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## **Guidelines on Disclosure Practices for High Yield Issuers in Light of Current Market Conditions**

Companies providing annual or quarterly reports to investors should be mindful that, in light of continuing adverse market conditions, rating agencies and investors (and for those companies that are listed, securities regulators) will be paying significant attention to those reports. In particular, the disclosures set forth in the Management's Discussion and Analysis of Financial Condition and Results of Operations or Operating and Financial Review section (collectively, for purposes of this memorandum, the "MD&A") of such reports will be closely scrutinized to gain a better understanding of a reporting company's results, liquidity and financial condition and its prospects.

In view of the greater scrutiny of periodic disclosure and the potential difficult decisions that issuers may well confront as they evaluate the impact of market conditions on operations and cash flow, on their levels of liquidity and on their access to capital, we use this opportunity to update reporting companies about disclosure practices that the market will expect will be followed.

We note that high yield issuers typically are subject to a reporting covenant that calls for periodic reports containing financial statements as well as an MD&A similar in scope to the financial statements and MD&A contained in the offering memorandum (the "Offering Memorandum") pursuant to which the relevant securities were issued. (For many high yield issuers, as they may well be non-listed companies, this reporting covenant may be the only source of external reporting obligations.) Because the initial disclosure typically would have been drafted in light of prevailing SEC disclosure rules, those rules, SEC staff guidance on applying those rules and SEC staff comments on actual disclosure made in SEC filings are useful guides to best practices, even for issuers that are not SEC reporting companies or even listed elsewhere in the world.

In light of the foregoing, we provide below an overview of best practices based on advice given to SEC reporting companies, with emphasis on considerations relevant to non-public high yield issuers. Although adequacy of disclosure will ultimately be a function of applicable rules, the following should be helpful in crafting informative disclosure.

### **Best Practices**

As management and boards of issuers evaluate the impact of the ongoing current financial crisis on operations and results, communications with shareholders, other stakeholders (such as bondholders) and the marketplace must adequately reflect the outcome of such evaluations. This in turn means that management, in the first instance, and also those on the

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\* This Guidance Note has been prepared on behalf of the European High Yield Association by Mark Bergman of Paul, Weiss, Rifkind, Wharton & Garrison LLP

board who review such communications, must ensure that press releases, investor presentations, quarterly conference calls and, most importantly, periodic reports convey the proper disclosures as to the impact of the crisis, as well as the impact of current economic conditions, on the issuer.

## **MD&A**

The MD&A has been required for SEC reporting companies for many years (the origins date back to 1968 and the current framework dates back to 1980) and would have been a key component of the disclosure in any Offering Memorandum. Item 303 of Regulation S-K sets forth the key elements that should be covered in an MD&A. Since the revisions to the MD&A requirements in 1980, the SEC has issued various interpretive releases, including one in 1989 (Release no. 33-6835), a second in 2002 (Release no. 33-8056) (the “2002 Release”) and a third in 2003 (Release no. 33-8350) (the “2003 Release”). The MD&A is to provide investors with the information “necessary to an understanding of [a company’s] financial condition, changes in financial condition and results of operations.” One of the key elements of the MD&A is the discussion and analysis of “known trends, demands, commitments, events and uncertainties.”

A perennial challenge in drafting an MD&A is how to get behind the numbers and present an accurate picture of the company from a financial point of view. As the MD&A is the opportunity for investors to see the company through the eyes of management, neither boilerplate disclosures nor mere recitals of changes in financial statement line items are what investors or the SEC expects to see. The disclosure of “known trends, demands, commitments, events and uncertainties” and the impact of any of the foregoing on the company’s financial statements is required and will be especially scrutinized in these uncertain times.

We discuss below some of the key elements of the MD&A that warrant particular attention in this environment.

### ***Factors Affecting Results***

The MD&A typically will have an overview section that describes the general trends in the business and the impact of those trends on financial results. As part of this discussion, management should focus on factors that have impacted, or can reasonably be expected in the future to impact, the results. These could be general, such as macro-economic conditions, general conditions in the company’s industry or foreign currency movements, or very specific, such as the loss of a major customer, supplier or competitor or the need to renegotiate a material contract or other arrangement. Reliance on significant customers or suppliers may well warrant disclosure if there is a heightened counterparty risk that could lead to material exposure were the risk to come to fruition. Customers or suppliers may be facing credit constraints the results of which could range from a delay in the receipt of revenue to a loss of revenue.

If market conditions have resulted in changes to a business plan that are likely to impact results, either because of an impact on the revenue side or increased costs to execute the shift, those changes should be highlighted.

Management should also consider the potential impact of changes in accounting standards, particularly in the areas of fair value accounting and impairment. The importance of current disclosure in respect of impairments can be highlighted by the fact that SEC reporting companies are required to issue real time disclosure (current reports) if a company concludes,

other than in the course of the period-end preparation of financial reports, that a material charge needs to be taken for impairment. A related consideration would be the impact of current market conditions on pension obligations.

Note that the SEC does not recognize for disclosure purposes a concept equivalent to judicial notice. This means that a company cannot assume that investors are aware of publicly available market or industry information that might impact the company. As a result, the disclosure requirements applicable to known trends are not limited to company-specific disclosure; the trends may be industry-specific or broadly applicable (and still need to be discussed and analyzed). A company should also not hide behind macro-economic trends and uncertainties; the disclosure needs to be tailored to the company and its financial statements, and should address how the company and its financial statements are specifically affected by events occurring in, and pressures created by, the broader economy both locally, and, as applicable, globally.

### ***Results of Operations***

In the comparisons of period-to-period results, stating that specific line items increased or decreased is not sufficient. The comparisons must also provide meaningful explanations as to why there were changes. If revenue decreased, was it because of lower levels of business (volume) or lower prices (rates)? Were there greater competitive pressures? And remember that in drafting the overview, once the reader gets to the comparisons, there should be no surprises, as the historical trends and more recent material developments should have been highlighted in the overview.

Where changes to a line item are attributable to more than one factor, recent SEC staff comments suggest that consideration should be given to quantifying those factors.

### ***Liquidity and Capital Resources***

The liquidity and capital resources section is intended to provide a clear picture of an issuer's ability to generate cash and meet existing and known, or reasonably likely, future cash requirements. The importance of this section is underscored by the SEC's view that the information in this section is "critical to an assessment of a company's prospects for the future and even the likelihood of its survival." A company is required to include in its MD&A, to the extent material (as outlined in the 2003 Release):

- historical information regarding sources of cash and capital expenditures;
- an evaluation of the amounts and certainty of cash flows;
- the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements;
- a discussion and analysis of known trends and uncertainties;
- indications of which balance sheet, income statement or cash flow items should be considered in assessing liquidity; and
- a discussion of prospective information regarding a company's sources of and needs for capital.

A company should evaluate separately its ability to meet upcoming cash requirements over both the short-term and the long-term. Stating that a company has adequate cash resources generally is not sufficient, particularly if there are known material trends, or uncertainties, related to cash flow, capital resources, capital requirements or liquidity.

**Liquidity.** At the annual AICPA National Conference on SEC and PCAOB Developments held in December 2008, the SEC staff again emphasized the importance of the liquidity discussion in the MD&A. It noted that the liquidity discussion must be user-friendly, display prominently the most critical information, be meaningful without resort to supplemental calculations by readers, include management's insights and exclude superfluous information. Readers should be able to review the disclosure as a stand-alone section.

SEC staff comments on liquidity sections typically direct issuers to revise disclosure to discuss the impact of disclosed events or developments, to discuss underlying business reasons for changes in operating cash flows and to indicate whether operating cash flow trends are expected to continue.

**Operating activities.** This discussion, which quantifies items contributing to period-over-period changes in net cash provided by/used in operating activities, should not simply repeat information derived from the cash flow statement. Rather, the discussion should address changes in cash received from, or paid to, customers, suppliers, employees and others, and any known trends or uncertainties that could reasonably affect separate sources or uses of cash (for example, the negotiation of a new material supply or customer contract).

**Investing activities.** This discussion should not simply quantify historical or anticipated capital expenditures. Rather, the discussion should evaluate capital expenditures on a discretionary and non-discretionary basis and address how such expenditures will be funded.

**Financing activities.** This discussion should not simply quantify unused availability under credit facilities. Instead, the discussion should discuss the sufficiency of the unused availability (or estimated utilization), anticipated circumstances triggering its use (for example, seasonality of operations), uncertainties as to availability of funds when they might be needed and the implications of not being able to access funds when needed.

**Credit ratings.** A discussion of ratings should not simply recite the various ratings. Instead, the discussion should discuss the factors that may materially influence the ratings, the potential impact of known or reasonably likely changes in ratings or rating outlook, and management's expectations as to rating changes. Stating that a change in ratings would increase borrowing costs typically would not be sufficient disclosure.

**Contingent obligations.** Remember to update the table of contingent obligations each period, and be sure to reflect any reduction in the outstanding principal amount of bonds as a result of market purchases or a tender offer. Also, the line item for the bonds should be footnoted to reflect estimated future interest expense, and to the extent that there are changes in any hedging arrangements that will impact the real cost to the company of payments of interest or principal in local currency, those changes should also be reflected as appropriate.

We note below some of the factors management should consider as it assesses both the company's liquidity needs and its MD&A disclosure:

- As for the company's liquidity needs and potential sources of capital:
  - When does the company need funding and what is the impact of the timing relative to the availability of the funding?

- Is the company reliant on a single bank or a group of banks and is it possible that lenders may be unwilling or unable to lend under existing credit facilities or may have changed their lending practices?
- Does the company access the commercial paper market or other short-term funding sources?
- When do the company's term loans mature and when do the company's revolving credit arrangements terminate?
- Does the company have "headroom" under a revolving credit facility, and does it make sense to draw down under the facility even if additional funds are not currently needed?
- Has the company relied on the securitization markets and, if so, what are the funding implications of the current state of the market?
- Is there a need for additional future pension funding to make-up any shortfall?
- What is the impact of existing share repurchase programs and dividend payments?
- Are alternative sources of equity and debt capital available? For example, would a controlling shareholder be in a position to fund shortfalls? If so, would applicable covenants require that the additional capital be provided in the form of deeply subordinated shareholder loans?
- Are there potential covenant compliance issues?
  - Is it possible that an amendment or waiver will be required from lenders under bank credit facilities?
  - Are there covenant issues under the high yield bond indenture (or other capital markets debt) that could require a consent solicitation?
  - Covenant issues could arise, for example, from changes in ratings or failure to meet maintenance covenants or from breaches of incurrence tests if the company were to take unexpected measures to relieve pressures associated with current market conditions.
  - Note the impact of accounting issues on debt covenant compliance.
- Do assets deemed to be liquid have the expected realizable value under current market conditions?
- What are the potential consequences of higher borrowing costs?
- If the company seeks amendments, waivers or consents, consider the possibility of the debt holders demanding new lender-friendly terms and conditions, and potentially expensive amendment or consent fees.

Other liquidity uncertainties will stem from the provisions in debt agreements that could trigger early payment, additional collateral support, more onerous terms or covenants, acceleration or additional financial obligations. These provisions could be tied to adverse changes in ratings, ratios, earnings, cash flow or stock price, or changes in underlying, linked or indexed reference assets.

Having considered the foregoing factors and questions, management should, in assessing the adequacy of disclosure, also consider the following points:

- analyze and discuss the sources and uses of cash;
- discuss changes in cash received from all sources, and cash paid out; and discuss any known trends and uncertainties that are reasonably expected to have material effects on the separate uses and sources of cash;
- evaluate capital expenditures on a discretionary and non-discretionary basis (meaning expansion and maintenance of existing capacity) and discuss any anticipated funding sources (for example, the extent to which cash received from customers will be available);
- quantify the unused availability under short-term funding arrangements (as well as the estimated utilization, if reasonably foreseeable), identify the anticipated circumstances requiring its use, discuss any uncertainty surrounding the ability to access funds when needed, and address any implications of not being able to access the funds;
- discuss the factors that may materially influence credit ratings, the potential implications of known or reasonably likely changes in credit ratings or credit rating outlook, and management's expectations with respect to credit ratings (or identify, if possible, developments that could reasonably be expected to impact ratings);
- discuss any uncertainty or trends surrounding future compliance with financial covenants, and the material implications of a breach (including possible cross-default scenarios); and provide company-specific calculations when ratios under a debt agreement are provided in a periodic report (if investors would need to perform their own calculations of ratios, consider providing the calculations in the report);
- discuss the capacity for additional borrowings under the most restrictive financial covenant, whether there is otherwise an ability to raise these funds, and whether this amount is sufficient or insufficient for current and long-term needs; and
- address current market conditions and any uncertainties relating to the commercial paper market, committed and uncommitted borrowings, cash and securities held at banks and other financial institutions, illiquid investments, future pension funding, share repurchase programs and dividend payments.

Separately, to the extent that any liquidity solutions involve related (*i.e.*, affiliated) parties, management needs to consider the general disclosure obligations for the MD&A in respect of material related party transactions. Any such arrangements may also trigger the requirements of the transactions with affiliates covenant in the indenture.

Note that some of the foregoing points will also appear in requests from the rating agencies in the form of liquidity reports or other requests for information.

Finally, to the extent that an issuer wants the flexibility to repurchase its debt in the future, it should consider adding disclosure in the MD&A to the effect that it may, from time to time,

consider repurchasing its debt securities in the open market, by tender offer or otherwise. This disclosure puts bondholders on notice that the levels of debt, and the related interest expense, may be reduced and that cash may be applied to reduce the debt (potentially involving a re-allocation of cash resources from previously disclosed capital or other expenditures).

### **Risk Factors**

Management should consider whether the existing risk factors in the most recently provided annual report are adequate or need to be updated. To the extent that updates are appropriate following the release of the annual report, the risk factors should be updated in the next periodic report – generally the next quarterly report. Changes in the MD&A may well result in corresponding changes to the risk factors, and vice-versa. More broadly, the effects of macro-economic changes are likely to have an impact on the business and should be adequately reflected in risk factor disclosure.

The key is to approach the risk factor section each quarter with a fresh eye and to consider whether the risks that management has faced, or expects to face, are adequately covered. With both the global financial crisis and the economic downturn evolving in terms of scope, severity and consequences, and with no sectors or geographic locations immune to these consequences, risk factor disclosure is likely to be in regular need of updates.

### **Forward-Looking Statements**

Management should consider whether specific factors cited in the note on forward-looking statements need to be updated with new or different factors, and whether the order of the factors listed should be modified based on changes in the probability of certain (previously remote) factors actually affecting results.

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In stable markets, informative disclosure that complies with both the letter and the spirit of the SEC's disclosure requirements should be a matter of best practice. In this environment, that informative disclosure (with particular sensitivity to trends and uncertainties) will be critical to help manage the expectations of investors and the market more generally, and to reduce surprise public announcements. To be informative, textual disclosure should not simply reiterate what is derivable from the financial statements or the notes to those financial statements. As the MD&A title implies, the results should be discussed *and* analyzed, and this should be done from the perspective of the information that management has to hand.

Informative disclosure should also reduce the strain on investor relations staff and the chief financial officer as they respond to the undoubtedly large (and increasing) volume of questions about a company's future, without violating any applicable selective disclosure rules (or best practices based on those rules). Finally, informative disclosure can also help reduce the likelihood of the enforcement actions and securities class actions that invariably follow market downturns.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content.