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# Navigating the Economic Storm: Considerations for Public Companies

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The current financial crisis, the slowing U.S. and global economy and the meltdown of the financial markets are creating many challenges for public companies. During turbulent times, it is particularly important for a company to review its business plan, assess its business risks, determine its financing needs and consider strategic alternatives. This memorandum highlights issues public companies<sup>1</sup> should consider, as well as some practical steps to assist directors and senior management as they navigate through the economic storm.

## Heightened Ongoing Vigilance

Given the sudden and unexpected challenges being presented by this financial crisis, a public company should, on a proactive basis, focus on risk management at all levels of its enterprise.

- Assemble a team of senior officers and key employees (legal, operational and financial) as well as outside lawyers, financial advisors and other experts, as necessary, to assess risks and review the current business plan
- Review the current business and the company's business plan for the next 6 to 24 months
  - Assess the impact of the financial markets crisis and economic slowdown on the company's financial condition and operations
  - Evaluate business strategy and operating and financing alternatives
  - Review key business drivers and identify business trends and uncertainties
    - Assess economic and industry-wide factors relevant to the company
    - Develop and evaluate various operational scenarios, particularly "worse case" scenarios; "stress test" the assumptions and be sensitive to red flags
  - Review the company's future cash flows, liquidity needs and capital requirements
    - Determine sources and availability of capital under different "downside" scenarios, including revolving credit facilities, commercial paper markets, lines of credit and accounts receivable
      - Assess borrowing capacity under existing credit agreements
      - Review receivables

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<sup>1</sup> This memorandum is directed at companies outside the financial services sector (e.g., bank holding companies, financial holding companies or investment banks, etc.).

- Consider alternative sources of capital and their cost, including debt, equity or bank; compare processes and timelines needed to access such capital, including potential requirements for shareholder approval
- Evaluate asset dispositions to raise capital
- Conserve cash
  - Identify cost savings in all operations
  - Review capital expenditure plan to identify opportunities to reduce or delay spending
- Review liquidity of investments
- Revise business plan after factoring in current data
- Assess the impact of the market on your suppliers, customers, manufacturers and lenders and their ability to survive the crisis
- Analyze impact of accounting requirements
  - Determine whether impairment charges are necessary, particularly if stock price is below book value
  - Review nature and quality of reserve positions generally
  - Assess need for loss contingencies
  - Consider the impact of accounting changes and available guidance and interpretations, such as the recent guidance regarding mark-to-market (fair value) accounting
- Monitor the company's compliance with debt agreements and other material contracts
  - Review credit facilities, indentures and material contracts in light of revised business plan
  - Analyze affirmative, negative and financial covenants and default, cross-default, acceleration and collateral provisions
  - Review payment provisions and governance rights
- Review credit ratings, assess possibility of an adverse rating change and its impact, including possible collateral calls, defaults, cross-defaults to other agreements and increased funding costs
- Analyze counterparty default/credit risks under debt agreements and other material contracts and determine exposure to bankrupt/distressed entities
- Assess exposure to derivative securities and hedging contracts
- Evaluate status of current litigations and impact of adverse determinations; consider risk and cost of any potential governmental proceeding or other third party litigation
- Review D & O insurance policies, bylaw provisions and other indemnification rights for scope and amount of coverage in light of potential for increased litigation
- Consider impact of recent U.S. and foreign government regulations and other actions; assess opportunity to access governmental assistance; monitor governmental activity for ongoing changes
- Assess effects of changes in the tax laws, including those relating to deductibility of executive compensation

The considerations identified above will be useful when considering corporate governance matters and disclosure obligations.

## Corporate Governance

During these turbulent times, a proactive and well-informed board of directors must be focused on effective company-wide risk management.

- Importance of enterprise-wide risk management and role of risk management officers
  - Create a corporate culture focused on risk management
  - Conduct risk management assessment – evaluate and improve, as necessary, risk management policies, procedures and conduct in all areas, including business, financial, legal and reputation
  - Assess long-term and short-term business risks from top to bottom
  - Enhance internal audit function
  - Evaluate how the board assesses risk and risk management policies
    - Ensure that risk management is a function of the full board; coordinate all areas of risk oversight – audit committee, compensation committee, disclosure committee and risk committee
    - Evaluate the composition of board and its committees to determine that it has the appropriate expertise to assess and oversee risk and to evaluate the business plan and strategic alternatives
    - Consider all aspects of the business, including subsidiaries, not just significant business lines
    - Discuss with management whether the board is comfortable with the current level of risk for the company
- Keep the board informed
  - Directors must be prepared to invest the necessary time
  - Maintain regular contact and have more frequent meetings, whether at regular scheduled meetings of the board and board committees or at special meetings, to discuss market risk, credit risk, third party risk and operational risk
  - Provide timely updates of key business drivers, operating and financial performance and changes in operating conditions that impact business and risk profile
  - Determine need for additional expert assistance, including legal, financial, appraisers, tax advisors and others
- Review capital structure for opportunities
  - Review dividend policy and existing stock repurchase program
  - Consider equity and debt repurchases (bonds or bank debt)
    - Assess legal and procedural issues, including tender offer questions, shareholder approval requirements, contractual restrictions and stock exchange issues
  - Evaluate ability to raise equity capital
    - Consider shareholder approval requirements under state law<sup>2</sup> and stock exchange rules.<sup>3</sup>

<sup>2</sup> Recent events have shown that companies that lack the ability to issue preferred stock without shareholder approval can suffer delays in obtaining necessary operating capital.

<sup>3</sup> Generally, NYSE and NASDAQ require shareholder approval prior to the private issuance of common stock (or securities convertible or exercisable for common stock) at a price less than the greater of book or market value that represents 20% or more of common stock or voting power outstanding before the issuance. These rules are complicated and have certain exceptions. Legal counsel should be involved early in the process to ensure that these rules are satisfied.

- Evaluate eligibility to use shelf registration statement (including WKSI shelf availability, if applicable) as a result of the impact of market turmoil on the company's market capitalization
- Compensation is in the spotlight – review executive compensation and identify issues early
  - Evaluate compensation policies in light of emerging standards that discourage compensation tied to “unnecessary and excessive risks”
  - Review stock-based compensation in light of potentially significant drop in stock price
  - Review employment contracts to determine ability to change compensation structure or amounts
  - Consider appropriateness of instituting “clawback” provisions requiring senior officers to return bonuses under specified conditions
- Monitor NASDAQ/NYSE listing requirements, such as minimum bid price and market values, to avoid delisting
  - Recent market conditions caused NASDAQ to suspend through January 16, 2009, the application of its continuing requirements for listing related to the bid price and market value; the NYSE has indicated that it is not currently considering a similar proposal
  - Consider a reverse stock split to increase share price and reduce the number of outstanding shares in order to stay in compliance with the listing requirements
- Establish a communication plan to respond effectively to internal and external situations
  - Confidentiality is essential for an effective governance process
  - Evaluate public statements in a timely manner, including required timing for such disclosure
  - Continue to be sensitive to Regulation FD, which prohibits selective disclosure of material non-public information to certain market participants; for example, a company cannot confirm guidance privately

### Disclosure Considerations

A company should engage in thoughtful analysis of disclosure requirements; disclosure should be specific to the facts and circumstances of the company.

- Consider whether current market and economic conditions make it necessary or advisable to revise periodic disclosure or other public statements, especially risk factors, MD&A and forward-looking statements (FLS)
- Evaluate whether providing guidance is appropriate for the company and, if so, which metrics – revenues, earnings or other measures such as non-GAAP measures
- Renew focus on disclosure controls and procedures
  - Consider establishing Disclosure Committee, if one does not already exist; review and strengthen membership of the Committee if one does – it should consist of people with sufficient seniority and authority who can see the broad picture and have the ability to understand the impact of events on the company
  - Review processes for the Committee to obtain information and review disclosure
  - Devote the time and personnel (management, audit committee, auditors) necessary to review existing disclosure and prepare new public disclosure

- Update disclosure, in particular risk factors, MD&A and FLS
  - Consider all information available, including events and trends that have occurred after the closing of a reporting period
  - Evaluate whether there is information in MD&A (overview, trends, liquidity and capital resources) or other disclosure that is no longer material or useful, or has become stale<sup>4</sup>
  - Assess whether any known trends, events, demands, commitments or uncertainties are reasonably likely to have a material effect on the financial condition or results of operations, such as:
    - Sources of capital, changes in the mix and cost of capital resources and strategies for managing liquidity and risk of being unable to maintain liquidity
    - Sources of cash, certainty of cash flows, ability to monetize investments
    - Availability of financing from commercial paper market, capital markets and bank market and the impact on liquidity
    - Challenges and risks caused by known material trends and uncertainties in the short and long term, as well as the actions being taken to address these challenges and risks
    - Availability and cost of raw materials and commodity prices
    - Timing of commitments for capital expenditures and other cash requirements
    - Impact of hedging obligations, counterparty risk and off balance sheet risk
    - Impact of known or reasonably likely changes in credit ratings or ratings outlook
    - Impact of a breach or expected breach of a covenant (including the effects of any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance and ability to undertake additional debt or equity financing under debt covenants
  - Review risk factors to ensure each risk disclosed is specific to the company, described accurately, in Plain English and devoid of “boilerplate;” do not include multiple risks in one paragraph; add new risks as necessary
  - Update FLS at each use – identify specific forward-looking statements, avoid “boilerplate” and use Plain English
  - Assess effects of accounting requirements, including recent changes
    - Evaluate impact of mark-to-market accounting (SFAS 157) and related disclosure. Companies must consider the facts and circumstances surrounding a particular transaction and use significant judgment when determining if a sale is an orderly transaction or not and therefore not an accurate measure of fair value. Apply valuation policies consistently. Maintain documentation to support analysis. Board of directors and management need to keep a close eye on this issue
    - Asset impairment (SFAS 142 and related guidance) – particularly of goodwill, given low stock prices, in many cases below book value – required at least annually but consider looking at this quarterly; consider using third parties for valuations

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<sup>4</sup> SEC has renewed its focus on MD&A disclosure. Review the SEC’s 2003 interpretive release ([www.sec.gov/rules/interp/33-8350](http://www.sec.gov/rules/interp/33-8350)) addressing MD&A disclosure requirements and the two “Dear CFO letters” (March 2008 and September 2008) and other sample letters – see “Accounting and Financial Reporting Frequently Requested Materials,” <http://www.sec.gov/divisions/corpfin/cfactfinrptfrms.shtml>; providing guidance relating to the use of fair value measurements.

- MD&A should focus on critical accounting estimates, not necessarily critical accounting policies (which are already in the notes to financials) – focus on assumptions and judgments
- Bad debt reserves
- Risk factor or FLS Disclosure – determine whether mark-to-market issues or any other accounting policy should be disclosed as a risk or included in the FLS
- Be mindful of specific Form 8-K triggering events and timing for filing
  - Item 1.02 – Termination of a material definitive agreement
  - Item 2.04 - Triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement
  - Item 2.05 - Cost associated with exit or disposal activities such as disposal of assets or a plan to terminate employees
  - Item 2.06 - Material impairment of assets, including impairments of securities or goodwill, needs to be disclosed if determined other than in the course of preparing financial statements to be included in a Form 10-K or 10-Q
  - Item 7.01 – For FD purposes, consider disclosure of material non-public information a company wants to discuss with shareholders, analysts or other market participants
- Consider whether any additional disclosure of other events should be made voluntarily under Form 8-K Item 8.01

During these turbulent economic times, it is particularly important for directors and senior management to adhere to best practices of corporate governance and be proactive and realistic in assessing the business and risks facing the company. Navigating through this storm will be challenging. The specific facts and circumstances facing each company are different; however, the considerations discussed above provide a framework to assist in the process.