

### SEC Files First COVID-19 Disclosure Enforcement Action

By Veronica E. Callahan, Michael D. Trager, Daniel M. Hawke, Jonathan E. Green, Kathleen Reilly, Joshua R. Martin, Adam J. Reinhart, and Yiqing Shi

On December 4, 2020, the SEC filed its first enforcement action against a public company for disclosures about the financial impact of the COVID-19 pandemic. In a settled administrative proceeding, the SEC found that The Cheesecake Factory Incorporated (The Cheesecake Factory or the Company) violated certain reporting provisions of the federal securities laws by making false and misleading statements in March and April 2020 about its financial health.<sup>1</sup>

This action follows a series of public statements by the SEC since the outset of the pandemic regarding the need for accurate financial disclosures by public companies. And, while this particular action involved non-fraud charges, it is a clear signal that the SEC will take prompt action if it finds issues with such disclosures.

#### The SEC's Emphasis on Accurate Disclosures in Light of the Pandemic

At the outset of the pandemic in March 2020, the Co-Directors of the SEC's Division of Enforcement issued a rare public statement emphasizing "the importance of maintaining market integrity and following corporate controls and procedures" during the pandemic and reminding public companies "to be mindful of their established disclosure controls and procedures, insider trading prohibitions, codes of ethics, and Regulation FD and selective disclosure prohibitions."<sup>2</sup>

© 2021 Arnold & Porter. Veronica E. Callahan, Michael D. Trager, Daniel M. Hawke, Jonathan E. Green, Kathleen Reilly, Joshua R. Martin and Adam J. Reinhart are with Arnold & Porter. Yiqing Shi, a graduate of Columbia University School of Law and employed in Arnold & Porter's New York office, contributed to this article. She is not admitted to the practice of law.

Importantly, the statement noted that the Enforcement Division was "committing substantial resources" against fraud and illegal practices "in these unprecedented market and economic conditions." To that end, later in March, the Co-Directors formed a Coronavirus Steering Committee to coordinate the Enforcement Division's response to COVID-19-related enforcement issues.

On April 8, 2020, Jay Clayton (then-SEC Chairman) and William Hinman (Director of the SEC's Division of Corporation Finance) issued a public statement on the importance of disclosure, urging 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" and noting that "detailed discussions of current liquidity positions and expected financial resource needs would be particularly helpful."<sup>3</sup>

On May 12, 2020, Steven Peikin (then-Co-Director of the SEC's Division of Enforcement) provided a keynote address in which he stated: "Recognizing that the economic impacts of any downturn may vary across different industries and sectors, the Steering Committee has developed a systematic process to review public filings from issuers in highly-impacted industries, with a focus on identifying disclosures that appear to be significantly out of step with others in the same industry. We are also looking for disclosures, impairments, or valuations that may attempt to disguise previously undisclosed problems or weaknesses as coronavirus-related."<sup>4</sup>

On June 23, 2020, the SEC's Division of Corporation Finance supplemented prior disclosure guidance related to the pandemic and advised companies to "provide robust and transparent disclosures about how they are dealing with short- and long-term liquidity and funding risks in the current economic environment" and

---

to consider other disclosure obligations, including where COVID-19 is adversely affecting revenues, where companies have accessed lines of credit, and where capital has been pursued in the public and private markets.<sup>5</sup>

On June 30, 2020, Chairman Clayton moderated a roundtable discussion of COVID-19-related disclosure considerations, where a panel of investors highlighted the importance of forward-looking disclosures, particularly on liquidity positions. Chairman Clayton, along with Corporation Finance Director Hinman, echoed that sentiment but also assured that the SEC would not second guess forward-looking disclosures made in good faith.<sup>6</sup>

## The Cheesecake Factory Action

On December 4, 2020, the SEC brought its first enforcement action against a public company related to COVID-19 financial disclosures by filing a settled administrative proceeding against The Cheesecake Factory.<sup>7</sup>

According to the SEC's order, on March 18, 2020, The Cheesecake Factory sent a letter to its landlords stating that it would not be paying April rent as a result of a "severe decrease in restaurant traffic [due to COVID-19 that] has severely decreased our cash flow and inflicted a tremendous financial blow to our business." By March 23, the Company was actively seeking additional liquidity and disclosed with lenders and potential private equity investors that it had cash to support only approximately 16 weeks of operations under the prevailing circumstances. During this time period, internal documents noted that the Company was experiencing a negative cash flow rate of \$6 million per week.

Then, on March 23, 2020, The Cheesecake Factory filed a Form 8-K and issued a press release, stating that it was "transitioning to an 'off-premise model' (*i.e.*, to-go and delivery) that was 'enabling the Company's restaurants to operate sustainably at present under this current model.'" The Company disclosed the fact that it

had drawn down \$90 million on a revolving line of credit but failed to disclose its decision not to pay rent or the negative information regarding liquidity and cash flows. In addition, on April 3, 2020, the Company filed a Form 8-K that attached a press release stating that "the restaurants are operating sustainably at present under this off-premise model."

The SEC found that The Cheesecake Factory's disclosures regarding the sustainability of its restaurant operations were inadequate because they failed to disclose that the Company "was, in fact, losing approximately \$6 million in cash per week" or that it "had only approximately 16 weeks of cash remaining, even after the \$90 million borrowing." The SEC also stressed that, although the March 23 disclosure noted that the Company was "evaluating additional measures to further preserve financial flexibility," it failed to disclose the landlord letters stating that it would not pay April rent. Accordingly, the SEC found that the disclosures at issue were materially false and misleading.<sup>8</sup>

Without admitting or denying the SEC's findings, The Cheesecake Factory agreed to a \$125,000 penalty and to cease-and-desist from further violations of the charged provisions, which consisted of Section 13(a) of the Securities Exchange Act of 1934 and Rules 13a-11 and 12b-20 thereunder.

## Key Takeaways

At first glance, the SEC's enforcement action against The Cheesecake Factory appears to be relatively modest and inconsequential—a settled action involving non-fraud charges with a small civil penalty relative to the amounts at issue and prior precedent for similar violations in different contexts.<sup>9</sup>

The action, however, seems to include a message from the SEC and its Enforcement Division: a shot across the bow of public companies at exactly the moment that they are in the midst of handling their year-end accounting,

---

financial reporting, and disclosure processes as well as wrestling with what to disclose about the impact of the pandemic on their businesses. The SEC knows that key disclosure decisions are being made at this very moment while, at the same time, COVID-19 business restrictions are once again beginning to intensify.

Accordingly, it appears that the SEC is signaling to public companies that it will be watching to ensure that all material information about the impact of the pandemic was and is being properly accounted for, reported, and disclosed. This appears to have been a carefully crafted, well-timed enforcement action that was designed to have maximum impact in real-time. It also presents high risk to those who fail to heed the message, because more is definitely coming.

Going forward, while the effects of the change in administration are yet to be seen, the SEC undoubtedly will continue to analyze disclosures in an attempt to ferret out false and misleading statements related to public companies' results of operations and financial condition in light of the COVID-19 pandemic. Moreover, as additional layoffs continue to occur across industries, it is possible that there will be an uptick in whistleblower complaints involving such disclosures. And, while certain companies might have seen business pick up over the summer and early fall, it is possible that newly-imposed restrictions may once again have a negative financial effect.

Accordingly, public companies should take action to protect themselves and decrease risk, including:

- Companies should pay close attention to their disclosures regarding the operational and financial impacts caused by COVID-19, including setbacks that have had or could have material negative effects on revenue, earnings, cash flows, and liquidity, among other financial metrics.
- Companies should take into account these potential negative effects when deciding whether and how to discuss expected future

results—for example, certain companies have either downwardly revised their forward-looking estimates due to the impact of COVID-19 or withdrawn guidance indefinitely. Companies also should include tailored risk disclosures in their public announcements and SEC filings.

- When considering new disclosures, companies should take into account prior statements made in SEC filings, press releases, investor presentations, and other publications. If new information contradicts earlier statements, companies should consider whether investors are still relying on those prior statements and evaluate the need for corrective disclosure.
- Companies should keep a close eye on what is being told to various parties with whom they do business (such as lenders and landlords) to ensure that a rosier picture is not being presented to investors and the marketplace.
- Companies should ensure that they have adequate disclosure controls in place and that these controls are being followed, including having disclosures and other public statements (for example, congressional testimony, traditional media, and social media) reviewed through the companies' disclosure counsel and, where applicable, disclosure committees.

The SEC has sent a message to public companies that disclosures about their results of operations, financial condition, and liquidity must be accurate and complete, including by reflecting the financial effects of the COVID-19 pandemic. This message was sent via an enforcement action that was filed at the same time that calendar-year reporting companies are considering annual accounting, financial reporting, and disclosure decisions.

And, while this particular action against The Cheesecake Factory involved disclosures that were inconsistent with the Company's own non-public communications, other companies should not assume that future enforcement actions will be limited to situations involving such obvious inconsistencies. The Cheesecake Factory case

---

also demonstrates that the SEC is willing to take action regardless of the egregiousness of the conduct at issue and even against a company in financial distress. By anticipating these factors, companies can help avoid securities enforcement issues from arising.

## Notes

1. In the Matter of The Cheesecake Factory Incorporated, Rel. No. 34-90565 (Dec. 4, 2020).
2. SEC, Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity (Mar. 23, 2020).
3. SEC, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020).
4. SEC, Keynote Address: Securities Enforcement Forum West 2020 (May 12, 2020).
5. SEC, Coronavirus (COVID-19) – Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources (June 23, 2020); *see also* SEC, Coronavirus (COVID-19) (Mar. 25, 2020).
6. SEC, Virtual Roundtable On Q2 Reporting: A Discussion Of COVID-19 Related Disclosure Considerations (June 30, 2020).
7. In the Matter of The Cheesecake Factory Incorporated, Rel. No. 34-90565 (Dec. 4, 2020). Although this is the first action related to the financial impact of the pandemic on a public company, the SEC already has brought a number of enforcement actions against public companies in the life sciences industry involving disclosures related to COVID-19 diagnostics and other products. For more information about these actions, *see* Arnold & Porter's Advisory entitled Securities Enforcement and Litigation Trends Affecting Life Sciences Companies in 2020 (Nov. 18, 2020).
8. The SEC did not challenge the liquidity disclosures in The Cheesecake Factory's Annual Report on Form 10-K filed on March 12, 2020, which was only six days before the Company sent the letter to its landlords concerning the non-payment of rent.
9. While Exchange Act Section 13(a), Rule 13a-11, and Rule 12b-20 require public companies to file current reports on Form 8-K that are not materially false or misleading, they are non-fraud provisions of the federal securities laws. Also, a \$125,000 civil penalty for false and misleading disclosures, while not insubstantial, is at the lower end of the penalty amounts available to the SEC against public companies.



Wolters Kluwer  
The Corporate Governance Advisor  
Distribution Center  
7201 McKinney Circle  
Frederick, MD 21704

## TIMELY REPORT

Please Expedite

March/April 10041526-0260

**To subscribe, call 1-800-638-8437 or order online at [www.WoltersKluwerLR.com](http://www.WoltersKluwerLR.com)**

### **Ordering Additional Copies of CORPORATE GOVERNANCE ADVISOR**

Don't wait for the office copy of CORPORATE GOVERNANCE ADVISOR to circulate to your desk. Get updated news and information on important developments the moment it is available by ordering additional copies of CORPORATE GOVERNANCE ADVISOR for your office now. For more information and to order multiple copies at a specially discounted rate, please call 1-800-638-8437.