

## Cheesecake Factory Penalty Signals Shift In SEC Virus Focus

By **David Kornblau** (December 8, 2020, 4:03 PM EST)

On Dec. 4, the U.S. Securities and Exchange Commission brought its first enforcement action charging a public company, The Cheesecake Factory Inc., with misleading investors about the financial effects of the pandemic.[1] The case is significant because it shows that the agency is moving past its initial bout of enforcement activity targeting blatantly fraudulent activity involving COVID-19.

Recent public remarks by a senior member of the SEC's Coronavirus Steering Committee indicate that the SEC Enforcement Division's pipeline includes COVID-19-related investigations concerning a broader range of potential securities law violations, such as negligent misrepresentations, material omissions and insider trading.



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The SEC's settled action against The Cheesecake Factory alleged that the company failed to adequately inform its investors of the extent of the impact of the pandemic on its global restaurant operations and financial condition during the initial surge of COVID-19 infections in late March and early April.[2] Yet the company did not paint a rosy picture.

On March 23, it withdrew prior financial guidance "due to economic conditions caused by COVID-19," announced that it was transitioning to a new business model based on selling food to go or for delivery, disclosed that it had drawn down the last \$90 million on a revolving credit line, and noted that it was "evaluating additional measures to further preserve financial flexibility." [3]

Despite these disclosures, the company got into hot water with the SEC when it also said, on two occasions, that under its new business model it was "operating sustainably at present." [4] The SEC found that statement materially false and misleading because the company did not disclose that it had excluded expenses attributable to corporate operations from its claim of sustainability, was losing money rapidly, had only approximately 16 weeks of cash remaining, and had informed its landlords that it would not pay April rent. [5]

Notably, despite finding that The Cheesecake Factory had made materially false and misleading statements to investors, the SEC did not charge the company with either scienter-based or negligence-based securities fraud. Rather, it alleged violations of the public company reporting requirements in Section 13(a) of the Securities Exchange Act and Rules 13a-11 and 12b-20. [6]

In addition, the SEC assessed a civil penalty of only \$125,000, which is on the very low end of the range for SEC settlements involving public companies — even those, like The Cheesecake Factory, that receive credit for cooperation with the SEC staff.[7]

The Cheesecake Factory settlement sends a clear message that the Enforcement Division staff is closely scrutinizing the disclosures of public companies regarding the effect of COVID-19 on their operations and financial performance. The agency appears to be demanding an unusually detailed level of disclosure in this area, especially with respect to adverse economic impacts.

This approach is consistent with the admonition by SEC Chairman Jay Clayton and the director of the SEC's Division of Corporation Finance on April 8 that companies "provide as much information as is practicable regarding their current financial and operating status, as well as their future operational and financial planning." [8]

For example, the SEC criticized The Cheesecake Factory's omission from its March 23 SEC filing that it had notified its restaurants' landlords that it was not going to pay April rent, even though the company publicly disclosed that fact four days later after it appeared in media reports.[9]

Likewise, the SEC found it misleading that the company did not disclose its dwindling cash position in its March 23 and April 3 SEC filings, yet the company announced on April 20 that it had received a cash infusion from a private equity investor.[10]

At the same time, perhaps in recognition that these promptly updated omissions are at best thin evidence of a disclosure violation, the SEC allowed the company to settle without a fraud charge and pay only a minimal penalty. As a practical matter, most companies would accept a settlement on those terms to avoid prolonged and costly litigation with the SEC, even if the company believed that it had done nothing wrong.

The type of allegations against The Cheesecake Factory stand in sharp contrast to those in the SEC's prior COVID-19-related enforcement cases and trading suspensions. In those actions, the SEC alleged that companies had made completely bogus claims regarding, for example, their purported ability to supply large quantities of masks,[11] offer unauthorized COVID-19 tests for home use,[12] and sell thermal scanning equipment that could assist in detecting people with COVID-19 at a 99.99% accuracy rate.[13]

The SEC's shift away from such scam-type actions was foreshadowed by comments in late October at the Securities Enforcement Forum 2020 by Carolyn Welshhans, an associate director in the SEC Division of Enforcement and a member of the agency's Coronavirus Steering Committee.[14]

In a panel discussion, Welshhans said that the division was looking at potential financial statement or issuer disclosure fraud based on negligence rather than intentional wrongdoing. She noted that current economic conditions could reveal pre-existing issues at companies that should have been disclosed earlier, and said that the Enforcement Division staff would consider whether a company's pandemic-related disclosures are in line with those of industry peers.

According to Welshhans, other potential cases in the division's pipeline include actions against regulated entities that fail to honor redemption requests because of an undisclosed issue. And she repeated the early warning by the Enforcement Division's co-directors that the pandemic created additional opportunities for illegal insider trading, as employees may learn of material COVID-19-related business

impacts unknown to the investing public and the prevalence of employees working at home increases the risk of leaks of confidential company information to family members or roommates.[15]

Although the SEC's investigative docket is nonpublic, another potential area of SEC focus is the possibility of bribery schemes involving foreign government contracts to distribute vaccines, personal protective equipment, and other COVID-19-related products. Such activities could be fertile ground for violations of the Foreign Corrupt Practices Act and related statutes.

Finally, since SEC investigations often continue for a year or more, much of the agency's forthcoming COVID-19-related enforcement activity will likely occur after Clayton's announced departure at the end of the year[16] and after President-elect Joe Biden takes office and appoints a new chair.

If the new chair embraces a more aggressive enforcement philosophy, as is generally expected, the agency's second wave of COVID-19-related enforcement actions, which began last week with The Cheesecake Factory case, may sweep into grayer areas of alleged conduct and disclosure, deploy more expansive legal theories, and result in bigger fines and other punitive sanctions against companies in the agency's crosshairs.

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[1] In the Matter of The Cheesecake Factory Inc., Securities Exchange Act Release No. 90565 (Dec. 4, 2020), available at <https://www.sec.gov/litigation/admin/2020/34-90565.pdf>.

[2] *Id.* at 2.

[3] *Id.* at 2-3.

[4] *Id.* at 3.

[5] *Id.*

[6] *Id.* at 4.

[7] *Id.*; see also Cornerstone Research, SEC Enforcement Activity: Public Companies and Subsidiaries, Fiscal Year 2020 Update, at 9 ("The median monetary settlement imposed in a public company or subsidiary action in FY 2020 was \$4 million, compared to \$5 million in FY 2019, and the median of \$4 million across FY 2010-FY 2019."), available at <https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-FY-2020-Update>.

[8] The Importance of Disclosure — For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020), <https://www.sec.gov/news/public-statement/statement-clayton-hinman>.

[9] In the Matter of The Cheesecake Factory Inc., Securities Exchange Act Release No. 90565, at 3.

[10] *Id.* at 4.

[11] SEC Charges Company and CEO for COVID-19 Scam, Litigation Release No. 24807 (Apr. 28, 2020), available at <https://www.sec.gov/litigation/litreleases/2020/lr24807.htm>.

[12] SEC Charges Company for Misleading COVID-19 Claims, Litigation Release No. 24819 (May 14, 2020), available at <https://www.sec.gov/litigation/litreleases/2020/lr24819.htm>.

[13] SEC Charges Penny Stock Company and Its CEO for Misleading COVID-19 Claims, Litigation Release No. 24820 (May 14, 2020), available at <https://www.sec.gov/litigation/litreleases/2020/lr24820.htm>.

[14] A video recording of Welshhans' comments, along with the rest of the panel discussion (in which the author participated), is available at <https://www.youtube.com/watch?v=G6XUGbErnuY&list=PL9RQJrnQB5o-tO17QrU9gRP36w0NkQsvn&index=2>.

[15] Statement from Stephanie Avakian and Steven Peikin, co-directors of the SEC's Division of Enforcement, Regarding Market Integrity (Mar. 23, 2020), <https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity>.

[16] Press Release, SEC Chairman Jay Clayton Confirms Plans to Conclude Tenure at Year End (Nov. 16, 2020), <https://www.sec.gov/news/press-release/2020-284>.