Managing the release of material information

What's new for directors in the SEC's new accelerated disclosure obligations.

BY CAROLYN A. MILLER

TODAY, BOARDS OF DIRECTORS find themselves in new territory. Expansive changes to federal securities laws and unprecedented decisions by the Delaware Supreme Court have materially increased boards' oversight responsibilities as well as their obligations to shareholders. In addition, attention on public companies has increased greatly following five years of high-stakes corporate scandals, rising executive compensation, and volatile financial performance. In tandem, these events have significantly raised the profile of corporate boards with investors, the public, shareholder activists, the judiciary, and regulators, to name a few. This means that as boards work to master their new, expanded responsibilities, they do so under a much brighter light.

One of the more critical proof points facing directors in the short term is the SEC's new accelerated disclosure obligations on Form 8-K, which take effect on Aug. 23, 2004. The SEC has identified eight new categories of information that are *de facto* material and must be publicly disclosed within four business days of their triggering events. Prior to the adoption of these new requirements, companies had, in certain instances, more than three months to disclose some of these items and no specific obligation to disclose others.

Importantly, six new disclosure items deal with issues that are likely to require either board involvement or approval and can bear directly on the company's share price upon release:

- Entry into a material definitive agreement not made in the ordinary course of the company's business.
- Termination of a material definitive agreement not made in the ordinary course of the company's business.
- Departures of directors or principal officers.
- Changes in the company's certifying accountant.
- Amendments to the company's code of ethics, or the waiver of a provision of the company's code of ethics.
- Material impairments.

These items carry with them specific issues and risks that need to be assessed before the date that the accelerated disclosure requirements take effect.

Identification and Anticipation

First, the board should identify the universe of people and entities that are likely to take the greatest interest in each type of disclosure and anticipate how their reactions could affect the company and the share price. Material contracts not made in the ordinary course of business, for example, may be of keen interest to competitors, as these contracts can signal that the company is diversifying its business model. Institutional or significant individual shareholders who do not share management's enthusiasm for these contracts may "vote with their feet," selling large positions in the company's stock, which can place downward pressure on the share price. Likewise, professional short sellers may increase their short positions in the company's stock.

In addition, shareholder watchdog groups are likely to pay particular attention to any waivers granted to provisions of the company's code of ethics. Given that significant ethical breaches by senior management were at the heart of the ex-

Carolyn A. Miller Esq., is senior vice president in the Corporate Communications Practice of Fleishman-Hillard, a leading global communications consultancy (www.fleishman.com). She develops internal communications strategies for public companies to help facilitate compliance with the Sarbanes-Oxley Act and SEC rules. She also advises clients on their investor and other external communications, with a particular focus on corporate integrity and governance. Prior to joining Fleishman-Hillard in 2003, she was vice president and special counsel in the Office of the Chairman at the American Stock Exchange.

treme violative behaviors that surfaced in the late 1990s, it is easy to understand why the SEC wants to see these waivers disclosed on a timely basis and why they will be closely watched by shareholder advocates following the date these new regulations take effect.

In the Proper Context

Second, to help protect against any adverse affects associated with investor overreaction, speculation, or confusion, the board should ensure management has developed effective guidelines regarding how much detailed information investors and other interested parties will need in order to place the disclosure in the proper context. Importantly, this will be the first time that companies are making discrete disclosures on individual topics in an extremely accelerated timeframe. And clearly, market participants will not immediately know how they should factor these disclosures into their valuations of the company. The SEC expressly refrained from requiring companies to include a "mini MD&A" analysis in these disclosures, responding to commenters' concerns that there is not sufficient time to prepare such analysis before the filing deadline. However, adequate context — which promises to be more art than science — is essential to ensure all market participants afford these disclosures the proper weight.

This will be the first time that companies are making discrete disclosures on individual topics in an extremely accelerated timeframe.

For example, when a company changes its certifying accountants today, the most common presumption is that the accountants are being replaced because they were unwilling to employ aggressive interpretations of GAAP requirements consistent with management's wishes. This presumption fosters the perceptions that unethical behaviors may be part of the company's culture and that the audit committee is not taking the hard line that it is now expected to take.

In reality, there are several, legitimate, non-nefarious reasons for a company to change its certifying accountants. Cost savings, for one, is high on the list, as every public company has seen audit fees skyrocket in a post Sarbanes-Oxley environment. As such, it is imperative that companies include the necessary information in their 8-K disclosures on sensitive issues like this one to help ensure market participants do not jump to erroneous conclusions.

The board should also have a clear understanding of what events actually trigger the company's disclosure obligation, bearing in mind that the policy reason underlying these new requirements is to ensure the capital markets have the information they need to fairly value the company's securities on a timely basis. Indeed, until a company has developed an accurate, good-faith interpretation of what the triggering events are for each new disclosure item, it will be walking a fine line between making premature disclosures that are tantamount to wearing its corporate heart on its sleeve and delaying the disclosure of material information in violation of the new 8-K reporting requirements.

Assume, for example, that a principal officer advises the company that he or she is voluntarily resigning. Clearly, the timing of this type of disclosure is tricky business and, in fairness to the company and its stakeholders, the announcement of such a departure is much better paired with the announcement of the replacement. So, when does the company consider this person to be "departing"? Is it on the date that the person gives notice, or his or her last day with the company, or somewhere in between — if there is an in between? What is the absolute outside date that this information can be disclosed without running afoul of the new 8-K reporting obligations?

Timing Pressures

To complicate this matter further, assume the departing principal officer has already accepted a new position with another public company, possibly a competitor. The new company, understandably, will be anxious to announce this positive news and, in fact, is also required to disclose this information within four days under the new 8-K reporting obligations. This, of course, places additional timing pressure on the company that is losing the principal officer and shifts the ability to determine what constitutes the triggering event to the company gaining the principal officer. So, how does that company interpret the triggering event? Is it the day that its board approves the appointment? Or the day the employment agreement is executed? Or the day the new principal officer begins work? To be sure, their analysis as to what constitutes their triggering event will fail to take into account what is best for your company.

Before a situation like this arises, the board must be confident that management has developed the strategy necessary to minimize any negative effects to the company and protect against avoidable volatility in the company's share price. And, in cases where the departing officer is the CEO, CFO, or other principal officer who is perceived as a credi-

ble successor to the CEO, the board's nominating committee should also be involved in developing this strategy.

The Board and Material Agreements

The board should also have a clear understanding of how the company is interpreting the triggering events related to entry into material agreements not made in the ordinary course of business. If board approval is required to enter one of these agreements, it is imperative that the board be apprised of other concurrent events that must be taken into account, such as disappointing quarterly numbers, adverse regulatory action, or a major new product announcement by a direct competitor.

Next, the board must consider how the concurrent events will bear upon the company's disclosure of this material agreement. Will the disappointing quarterly earnings draw more attention to and invite criticism of the board's approval of this material agreement? Will a direct competitor's major new product announcement divert the attention of analysts, shareholders, and the media away from this disclosure by the company? And, if so, is this a preferred outcome?

Establishing the triggering events related to the termination of a material agreement not made in the ordinary course of business poses even greater challenges — particularly when both parties to the agreement have this disclosure obligation and disagree as to whether it has been terminated. At this point, it can become a "race to disclosure," with each company trying to avoid being placed on the defensive. While events like these are fact-specific, the board should ensure that management has anticipated various scenarios and developed "if-then" strategies based on guidelines that are ethically and professionally acceptable to the board and the company.

Direct Access, or Filtered?

Board members should also consider how these new 8-K disclosures will reach the company's key stakeholders. Will they read these disclosures in the company's 8-Ks directly, or will they learn of them through a filter, such as the press? In this regard, board members should make ample use of their access to the company's director of corporate com-

When directors depart

The new disclosure requirements regarding the departure of directors also carry with them a very public twist — one that is further exacerbated by the reshuffling of boards currently under way at some companies in response to new independence requirements that took effect this year at the New York Stock Exchange and the Nasdaq Stock Market.

Formerly, any disclosure of a director's departure that resulted from a disagreement rested solely with the discretion of the departing director. Beginning August 23, however, if a director resigns or refuses to stand for re-election because of a disagreement with the company that was known to an executive officer — on any matter relating to the company's operations, policies, or practices — or if a director has been removed for cause, the company must disclose:

— The date of the director's resignation, refusal to stand for re-election, or removal;

— The positions the departing director held on any committees of the board; and

— A brief description of the disagreement that management believes contributed to the resignation, refusal to stand for re-election, or removal.

Further, the company must file a copy of any correspondence it receives from the director concerning his or her resignation, refusal, or removal, as an exhibit to the Form 8-K.

The company must then provide the departing director with the opportunity to furnish, in writing, his or her "side of the story" and, if the director does so, the company must file this document as an exhibit by amendment to the previously filed Form 8-K.

The company must provide the departing director with the opportunity to furnish, in writing, his or her 'side of the story.'

Some would argue this new requirement may discourage lively debate among board members and foster the age-old practice of respectful acquiescence in the boardroom.

However, the introduction of new directors less familiar to existing boards for purposes of meeting the new independence requirements adds an element of uncertainty to boardroom debates. And this new requirement may make it more difficult for existing board members — who technically meet the new independence requirements but have such long tenure with the company that critics deem them as "native" — to summarily dismiss new directors who are willing to take positions that are unpopular with the status quo but are arguably better for the company and shareholders over the long term.

Alternatively, new directors with strong convictions and aggressive tactics may seek to use this new disclosure requirement as a mechanism by which to pressure other board members into supporting these convictions at the risk of facing potential public embarrassment or harsh criticism from shareholder advocate groups. As such, it is crucial that board members establish parameters that support healthy and spirited debates, with an unshakable tenet to agree to disagree.

It is equally important that these parameters and this tenant are staunchly upheld by a strong chairman or lead director. After all, if board members are always agreeing on everything, then only one of them is thinking.

— Carolyn A. Miller

munications to gain a solid understanding of the journalists who cover the company and its sector. In addition, board members should know the various approaches that different journalists take: Do they seek to stir controversy? If so, do they refuse to let the facts get in the way of a good story? Or are they more inclined to take a fact-based, straightforward approach to reporting?

Board members should also consider how these new 8-K disclosures will reach the company's key stakeholders.

For better or worse, the press essentially serves as the highest court of equity in the U.S. and is subject to very little regulation when it comes to an obligation to be accurate. Forewarned is truly forearmed in this regard, and succinct, accurate standby statements in plain English are a must when dealing with controversial, high-profile reporters who will be trolling companies' newly accelerated and discrete disclosures on sensitive topics for tomorrow's headlines. Accordingly, it may be in a company's best interest to write Form 8-K disclosures in plain English in an effort to facilitate an accurate understanding by journalists and stakeholders alike. To be sure, federal and state regulators routinely look to newspapers and other news sources for indications of wrongdoing within companies and among their boards.

Ahead of the Game

At this point, there are clearly many more questions than answers when it comes to the new reporting requirements on Form 8-K. And certainly, the nitty-gritty of these rules are the responsibility of the subject matter experts within the company — primarily the general counsel, chief financial officer, and investor relations officer. However, boards who ensure that management takes a thorough, interdisciplinary approach to preparing strategies and guidelines to address these new disclosure requirements will be well ahead of the game when these reporting obligations take effect on August 23.

The key, of course, is to break down internal silos and determine how each new disclosure topic affects various operating divisions companywide. If you find that people within the company who have never worked together before are collaborating on how best to meet these new requirements, chances are your management team is on the right track. ■