SEC Disclosure Considerations Following Bank Sector Disruptions

Recent failures of certain domestic and international banks and resulting government intervention, acquisitions and subsequent developments have resulted in significant disruption in the bank sector. Compliance with U.S. securities laws is important, especially in times of heightened uncertainty. This alert focuses on the impact that the current volatility may have on disclosures that public companies make in their filings with the U.S. Securities and Exchange Commission (SEC).

Since the recent bank failures, hundreds of companies have filed current reports on Form 8-K to report impacts that the bank sector disruptions have had on their businesses. Companies should continue to assess whether developments in this area should be disclosed currently on Form 8-K, as well as consider the impact of the bank sector disruptions in connection with future filings with the SEC, such as annual reports on Form 10-K, quarterly reports on Form 10-Q and registration statements under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act).

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. Determining what is material can be difficult as there is no bright-line test. Information is material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. In unprecedented or extraordinary circumstances, management may lack a feel for what is material. In these situations, consulting with experienced securities counsel may help. Since materiality is often judged with the benefit of hindsight, and the SEC has often looked to trading volume and stock price movements as evidence of materiality, it is essential to consider closely whether disclosures relating to the bank sector disruptions would be viewed as impacting the market for the company's securities.

Assessing the Evolving Impacts of the Bank Sector Disruptions

To illustrate the types of impacts that the bank sector disruptions may have on a company and that could affect a public company's disclosure obligations, the following is a non-exhaustive list of questions to consider:

- How have these recent developments, including the resulting volatility in the financial markets, impacted your capital and financial resources, including your overall liquidity position and outlook?

- Has any bank failure impacted your ability to access lines of credit, revolving credit facilities or other forms of liquidity?
- Have you had to, or do you anticipate needing to, find other liquidity sources, including entering into new or additional lines of credit with different banks or other lenders?
- Has any rating agency announced that the company's securities are on a watch list for potential downgrade or have been downgraded?
- Have the current disruptions impacted your ability to access the capital markets?
- Have the current disruptions affected the value of assets on your balance sheet, including, but not limited to, your investment portfolio? Do you anticipate any material impairments or write-downs of such assets? Have recent disruptions affected the effectiveness of any hedging positions or the cost of any of your hedging arrangements?
- Does your investment portfolio have significant exposure to stocks or other securities of companies in the bank or technology sectors?
- How have the bank sector disruptions affected, or do you expect the banking disruptions will affect, how and where you keep your cash and short-term investments?
- How has, or how could, significant increases in interest rates impact your financial results and cash flow?
- Is the company at material risk of not meeting any covenants in its credit and other agreements?
- Have the banking disruptions significantly increased your counterparty credit risk, including, but not limited to, counterparties in the bank and technology sectors? If so, how do you intend to address those risks? Have current developments affected your derivatives counterparties?
- Have the banking disruptions impacted, or do you expect the banking disruptions to have a material impact, on any of your customers or suppliers that have the potential to affect the company's business?
- Do you anticipate any material allowances for credit losses, restructuring charges, other expenses or changes in accounting judgments?

A company's disclosure should be tailored to its business, providing material information about the impact of the bank sector disruptions through the eyes of management. In addition, the SEC encourages companies to "proactively revise and update disclosures as facts and circumstances change."

Disclosure in Current Reports on Form 8-K

Depending on the impact of the bank sector disruptions on a particular company, timely 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 company "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 company has an existing material credit agreement with a lender that has moved into receivership or has been acquired, it may need to amend or terminate such agreement and/or enter into a new credit facility entirely. In such a case, the company would need to provide a brief description in the Form 8-K of certain details, including, as applicable, the date on which 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 company 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 impairment charge to one or more of a company's assets is required under generally accepted accounting principles.

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

Disclosure in the Risk Factors Section

The risk factor disclosure requirement is contained in Item 105 of Regulation S-K (17 C.F.R. § 229.105). It requires, in relevant part, companies to disclose "a discussion of the material factors that make an investment in the company or offering speculative or risky." Risk factor disclosure appears in SEC filings where the form being filed requires a risk factor section to be compliant with Item 105 of Regulation S-K, such as annual reports on Form 10-K, quarterly reports on Form 10-Q, and registration statements under the Securities Act or the Exchange Act.

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 or squeezed for liquidity).

Companies should specifically address the availability of funds under existing credit facilities in which a failed bank is a lender and determine what is material to disclose. Likewise, companies should disclose if any agreements with a failed bank are terminated or if a failed bank is replaced with another lender. Other actions under credit facilities may be hindered or prohibited as a consequence of the banks' closures. For example, in the case of credit facilities in which a failed bank acted as administrative agent, requesting funding of loan proceeds from other lenders in the syndicate may be difficult or delayed. Companies should review credit documentation to help navigate potential hurdles and be aware of any potential risks and uncertainty relating to these relationships that need to be disclosed. For example, credit may become more expensive to obtain.

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. Companies should review their liquidity requirements after giving effect to the receiverships and consider if any interim bridging arrangements may be necessary.

If a company's vendors or suppliers had exposure to a bank failure, it may be appropriate for the company to disclose that such failure may inhibit such vendors' or suppliers' ability to provide services and materials to the company, creating additional operational risk.

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.

Companies should also consider risks related to general economic conditions, including the volatility of the capital markets and rising interest rates and inflation, including their impact on revenues and earnings. The impact of interest rate uncertainty during this period of bank sector turmoil should be monitored by companies when disclosing risks.

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.

While an annual report on Form 10-K must include a complete set of material risk factors, it is important to recognize that (with the exception of smaller reporting companies) quarterly reports on Form 10-Q are required to disclose "any material changes from risk factors as previously disclosed in the company's Form 10-K." For many companies there is a relatively short time period between the filing of their annual reports on Form 10-K and their first quarterly report on Form 10-Q. However, due to the timing of the banking disruptions, there is a real possibility that many companies may not have experienced the effects from these disruptions until shortly after such companies filed their annual reports on Form 10-K. While there might be existing risk factor disclosures in the Form 10-K that may initially seem broad enough to cover the current situation, risk factors should not be discussed only in hypothetical terms if the particular risk has already been experienced. Therefore, it is particularly important for companies to review their annual risk factor disclosure in its entirety to consider if any of the risk factors should be updated, and if any new risk factors should be added, in their next quarterly report on Form 10-Q.

Disclosure in the MD&A Section

Management's discussion and analysis of financial condition and results of operation (MD&A) is a key portion of a public company's filings with the SEC, intended to provide shareholders with a view of the company's business and financial results through management's eyes. Companies should revisit their MD&A disclosure each time they prepare an SEC filing that requires it. Item 303(a) (17 C.F.R. § 229.303) of Regulation S-K, 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.

Additionally, Item 303(a)(1)(i) of Regulation S-K requires companies to specifically address any known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the company's liquidity increasing or decreasing in any material way. MD&A should discuss bank and liquidity risk as a known trend or uncertainty and give management's perspective on the type and extent of bank and liquidity risk's effect on the company to the extent material. 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. Companies with longer timelines prior to their next periodic report may take a wait-and-see approach in order to assess the impact and potential risks before determining the extent of disclosures they may need. However, it could be useful for such companies to begin thinking about this issue now and when available, review relevant peer disclosure, in order to be in a position to have up-to-date disclosure ready closer to their filing dates.

While some MD&A disclosure by its nature needs to wait until the period results become available, not all of it does. For example, companies that previously entered into loan agreements with subsequently failed banks, should disclose how management is responding, and how the companies are planning for any future bank failures and liquidity-related uncertainties.

Companies may face difficulty accessing bank facilities, the capital markets, or, in some situations cash deposits, or they may be subjected to limitations on money market transactions or commercial paper facilities. Companies may also suffer losses on investments, especially those tied to the affected financial institutions or invested in financial products that reference the performance of 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 affect shareholders. Companies should also disclose whether their remaining cash, equivalents, securities, loan facilities and other net proceeds would be sufficient to continue funding their capital expenditure requirements, debt service obligations and operating expenses in both the near- term and long- term. Companies that expect to go to market with new equity or debt securities should be especially attentive to these disclosures and potential risks.

Overall, there are many possible questions for companies in assessing the materiality of the bank failures as they prepare their MD&As. For example, have the bank failures affected liquidity? Has the company drawn down on bank facilities for any reason, including because it has not been able to access the capital markets? Is the company party to contracts with "Defaulting Lender" provisions that are or may be triggered by the banks' failures, and, if so, is that having a material impact on the company's business? Has the company experienced problems within its supply chain or distribution networks, and, if so, are such issues anticipated to be ongoing? In addition to these questions, companies should consider the points noted above when preparing their MD&A disclosures.

Disclosure in the Legal Proceedings Section

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 company or its subsidiaries is a party or to which any of their respective property is subject. For example, if the failure of a lender results in a company being unable to meet its debt service obligations or to 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 Business Section

To the extent companies have upcoming annual reports on Form 10-K or are otherwise filing reports or registration statements that require business descriptions, they should consider whether they need to add or revise their business disclosure in order to take into account the evolving situation of bank failures and responses. Item 101 (17 C.F.R. § 229.101) of Regulation S-K requires a company to provide a narrative description of the business, including the business undertaken and intended to be undertaken by the company. Among the things that should be addressed as part of this disclosure are the principal products produced and services rendered by the company, the sources and availability of raw materials, dependence on a single customer, the amount of backlog orders, competitive conditions in the business, and the number of employees. To the extent that the banking disruptions have impacted the company's business, updated disclosure may be necessary.

Exhibit Requirements

Companies that are preparing filings that have exhibit requirements, including annual reports on Form 10-K, quarterly reports on Form 10-Q and certain registration statements, should determine whether there are any exhibit filing requirements arising out of the current banking environment. For example, Item 601 (17 C.F.R. § 229.601) of Regulation S-K requires the filing of material contracts and instruments defining the rights of security holders, as well as information about subsidiary guarantors and issuers of guaranteed securities and affiliates whose securities collateralize securities of the SEC-reporting company.

Forward-Looking Statements

There are a number of sections in SEC filings, especially in the MD&A, where trend and other forward-looking disclosures are encouraged. In order to encourage companies to provide additional forward-looking statements, the Private Securities Litigation Reform Act of 1995 (PSLRA) includes a safe harbor for forward-looking statements. In the context of a private action brought under the Securities Act or the Exchange Act that is based on an untrue statement of a material fact or an omission of a material fact necessary to make the statement not misleading, a company covered by the PSLRA safe harbor would not be liable for a forward-looking statement if the statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements that identify the factors that could cause actual results to differ materially from those in the forward-looking statement. In preparing SEC filings, including current reports on Form 8-K that are "furnished" as opposed to filed under Items 2.02 or 7.01, companies should consider whether they should update the cautionary statements in their forward-looking statements disclosure in light of recent bank failures and associated developments.

Financial Statement Issues

Companies should discuss with their accountants whether any aspect of the bank failure situation requires disclosure as part of their financial statement notes, including a subsequent event note. Contingency disclosures is another area that should be carefully assessed, particularly from the perspective of whether a contingent related loss arising from the situation is remote, reasonably possible or probable. Companies will also need to determine from an accounting perspective whether the bank sector disruption has led to any impairment of various types of assets. Among other financial statement concerns to be considered in extreme cases are going concern issues.

Financing Alternatives

Some companies may be considering their financing alternatives at this time in order to bolster their capital, to provide third parties with confidence regarding the company's ability to weather continued volatility, to address securities exchange rules relating to market capitalization or stock price issues, to continue to comply with bank or other contractual covenants, or simply for opportunistic reasons. The financing alternatives may be quite dependent on whether the company is undergoing financial distress or merely wants to strengthen its financial position.

In connection with any financing transaction, the company and its advisors will have to consider closely whether all of the company's disclosures, including risk factors, business and MD&A disclosures, are current. Companies may want to consider minimizing the gap in time between their earnings announcements and the filing of their Forms 10-K or Forms 10-Q, as the case may be, and placement agents and underwriters may wish to see such periodic reports prior to undertaking an offering.

Controls and Procedures

Item 307 (17 C.F.R. § 229.307) of Regulation S-K requires a company to disclose the conclusions of its principal executive officer and principal financial officer regarding the effectiveness of its disclosure controls and procedures as of the end of each quarterly period. Similarly, Item 308(c) (17 C.F.R. §229.308(c)) of Regulation S-K requires a company to disclose any change in its internal control over financial reporting that occurred during each quarter that has materially affected, or is reasonably likely to materially affect, its internal control over financial reporting.

"Disclosure controls and procedures" is defined in Exchange Act Rule 13a-5 and 15d-15 to mean controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. "Internal control over financial reporting" is defined in each rule as a process designed by, or under the supervision of, a company's principal executive and principal financial officer and effected by the company's board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company.
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors.

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because the bank sector disruptions and related responses have the potential to impact many aspects of business, companies should continually monitor and evaluate their disclosure controls and procedures and internal control over financial reporting to make sure that they remain effective in the current environment, as well as consider whether changes need to be made to ensure that they remain effective in gathering and reporting all required information. In addition, because of the swiftly moving developments and responses to this situation, it is especially important for companies to take into account all aspects of their business, including reaching out to areas that may not normally be part of their controls and procedures processes to ascertain whether there are any developments that would need to be reflected in periodic disclosures.

Companies need to recognize that the SEC has commenced enforcement proceedings in connection with what it has determined to be failures of controls and procedures. These proceedings have emphasized the importance of maintaining the effectiveness of disclosure controls and procedures and internal control over financial reporting by updating them to reflect significant developments.

Conclusion

As always, it is important for public companies to provide disclosure responsive to requirements of the federal securities laws that are tailored to their particular facts and circumstances in order to keep investors and other market participants informed of material information about their companies. Companies should always err on the side of caution when unsure if risks or events are material and disclose. This applies to all disclosure issues and is particularly true for MD&A and risk disclosures and Form 8-K considerations. In light of recent developments and lingering uncertainties arising from the bank sector disruptions, now is the time for companies to review past disclosures and prepare for future disclosures to reflect how recent developments have affected or are affecting their businesses and prospects. We expect the situation to continue to evolve but recommend that companies begin to prepare updated disclosures to describe the actual and potential ramifications they are experiencing.

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