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Legal Update

Maintaining Perspective: Governance and Disclosure Reminders for Public Companies

Companies will be affected in a variety of ways by the receivership of Signature Bank, Silicon Valley Bank and any other similarly situated financial institution. Companies may face difficulty accessing cash deposits, bank facilities or the capital markets or limitations on money market transactions or commercial paper facilities. Companies may also face losses on investments, especially those tied to the affected financial institutions or invested in broader investments tied to financial institutions generally. Resulting liquidity constraints may lead to difficult decisions, including prioritizing the uses of limited cash. The constituents of many companies may be affected, including employees, suppliers, lenders and customers. The effects may also impact shareholders.

Companies must also be diligent in ensuring their continued compliance with federal securities laws. In light of increased market volatility and uncertainty, U.S. Securities and Exchange Commission (SEC) Chair Gary Gensler issued a statement on March 12, 2023 that the SEC was "particularly focused on monitoring for market stability and identifying and prosecuting any form of misconduct that might threaten investors, capital formation, or the markets more broadly."

Board oversight of resulting decision making will be implicated in many cases. Senior executives are advised to maintain a regular dialogue with boards, particularly independent chairs or lead independent directors, as well as audit committee members. Boards and officers should coordinate with inside counsel and outside counsel as needed to assure compliance with applicable laws, including those concerning board duties and oversight and securities law disclosures.

Below, we provide a brief overview for companies and their directors and officers.

DUTIES OF DIRECTORS AMID HEIGHTENED UNCERTAINTY

When a company operates amid heightened uncertainty, certain stakeholders may second-guess decisions by the company. Decisions to raise capital or pursue other strategic alternatives, or other significant decisions, or the failure to take action or even consider certain alternatives, could all be challenged (with the bias of hindsight) as a breach of fiduciary duties.

As a general matter, under Delaware law a corporation's directors will have fulfilled their fiduciary duties if they act in an informed manner, with requisite care, and in the best interests of the company as a whole. Under Delaware law, the primary fiduciary duties of directors in the corporate context are the duty of care and the duty of loyalty, which also encompass a duty of risk oversight.

The Duty of Care

The duty of care requires that the actions and conduct of directors be informed and considered and that decisions be made with "requisite care." In satisfying their duty of care, directors should: (1) inform themselves of all material information reasonably available; (2) carefully consider that information and all reasonable alternatives; and (3) act with requisite care in discharging their duties. In discharging their duty of care, directors may reasonably rely upon the advice of management and the company's officers and advisors, but should independently evaluate assumptions and information presented. It is important to establish and follow a decision-making process and maintain thorough records to satisfy the duty of care.

The Duty of Loyalty

The duty of loyalty requires that directors act in good faith and in a manner they reasonably believe to be in the best interests of the company. Directors must exercise disinterested and independent judgment. Directors cannot act for a personal or non-corporate purpose, such as to preserve their positions or compensation, and should promptly disclose any conflicts (or potential conflicts) so that the board can evaluate and "neutralize" conflicts, if necessary. Directors must avoid an intentional dereliction of duty, a conscious disregard for their responsibilities, or, put differently, deliberate indifference and inaction in the face of a duty to act. As an example, preferring debts owed to insiders, including substantial shareholders, at the expense of other creditors, could give rise to claims of a breach of the fiduciary duty of loyalty.

Any director must exercise particular caution to minimize or mitigate an actual or even an apparent conflict of interest. In general, transactions undertaken with existing equity holders are likely to be closely scrutinized, especially in a distressed context. Directors who hold equity or are affiliated with existing equity holders (i.e., "insiders") should ensure actions considered in their capacities as directors are determined by reference to the interests of the company and all of its shareholders. It is also paramount for directors to fully disclose any actual or potential conflicts of interest.

THE BUSINESS JUDGMENT RULE

If directors satisfy the duties of care and loyalty, they are afforded the protection of the "business judgment rule" if a transaction they authorize is challenged. The "business judgment rule" is a highly deferential, protective standard that shields directors in their decision-making process if they satisfy their fiduciary duties in making a decision. The business judgment rule creates a presumption that the directors acted on an informed basis, in good faith, and with the honest belief that the action was in the best interests of the company.

THE ENTIRE FAIRNESS STANDARD

In cases of conflicts of interest, self-dealing, lack of good faith, fraud, failure to act reasonably or exercise reasonable judgment, or abdication of responsibilities, the less deferential entire fairness standard applies. **Because of concerns about future second-guessing, directors acting amid heightened uncertainty should act as if this higher level of scrutiny will apply to their actions.** The entire fairness standard shifts the burden to directors to prove that the decision or transaction was both procedurally and substantively fair. The entire fairness standard is the most onerous standard of review in the corporate context.

POTENTIAL CLAIMANTS: THE VICINITY OF INSOLVENCY

A director always owes fiduciary duties to the company and its shareholders, but certain other stakeholders may be able to assert derivative claims on behalf of the company (i.e., obtain "standing") for

breach of those duties. When a company is solvent, only equity holders may obtain standing to bring a derivative action on behalf of the company for breach of fiduciary duties.

When a company is insolvent, creditors may obtain standing to bring a derivative action on behalf of the company for breach of fiduciary duties. Although the fiduciary duties of care and loyalty to the company remain the same, the beneficiaries of those duties shift. **Since it can be hard to tell in real time when a company becomes insolvent, directors of a company in the vicinity of insolvency should view their duties through the lens of the different beneficiaries of those fiduciary duties.**

A prudent board of directors should focus on maximizing the value of the enterprise's long-term wealth-creating capacity when it is not sure of the company's solvency. Under Delaware law, one test of insolvency (i.e., the balance sheet test) is whether the sum of a company's debts exceeds the aggregate value of its assets and there is no reasonable prospect that the business can be successfully continued in the face of that insolvency.

In applying this test, the valuation of assets must be calculated at "fair market value" – neither book value nor GAAP accounting principles are controlling, though courts have not provided significant guidance on the precise calculation method. A company is considered insolvent under the equity or cash flow test if it is unable to pay its obligations as and when they come due. The key consideration in this case is whether the company has the ability to produce sufficient cash to pay its debts as they mature, and such cash can come from continuing operations, the disposition of assets, or other capital raising activities. Ordinary course liquidity management (for example, timing transactions to "smooth out" cash flows) does not provide sufficient evidence that a company is insolvent.

EMPLOYMENT LAW

Companies operating with limited cash or facing other liquidity challenges may be tempted to temporarily delay or reduce payment of certain current expenses, which may be desirable and feasible with certain contract parties such as landlords or suppliers. Corporate officers and directors should be aware, however, of legal limitations on such flexibility when it comes to obligations to pay employees' wages and overtime benefits.

For instance, the federal Fair Labor Standards Act, 29 U.S.C. 203(d), imposes personal liability on corporate officers and directors for minimum wage and overtime violations under certain circumstances. An "employer" under FLSA includes not only a company but "any person acting directly or indirectly in the interest of an employer in relation to an employee." For this purpose, courts consider factors such as whether a person has power to hire or fire employees, supervises or controls employees or conditions of employment, sets pay levels or maintains records.

Section 558.1 of the California Labor Code provides that "(a) Any employer or other person acting on behalf of an employer, who violates, or causes to be violated, any provision regulating minimum wages or hours and days of work . . . may be held liable as the employer for such violation. (b) For purposes of this section, the term 'other person acting on behalf of an employer' is limited to a natural person who is an owner, director, officer, or managing agent of the employer . . . ."

Companies faced with the prospect of adjusting payroll due to liquidity crunches should first consult counsel to evaluate the specific facts and applicable legal details.

OVERSIGHT DUTIES

A board's risk oversight responsibility derives primarily from state law fiduciary duties. To be clear, the board is not required to be involved in actual day-to-day risk management. Its responsibilities are limited

to oversight. Generally, directors can only be liable for a failure of board oversight where there is "sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists." *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996).

Board oversight obligations also appear in the rules of the securities exchanges. For example, the New York Stock Exchange rules impose certain risk oversight obligations on the audit committee of a listed company. While acknowledging that "it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk," NYSE rules require that an audit committee "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken."

Additional oversight duties apply to companies in certain industries, including banks

Federal Reserve Board rules adopted under the Dodd-Frank Act require all covered companies, as well as publicly-traded bank holding companies with $50 billion or more in assets, to create a risk committee to oversee risk management practices on an enterprise-wide basis. The committee must have at least one independent director and at least one member with relevant risk management expertise. Each member of the committee must have an understanding of relevant risk management principles and practices.

Audit Committees

In all areas of corporate governance and law, special emphasis is on the audit committee. Among other things, audit committees oversee policies designed to manage major financial risk exposures and the steps the company has taken to monitor and control such exposure, including a general review of the company's risk management programs. Audit committees charged with the primary risk oversight function should engage directly with corporate officers in managing evolving risks concerning liquidity and solvency and otherwise addressing challenging financial conditions.

DUTIES OF OFFICERS

Officers' duties and scope of authority are usually outlined in a company's bylaws and detailed in employment agreements. In addition, officers are generally understood to owe their corporations the same duties as directors do. See *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). But officers do not possess the statutory authority or duty to act for the corporation that boards of directors do and there are fewer cases addressing officer duties compared to director duties. In a recent case, the Delaware Chancery Court held that officers owe their corporations a duty of oversight, fitted to the context of their scope of authority. Cases stating such officer duties do not always clarify whether the business judgment rule applies, although most authorities explicitly addressing that question indicate that the business judgment rule applies to officer decisions just as it does to director decisions. When officers operate in challenging environments posing extraordinary decisions, it is advisable to consult with senior officers or the board of directors.

SECURITIES LAW DISCLOSURE DUTIES

Compliance with U.S. securities laws is important, especially in times of heightened uncertainty. Every public disclosure, including SEC filings, press releases and investor presentations must be presented in a manner that does not contain an untrue statement of material fact or omit to state a material fact necessary in order to make the disclosure, in light of the circumstances under which it is presented, not misleading.

Reporting for U.S. companies under the Securities Exchange Act of 1934 (Exchange Act) includes annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Forms 8-K and proxy and

information statements. Public companies are subject to detailed requirements regarding the public disclosures they must make. Every effort should be made to ensure that information required to be disclosed is disclosed in a timely manner, including on all aspects of risk and risk management as well as financial reporting consequences.

All material information must be disclosed. There is no bright line test; materiality depends on whether a reasonable investor would consider the information important in making an investment decision. In unprecedented or extraordinary circumstances, managers may lack a feel for what is material. In these situations, consulting with experienced securities counsel can help.

Be careful about omissions. Liability can also arise if information is omitted and the omission makes a disclosure misleading. Items which are likely to be material: liquidity or solvency concerns, difficulty accessing credit, money markets, or commercial paper markets, significant counterparty risk, credit risk or concentration of risk, significant changes in assets and impairment in the value of assets, and efforts to raise capital and other related matters.

The major stock exchanges also require the prompt public disclosure of material information. Companies must also be mindful of the SEC's requirements to avoid selective disclosure of material non-public information. Generally public companies often release to the public more information, and more frequently, than the SEC's rules would otherwise require.

Disclosures in connections with securities offerings should be reviewed carefully for omissions and misstatements arising from a bank failure and related circumstances. Risk factors, in particular, will need careful consideration. The company's own liquidity must be reevaluated. Any change in the company's situation should be assessed.

Disclosure in Current Reports on Form 8-K

Depending on the impact of the situation on a particular company, disclosure could be required in a current report on Form 8-K. For example, Item 1.01 of Form 8-K requires disclosure whenever a registrant "has entered into a material definitive agreement not made in the ordinary course of business of the registrant, or into any amendment of such agreement that is material to the registrant," while Item 1.02 requires similar disclosure in the event of the termination of such agreement.

If a registrant has an existing material credit agreement with a lender that has moved into receivership, it may need to amend or terminate such agreement and/or enter into a new credit facility entirely. In such a case, the registrant would need to provide a brief description in the Form 8-K of certain details, including, as applicable, the date the agreement was entered into, amended or terminated, material terms and conditions of the agreement, material circumstances surrounding the termination, and any material termination penalties incurred. Entry into a new or amended credit agreement may also require disclosure under Item 2.03 of Form 8-K, as the creation of a direct financial obligation.

If the registrant itself is materially and adversely impacted by current events, it may need to report defaults or similar events causing an increase or acceleration of a direct financial obligation, such as a credit agreement, under Item 2.04 of Form 8-K. Additionally, Item 2.06 of Form 8-K requires disclosure when a material charge for impairment to one or more of a registrant's assets is required under generally accepted accounting principles applicable to such registrant.

Disclosure in Periodic Reports on Forms 10-K and 10-Q

A company's CEO and CFO must evaluate the company's internal control over financial reporting and disclosure controls and procedures. Exchange Act rules promulgated to implement Sections 302 and 906

of the Sarbanes-Oxley Act require CEOs and CFOs of public companies to include certifications in periodic reports filed with the SEC that address, among other things, the accuracy and fair presentation of the report's disclosure. Criminal penalties can be levied against CEOs and CFOs personally, which could result in significant fines.

Consideration should be given to how current events will affect the primary content in Forms 10-K and 10-Q. Public companies should consider making disclosures as appropriate in the following areas, among others, in accordance with Regulation S-K: (1) Risk Factors, (2) Legal Proceedings, and (2) Management's Discussion and Analysis of Financial Condition and Results of Operations, each of which is further discussed below.

Disclosure in the Risk Factors Section

Item 105 (17 C.F.R. § 229.105) of Regulation S-K requires a description of material factors that make an investment in the company or the securities being offered speculative or risky, with a concise explanation as to how each risk affects the company or the securities. Such risks may assume many forms and vary by company. The risk factors section of a periodic report should be updated to reflect new and evolving risks arising not only from direct exposure to any bank failure and related solvency, operational or liquidity concerns, but also from indirect exposure, i.e., through the company's relationships with vendors, suppliers, customers, lenders and others who may be directly or indirectly affected by a bank failure (and interest rate policy or interest rate exposure more generally) and squeezed for liquidity. Receivables and other assets should be reassessed for liquidity and default risk.

For example, with respect to operational risk, a public company that held a significant amount of deposits in a failed bank should consider whether it needs to disclose that the failure of such bank could lead the company to lose its deposits in excess of federally insured bank deposit limits, which could create an inability or delay in paying operational expenses and other costs. Conversely, if a company's vendors or suppliers had exposure to a bank failure, the company may disclose that such failure may inhibit such vendors' or suppliers' ability to provide services and materials to the company, creating additional operational risk. A company that previously had a loan agreement with a failed bank may need to disclose a loss of liquidity that could result in an inability to service debt obligations.

With respect to financial risk, a company with significant exposure to assets such as U.S. Treasuries and mortgage-backed securities should consider disclosing the potential impact of fluctuations in interest rates on their balance sheets. Additionally, a company with a customer base concentrated in a specific industry (such as the technology sector) should consider disclosing the financial risk of decreased demand, in the event that such customers relied or could rely on a common bank or lender.

A company should also consider disclosing any related risks of litigation and potential reputational harm that may arise from the inability to pay vendors, suppliers or other third parties or to service debt obligations.

Disclosure in the Legal Proceedings Section

Item 103 (17 C.F.R. § 229.103) of Regulation S-K requires a description of any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or its subsidiaries is a party or to which any of their property is subject. For example, if the failure of a lender results in a public company being unable to meet its debt service obligations, or pay its vendors, suppliers, employees or other third parties, it may be subject to material litigation or administrative or judicial proceedings that it would need to disclose under this section.

Disclosure in the MD&A Section

Item 303(a) (17 C.F.R. § 229.303) of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), requires a discussion of a company's financial condition and results of operations and any material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This includes descriptions and amounts of matters that have had a material impact on reported operations, as well as matters that are reasonably likely based on management's assessment to have a material impact on future operations. The MD&A should not include merely generic or boilerplate disclosures but should reflect how particular facts and circumstances affect the company and its business.

Public companies should include in the MD&A section any trends and uncertainties. The discussion should address the company's liquidity, contingencies and litigation as well as how the company may be impacted given its counterparty relationships, including those with customers and suppliers. For example, Item 303(a)(1)(i) of Regulation S-K requires registrants to disclose "any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way," as well as any course of action to remedy any material deficiency.

Accordingly, a public company that had previously entered into a loan agreement with a failed bank as lender should consider (i) disclosing that it may no longer have access to certain credit facilities due to such bank moving into receivership, and (ii) affirming whether its remaining cash, cash equivalents, securities, loan facilities and other net proceeds would be sufficient to continue funding its capital expenditure requirements, debt service obligations and operating expenses in both the near- and long-term.

Item 303(a)(2)(ii) similarly requires registrants to disclose "known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Such uncertainties could include decreased demand if, for example, a company's customers were concentrated in a single sector and were exposed to market uncertainty.

PARTICULAR CHALLENGES IN THE CURRENT ENVIRONMENT

Maintaining Liquidity

During periods of systemic instability, maintaining liquidity is always a paramount concern, so building additional liquidity is a critical focus. One source of liquidity is lines of credit. Consideration may be given to expanding or adding additional lines of credit with banking partners. Issuance of debt securities can provide additional liquidity. It is likely that short-term, floating rate debt is preferred by investors in this environment, although longer term debt may provide more stability. Commercial paper facilities can provide quick access to short-term funding markets on a daily basis and can be established relatively quickly.

Secured funding and securitization can both provide access to funding in difficult times. For secured funding, the market liquidity of the assets securing the facility will be of concern to investors. Necessary lead times for securitizations mean that early planning is essential.

Capital relief transactions through risk transfer or asset sales also can reduce capital pressures and improve liquidity.

In times of rising interest rates, hedging costs tend to increase, but, nevertheless, the failure to hedge interest rate exposure can prove fatal. A company also may evaluate a capital injection—this may take the form of a private placement made to a strategic partner, private equity investor, or other private capital source. Of course, a company with an existing shelf registration statement might always consider a takedown off of its shelf registration statement, on a confidentially marketed basis, depending on market conditions, or accessing an at-the-market offering program.

SUMMARY

Examples of actions that directors and officers can take to discharge their duties and minimize risks include:

- ensuring directors are sufficiently informed about, and are appropriately analyzing, the company's solvency throughout any crisis response situation or process
- obtaining advice from outside advisors as alternatives are presented and assessed
- discussing with counsel whether it is prudent under the circumstances to appoint one or more disinterested directors and/or forming strategic or crisis response committees comprised of such directors
- documenting the basis or reasoning underlying director and officer decision-making
- when a director is also an equity holder or represents an equity holder, ensuring decisions are made based on the interests of all equity holders
- being vigilant in embracing and understanding prevailing and potential risks and being informed and adaptive in response
- assuring accurate, complete and timely disclosure of all material information concerning lenders, liquidity, solvency, financial risks and operating risks, including effects on third parties that could materially affect the operation and its business

CONCLUSION

As federal and state authorities and private institutions work to maintain the stability of the financial system, it is important for corporate leaders to maintain perspective as well. The duties of officers and directors of public companies are unchanged but the context in which they are applied may differ for some companies. We are happy to discuss these and other topics of interest.

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