

Say Cheese: SEC Charges the Cheesecake Factory in its First Action Against a Public Company for Improper Disclosure on the Effects of COVID-19

February 3, 2021

On December 4, 2020, the United States Securities and Exchange Commission (SEC) announced a charge against a public company for misleading investors about the financial impacts of the COVID-19 pandemic.¹ Between March and April 2020, The Cheesecake Factory Inc. (Cheesecake Factory) made several disclosures which failed to adequately inform investors of the extent of the impact of COVID-19 on the company's operations and financial condition. This improper disclosure resulted in a \$125,000.00 penalty. This is the first instance of the SEC charging a public company for a misleading disclosure arising from the pandemic.

While we are unaware of any similar regulatory actions in Canada, Canadian regulators have indicated that they are closely monitoring potentially misleading disclosure relating to COVID-19.

The SEC often sets trends that are followed by Canadian regulators and we anticipate that there may be similar investigations and charges in Canada in the future. As a result, public companies should be diligent in disclosing the potential impacts of COVID-19 on their operations and finances.

Key Takeaways

- **Silence on current cash flow, projected cash flow, and steps taken to conserve cash may mislead investors as to COVID-19's impact on a company.** The Cheesecake Factory disclosed that its restaurants were "operating sustainably," but was in fact incurring substantial losses and projected having no cash on-hand within a number of months. In addition to this misleading disclosure, the Cheesecake Factory privately disclosed its financial situation to certain potential investors, while keeping all existing shareholders in the dark.
- **Securities regulators have maintained, and even intensified, their scrutiny of COVID-related disclosure obligations.** Early in the pandemic, the SEC expressed its commitment to scrutinize public disclosure on the financial impacts of COVID-19. Canadian regulators – and the Canadian Securities Administrators (CSA) – have made similar commitments, and we anticipate that we will see investigations and charges relating to issuers' COVID-19 disclosures in the future.

- **Canadian issuers should adhere strictly to the CSA's guidelines on adequate disclosure of the effects of COVID-19.** Given the likelihood of COVID-19 disclosure cases in Canada, public issuers should exercise diligence in their disclosure relating to the pandemic to ensure that they comply their applicable disclosure obligations.

Summary and Background

On December 4, 2020, the SEC announced that it had settled charges made against the Cheesecake Factory for misleading disclosures relating to the extent of the impact of COVID-19 on the company's operations and financial condition. The SEC determined that the Cheesecake Factory failed to satisfy its disclosure obligations and, accordingly, ordered the restaurant group to pay a \$125,000.00 fine.²

The Cheesecake Factory's SEC filings dated March 23 and April 3, 2020 stated that its restaurants were "operating sustainably," when in fact the restaurant chain was losing approximately \$6 million in cash per week and only had a projected 16 weeks of cash remaining from the date of its disclosures. Similarly, the Cheesecake Factory failed to disclose its financial concerns and the steps it took to conserve its financial position. For example, the Cheesecake Factory did not report that the company notified each of its landlords that it would not be in a position to pay rent for April 2020. However, the Cheesecake Factory privately disclosed its actual cash position and projected earnings with lenders and potential private equity investors.

The SEC found that the Cheesecake Factory violated its disclosure obligations by omitting material information in its public filings, which constituted misleading disclosure. In its press release, SEC Chairman Jay Clayton made the following comment:

As our local and national response to the pandemic evolves, it is important that issuers continue their proactive, principles-based approach to disclosure, tailoring these disclosures to the firm and industry-specific effects of the pandemic on their business and operations. It is also important that issuers who make materially false or misleading statements regarding the pandemic's impact on their business and operations be held accountable.³

What Canadian Issuers Need to Know

The SEC brought the action against the Cheesecake Factory eight months following the company's public filings, pursuant to the SEC's ongoing commitment to scrutinizing public disclosure on the impacts of COVID-19. Canadian regulators have voiced similar commitments to keeping Canada's capital markets open and conducting vigilant enforcement of securities law.⁴

The disclosure principles set out by the SEC mirror the guidance from the CSA and the International

Organization of Securities Commissions (IOSCO). Accordingly, we expect that Canadian securities regulators may conduct investigations or commence proceedings that are similar to those levied against the Cheesecake Factory. Canadian public issuers should be particularly diligent in considering how they may be impacted by COVID-19, and what disclosures need to be made. As described in our earlier article, COVID-19 Impact: Disclosure Obligations and Risks for Canadian Public Companies, and pursuant to the guidelines published by the CSA and IOSCO, public disclosures relating to COVID-19 should:

1. Discuss important trends and risks relating to COVID-19 that have impacted, or are likely to impact, financial statements;
2. Provide detailed and specific steps that the issuer has taken and will take to mitigate risk with respect to COVID-19;
3. Inform investors about the quality and potential variability of profit, loss, and cash flow, and whether past performance can be understood to be indicative of future performance;
4. Discuss the impact of COVID-19 on the issuer's operations, including changes in total revenue, risks, and uncertainties that may materially affect future performance;
5. Be cautious when sharing forward-looking information and, given the uncertainty surrounding the COVID-19 pandemic, only disclose that which an issuer has a reasonable basis to disclose;
6. Keep disclosures up-to-date as new information becomes available and changes any judgments and/or estimates contained in financial statements; and
7. Avoid inconsistencies in transparency and detail between an issuer's private disclosure to investors and its required public disclosure.

In sum, issuers should be detailed, forward-thinking, and measured in how they disclose the impacts of COVID-19 on a company's operations and finances.

The Upshot

Though the Cheesecake Factory case is the first instance in North America of a securities regulator holding a public company accountable for incomplete disclosure relating to COVID-19, we anticipate that securities regulators will continue to scrutinize disclosure matters relating to the pandemic for the foreseeable future. Canadian public companies should be diligent in their consideration of how they disclose matters relating to COVID-19, to ensure that they continue to meet all disclosure obligations.

The authors of this article gratefully acknowledge the contributions of articling student Beth Burnstein.

¹ <https://www.sec.gov/news/press-release/2020-306>.

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² <https://www.sec.gov/litigation/admin/2020/34-90565.pdf>.

³ See <https://www.sec.gov/news/press-release/2020-306>.

⁴ CSA COVID-19 Information Hub.

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