financial consequences. A year has since passed, and despite our earlier assessment, we can now report that there has been a relatively *low* number of COVID-19-related Securities Act filings in the year following the onset of the pandemic. As of April 30, 2021, there have been only four Securities Act cases with substantive allegations related to COVID-19, all of which held initial public offerings (IPOs) in either January or June 2020. The small number of COVID-19-related Securities Act class actions is consistent with the slowdown in Securities Act class action filings toward the end of 2020, which experts have theorized was a function of COVID-19-induced market drops in the first quarter of 2020 and subsequent rebound in the second through fourth quarters.[2]

Though they are few in number, understanding what COVID-19-related Securities Act class actions have been filed to date and their substantive allegations provides insight into how the landscape of COVID-19-related Securities Act class actions may continue to develop as the pandemic continues. Indeed, the commonalities among the allegations in these four cases shed light on the types of arguments that plaintiffs in this area are pursuing.

I. Securities Act Actions Related to COVID-19

***Wandel v. Gao, et al.*, Docket No. 1:20-cv-03259 (S.D.N.Y. April 24, 2020).** The first Securities Act class action related to COVID-19 was filed against Phoenix Tree Holdings (Phoenix) and its

[1] Michael Bongiorno, Christopher Davies, Timothy Perla, Robert Kingsley Smith, *COVID-19: An Early Look at Securities Act Litigation Amid COVID-19*, WilmerHale (May 8, 2020).

[2] Cornerstone Research and Stanford Law School Securities Class Action Clearinghouse, Securities Class Action Filings—2020 Year in Review, 23 (2021).

CEO on April 24, 2020, in the Southern District of New York. The plaintiffs filed an amended complaint on January 15, 2021.

Phoenix, a holding company based in the Cayman Islands, is in the business of renting apartments in China. In the initial complaint, plaintiffs represented that Phoenix warned investors in very general terms that the business could be affected by diseases and epidemics without addressing the fact that COVID-19 was already spreading quickly throughout China.

In the amended complaint, plaintiffs made slightly more specific allegations—namely, that the offering documents misrepresented and omitted material information related to the presence of COVID-19 throughout China prior to the IPO, the virus's financial impact on Phoenix, and the measures that Phoenix intended to take in response to the spread of the virus.[3] Specifically, plaintiffs claimed that Phoenix's warnings about investment risks should have been more robust because, as a company doing business in Wuhan, China, where the coronavirus is widely believed to have originated, Phoenix had "received enough information to understand that an outbreak was occurring before the IPO."[4] Additionally, plaintiffs claimed that the defendant company and CEO failed to specify any of Phoenix's pandemic-related measures that could have impacted its business (such as requiring employee quarantines or office disinfections). The plaintiffs also alleged that the offering materials failed to provide specifics on Phoenix's pandemic-related relief offerings such as rent abatements. Finally, while Phoenix warned investors about the consequences of a theoretical epidemic, plaintiffs asserted that these risk warnings were insufficient because they "failed to apprise investors that the [c]ompany was already subject to the potentially devastating effects of the coronavirus."[5]

According to the amended complaint, the American Depository Shares price per share dropped by 48.4% roughly three months after the January 2020 IPO and continued to drop through the remainder of 2020 following reports concerning the company's financial troubles—including possible bankruptcy— over that time frame.

This action is still pending in the Southern District of New York. Underwriter defendants filed a motion to dismiss for failure to state a claim upon which relief can be granted on May 3, 2021.[6] In their motion, defendants argued the COVID-19-related Securities Act claims in the amended complaint should be dismissed because plaintiffs could not plausibly allege the potential impact of COVID-19 was known or knowable at the time of the IPO.[7] Defendants argued that "nothing in the [c]omplaint support[ed] a reasonable inference that Phoenix [] knew or could have predicted on

[3] The plaintiffs also asserted additional allegations unrelated to the pandemic. In particular, they alleged that Phoenix omitted and/or materially misrepresented the fact that there were customer complaints both before and after the IPO, the company adjusted its sales and marketing tactics before the IPO, and business had already declined by the time of the IPO. *See* Amended Complaint at 42*,* ECF No. 32, *Wandel v. Gao, et al.*, Docket No. 1:20-cv-03259 (S.D.N.Y. January 15, 2021).
[4] *Id*. at 21.
[5] *Id*. at 44-45.
[6] Motion to Dismiss, ECF No. 57, *Wandel v. Gao, et al.*, Docket No. 1:20-cv-03259 (S.D.N.Y. May 3, 2021).
[7] *Id*. at 13.

January 16, 2020 – the effective date of the Offering Materials – that the 41 reported cases of novel coronavirus infection among Wuhan's 11 million residents would worsen and become a once-in-a-century pandemic."[8] Further, defendants contended that Phoenix promptly updated its disclosures to address COVID-19 in March 2020 in accordance with SEC guidance and that Phoenix's original disclosures, which included disclosures related to virus risks, would have been understood by a reasonable investor as extending to COVID-19.

Any opposition to the motion to dismiss is due July 1, 2021, and defendants' reply is due August 2, 2021.[9]

***Berg v. Velocity Financial, Inc., et al.*, Docket No. 2:20-cv-06780 (C.D. Cal. July 29, 2020).** The second Securities Act action related to COVID-19 was filed against Velocity Financial, Inc. (Velocity) and its CEO on July 29, 2020, in the Central District Court for the District of California. The plaintiffs filed an amended complaint on November 6, 2020.

Velocity is a California-based finance company that primarily issues real estate loans. Velocity also holds and sells loans for other investment purposes. In both the original complaint and the amended complaint, plaintiffs alleged that Velocity failed to adequately represent the financial consequences of the pandemic.[10]

In the amended complaint, plaintiffs alleged that Velocity overstated its financial growth and resiliency while understating the negative conditions of the market. Specifically, plaintiffs asserted that Velocity underrepresented the amount of nonperforming loans it had in its portfolio while claiming that it "ha[d] developed the highly specialized skill set required to effectively compete in this market."[11] According to plaintiffs, this characterization was materially misleading because the demand for Velocity's loan originations was not as long term as the company predicted, in part because of the pandemic. In fact, per plaintiffs, "the U.S. regions where Velocity had historically originated, and continued to originate, most of its loans were among the most vulnerable to – and ultimately the hardest hit by – the virus."[12] Additionally, plaintiffs criticized Velocity's alleged overly optimistic picture of the market. The plaintiffs asserted that it was "misleading for the Offering Materials to describe a robust market and strong demand for real estate investor loans when those conditions were not realistic given the evolving circumstances arising from a new and quickly

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[8] *Id.* at 2.
[9] Order, ECF No. 51, *Wandel v. Gao, et al.*, Docket No. 1:20-cv-03259 (S.D.N.Y. March 18, 2021). New counsel for Phoenix Tree is being appointed and thus the underwriter defendants—Citigroup Global Markets, Inc., Credit Suisse Securities, J.P. Morgan Securities, Tiger Brokers Ltd., and US Tiger Securities—filed the motion to dismiss.
[10] Like plaintiffs in *Phoenix*, plaintiffs in *Velocity* asserted additional allegations that are not related to COVID-19. In particular, plaintiffs in *Velocity* alleged Velocity mischaracterized its underwriting practices as disciplined and stable, when in reality, they were very risky as compared with those of other lenders. *See* Amended Complaint at 13, ECF No. 40, *Berg v. Velocity Financial, Inc., et al.*, Docket No. 2:20-cv-06780 (C.D. Cal. Nov. 6, 2020).
[11] *Id*. at 3.
[12] *Id*. at 3.

spreading disease."[13] Finally, like the plaintiffs in the *Phoenix* litigation, plaintiffs contended that Velocity's "generic risk warnings" about "conditions that negatively impact this market" failed to warn investors about the risks associated with investing at such a volatile time.[14]

Per plaintiffs, roughly four months after the IPO, Velocity's stock price had dropped by more than 80%.

The defendants filed a motion to dismiss on October 27, 2020, arguing that the optimistic statements in offering documents concerning the state of the real estate market were nonactionable puffery, that Velocity could not have foreseen the impact of the pandemic at the time of the IPO, and that the statements included adequate disclosures concerning the possibility of economic disasters. On January 25, 2021, the court sided with defendants.[15] First, the court held that Velocity's statements were nonactionable puffery. Specifically, the court instructed that where "companies propound the favorable state of their respective markets, and the companies' ability to capitalize on them," such statements cannot serve as the basis for Section 11 liability.[16] Next, the court held plaintiffs failed to state a claim concerning the failure to disclose the uncertainty in the market caused by the pandemic in offering materials because plaintiffs "[did] not allege that [d]efendants would or could have known the extent of the coronavirus pandemic, or even the presence of the disease in America, at the time of the IPO."[17] Finally, the court held that the "[d]efendants did not need to include more specific disclosures about the coronavirus pandemic" because plaintiffs "ha[d] not adequately alleged how [d]efendants would have known about the coronavirus risks at the time of the IPO to include a more specific warning."[18] Based on that reasoning, the court dismissed the case.

The plaintiffs did not file an appeal.

***Soe v. Progenity, Inc., et al.*, Docket No. 3:20-cv-01683 (S.D. Cal. Aug. 28, 2020).** Another Securities Act action related to COVID-19 was filed against Progenity and its CEO on August 28, 2020, in the Southern District of California. The plaintiffs filed an amended complaint on February 4, 2021.

Progenity, a San Diego-based biotechnology company, produces and sells medical tests and instruments. Its products include in vitro molecular tests that can help with family planning, as well as with certain diagnoses. In the original complaint, plaintiffs only briefly referenced the pandemic

[13] *Id.* at 22.
[14] *Id*. at 23.
[15] Civil Minutes, ECF No. 53, *Berg v. Velocity Financial, Inc., et al.*, Docket No. 2:20-cv-06780 (C.D. Cal. Jan. 25, 2021).
[16] *Id.* at 15.
[17] *Id.* at 16.
[18] *Id.* at 17.

as a cause of the downturn in the company's testing volumes. In the amended complaint, however, the pandemic's financial consequences were central to plaintiffs' allegations.

More specifically, in their amended complaint, plaintiffs alleged that Progenity overstated the growth of its business and understated the negative effects of the virus.[19] The plaintiffs asserted that Progenity's assurances of its test volume growth in the offering materials "were materially false and misleading […] because they indicated that Progenity's test volumes were still growing at the time of the IPO and that these test volumes exceeded those from the same time period in the previous year."[20] Per plaintiffs, these statements "failed to disclose that Progenity's test volumes were sharply lower in April and May of 2020 and were likely to remain depressed due to known trends."[21] Additionally, like the plaintiffs in the *Phoenix* and *Velocity* cases, plaintiffs also contended that Progenity's overly general warnings about the pandemic were insufficient because they "presented as a mere hypothetical risk that Progenity 'may' experience a decrease in test volumes, and failed to disclose that Progenity was at the time of the IPO experiencing significant test volume declines."[22] Finally, plaintiffs criticized Progenity's insufficient warnings about decreases in the average selling price of its tests, which they alleged were due in part to the pandemic.

Per plaintiffs, less than two months after the IPO, Progenity's stock price had dropped by almost 50%. This drop followed Progenity's announcement that it owed government healthcare programs $10.3 million for overcharging for tests.

This action is still pending in the Southern District of California. On April 5, 2021, defendants filed a motion to dismiss for failure to state a claim upon which relief can be granted. In their motion, defendants argued that plaintiffs failed to state a claim because the exact disclosures plaintiffs claim were omitted—that testing volume and revenue declined as a result of COVID-19 and may not recover—were in fact expressly included in the offering materials. Plaintiffs' opposition is due by June 4, 2021, and defendants' reply is due July 19, 2021.[23]

***Gutman v. Lizhi Inc., et al.*, Docket No. 1:21-cv-00317 (E.D.N.Y. Jan. 20, 2021).** The most recent Securities Act action related to COVID-19 was filed against Lizhi, Inc. (Lizhi) and its CEO on January 20, 2021, in the Eastern District of New York.

[19] Like the plaintiffs in *Phoenix* and the plaintiffs in *Velocity*, plaintiffs in *Progenity* also asserted additional allegations that were not related to COVID-19. In particular, they alleged that the Registration Statement failed to disclose that (1) Progenity overcharged the government $10.3 million, (2) test volumes were dropping, (3) average selling prices were dropping and (4) revenues were dropping. *See* Amended Complaint at 2-3, ECF No. 38, *Soe v. Progenity, Inc., et al.*, Docket No. 3:20-cv-01683 (S.D. Cal. Feb. 24, 2021).
[20] *Id*. at 33.
[21] *Id*. at 33-34.
[22] *Id*. at 36.
[23] Order, ECF No. 34, *Soe v. Progenity, Inc., et al.*, Docket No. 3:20-cv-01683 (S.D. Cal. Dec. 14, 2020).

Lizhi provides a social audio platform for user-generated content in China. The plaintiffs allege that Lizhi failed to warn investors that at the time of the IPO, which took place in January 2020, the company already had suffered financially due to the pandemic.

Specifically, plaintiffs asserted that the virus "was already ravaging China, the home base, principal market, and significant hub for Lizhi, its employees, and its customers," when the IPO took place.[24] Additionally, according to plaintiffs, the virus was directly hurting Lizhi's business, "as employees and customers contracted the virus, lost employment, or otherwise experienced difficulty in generating, publishing, and monetizing the content critical to Lizhi's platform."[25] While the offering materials warned investors that the company "may be subject to social and natural catastrophic events […] such as natural disasters, health epidemics, riots, political and military upheavals[,] and other outbreaks,"[26] plaintiffs claim that they were misled because Lizhi failed to detail the effects of the pandemic that the company was already experiencing.[27]

Roughly three months after the IPO, Lizhi's share price had dropped by more than 63%. This drop followed the release of the company's Form 20-F on April 20, 2020, which disclosed that the virus caused the company to experience a major economic downturn and that the company might not be able to raise the capital necessary for working capital and liquidity if the pandemic continued.

This action is still pending in the Eastern District of New York. On April 28, 2021, plaintiffs filed a motion to appoint counsel and lead plaintiff. No motion to dismiss has been filed to date.

II. Observations

The universe of COVID-19-related Securities Act cases is small, and two of the companies subject to these cases have unique exposure at the forefront of the pandemic in China. Nevertheless, there are several commonalities in the substantive allegations that shed light on how plaintiffs may position COVID-19-related Securities Act claims.

> **Generic Warnings.** The plaintiffs have generally asserted that defendants offered only theoretical warnings that ignored the reality of the unfolding pandemic. In *Phoenix*, defendants allegedly warned investors about the ramifications of a *hypothetical* epidemic, but not about the ramifications of the *actual* COVID-19 pandemic. In *Velocity*, defendants allegedly warned investors only about market threats in the abstract. In *Progenity*, defendants allegedly warned investors about the *theoretical* risk that the company might

[24] Complaint at 10, ECF No. 1, *Gutman v. Lizhi Inc., et al.*, Docket No. 1:21-cv-00317 (E.D.N.Y. Jan. 20, 2021).
[25] *Id.*
[26] *Id.*
[27] Like the *Phoenix*, *Velocity* and *Progenity* plaintiffs, the *Lizhi* plaintiffs also asserted additional allegations that were not related to COVID-19. In particular, they alleged that the company failed to disclose that "even prior to the IPO, Lizhi employees and customers complained of, and to, Lizhi, which harmed the Company's reputation and financial condition and prospects." *Id*.

experience test volume drops, rather than the *actual* risk that this could occur. And finally, in *Lizhi*, defendants allegedly warned investors that the company *might be exposed* to epidemics and similar events, when the company *was already exposed* to the COVID-19 pandemic.

Overly Optimistic Market Depiction. The plaintiffs have also generally posited that defendants falsely portrayed a favorable view of the market, despite the ongoing effects of COVID-19. In *Phoenix*, defendants allegedly failed to warn investors about the presence of the virus in China before the IPO and how it was impacting the company's business. Likewise, in *Velocity*, defendants allegedly falsely depicted a "robust market" and "strong demand for real estate investor loans," despite demand for real estate investor loans allegedly being tempered by the pandemic.

Overstating Financial Health. The plaintiffs have also alleged that defendants overstated the financial health of the companies because they failed to take into account the impact of the pandemic on the company's market position. In *Velocity*, for example, defendants allegedly advertised Velocity's competitiveness in the market, despite the increase of nonperforming loans in its portfolio and despite the fact that the pandemic, according to plaintiffs, lessened demand for the company's loan originations. Similarly, in *Progenity*, defendants allegedly publicized the growth of Progenity's test volumes, despite what plaintiffs allege was a decline in test volumes caused in part by the pandemic.

If the court's decision in *Velocity* is any indicator, companies have a reasonable chance of filing successful motions to dismiss where they can show that any optimistic statements about the state of a given market are puffery and thus nonactionable under the Securities Act, or where plaintiffs fail to or cannot plausibly allege defendants could have known the extent of the virus at the time of the relevant offering. The defendants in *Phoenix* make the latter argument, the success of which is not yet known.

WilmerHale is continuing to closely monitor developments and trends related to Securities Act litigation amid the COVID-19 crisis. If you have any questions or require assistance with a securities litigation matter, please feel free to reach out to the authors of this alert or any of your contacts at WilmerHale.

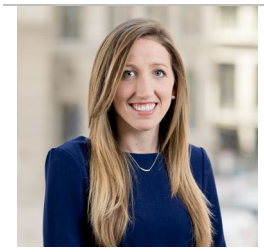
Contributors

Timothy J. Perla
PARTNER

timothy.perla@wilmerhale.com
+1 617 526 6696

Robert Kingsley Smith
PARTNER

robert.smith@wilmerhale.com
+1 617 526 6759

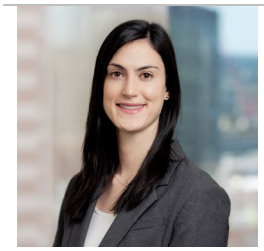


Jessica Lewis
COUNSEL

jessica.lewis@wilmerhale.com
+1 617 526 6906

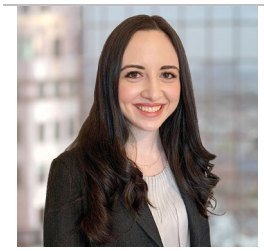
Michael J. Brown
SENIOR ASSOCIATE

mike.brown@wilmerhale.com
+1 617 526 6310



Margaux Joselow
ASSOCIATE

margaux.joselow@wilmerhale.com
+1 617 526 6916



Rebecca Pritzker
ASSOCIATE

rebecca.pritzker@wilmerhale.com
+1 617 526 6804