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When Very Bad Things Happen After Pricing: Legal and Practical Considerations

The underwriters have priced the deal. The underwriting agreement has been signed. The issuer has returned its focus to running its business and the underwriters have moved on to the next deal. All that is left is for the lawyers to document the terms and to ensure that the underwriters are in a position to move money at closing. Then, a day or two after pricing, the plant unexpectedly blows up. What happens if an unforeseeable and materially adverse event[1] (a "MAC Event") occurs after the pricing of the securities but before closing?

In such a situation, a standard underwriting agreement would allow the underwriters to terminate the deal and all parties could walk away. That said, in certain circumstances, issuers, underwriters and investors may forgo the termination option and opt to stay in the deal. Navigating an alternative to termination in a "plant blows up"-after-pricing scenario is particularly challenging because SEC rules and guidance are not always helpful and, given the infrequency with which these events occur, rarely do participants have a set of "best practices" to guide them.

Legal Framework

With Securities Offering Reform in 2005, the SEC focused the liability inquiry on the quality of disclosure at the "time of sale," which, according to the SEC, occurs when the investor becomes committed to purchase the securities.[2] In most investment-grade debt transactions, this commitment occurs roughly contemporaneously with pricing. In practical terms, the SEC shifted the liability focus from the disclosure in the final prospectus to the combined disclosure in the preliminary prospectus and the term

[1] A material disclosure is one to which there is a substantial likelihood that a reasonable investor would attach importance in making an investment decision because the disclosure would significantly alter the "total mix" of available information. *TSC Industries, Inc., v. Northway, Inc.,* 426 U.S. 438 (1976).

[2] See Reform Release, Section IV.A.2.

sheet, i.e., the disclosure package, because the disclosure package is available at pricing and the final prospectus only subsequently.

Section 12(a)(2) provides a private right of action for offers or sales by means of a prospectus or an oral communication that contains a material misstatement or omits a material fact. In Rule 159, the SEC makes it clear that if the time of sale disclosure package does not meet the 12(a)(2) standards, “any information conveyed to the purchaser only after such time of sale (including contract of sale) must not be taken into account.” In the “plant blows up”-after-pricing scenario, because the MAC Event occurs *after* the securities have priced and commitments been obtained based on then-complete and -accurate disclosure, no rights to recovery under Section 12(a)(2) will arise for failure to disclose such event.

Likewise with Section 11. Section 11 imposes liability for any part of a registration statement, if, when such part became effective, it contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements included not misleading. Under Rule 430B, the effective date for a shelf registration statement for Section 11 liability purposes (for both the issuer and underwriter) is the earlier of the date it is first used or the date and time of the first contract of sale. Because in the “plant blows up”-after-pricing hypothetical the MAC Event occurred subsequent to the first contract of sale, the issuer and underwriters would not have liability under Section 11 for failure to disclose such event.

Contractual Rights of the Underwriters and Investors

Despite the lack of Section 11 or 12(a)(2) liability at the time of sale,[3] the issuer could not proceed to closing without disclosing the MAC Event. Every standard underwriting agreement requires the issuer to deliver an officer’s certificate stating that no MAC Event has occurred since the pricing disclosures and to “bring down” its representations, including its representations regarding disclosure, at the time of closing. In addition, the 10b5 negative assurance letters, provided by issuer’s and underwriters’ counsel, are required to address the adequacy of the disclosure package delivered not just at the time of pricing, but also at closing. This process is designed to compel both the issuer and counsel to perform diligence to confirm that no MAC Event has occurred, which is a condition to closing enumerated in virtually all underwriting agreements.

[3] In a 144A offering, Section 11 and Section 12 do not apply. But there would remain the same need for the issuer to correct its disclosure under the parallel provisions contained in Rule 144A purchase contracts.

If a MAC Event occurs after pricing and prior to closing, the underwriters will have two options. The first would be to terminate the transaction based on the inability of the issuer to satisfy the conditions to close in the underwriting agreement. Termination of the underwriting agreement will also result in the termination of the contracts between the underwriter and its customers due to the fact that such contracts are on a “when, as and if” issued basis. The second option would be to proceed with closing after updating the disclosure documents and the underwriting agreement appropriately. In so doing, the underwriters will need to be sensitive to investors’ reactions to the MAC Event. It would be highly unlikely that any underwriter would proceed to closing without obtaining most investors’ consent and without releasing the investors who fail to do so. In our experience, no underwriter (nor any issuer that would regularly need to access the capital markets) would want to override investors who balk at accepting securities of an issuer that suffered a MAC Event. If most investors are willing to proceed and, despite the MAC Event, accept the original pricing, then closing could proceed as originally planned. Of course, investors may ask to be compensated for the MAC Event. In such case, it will be up to the issuer and the underwriters to determine how and whether the issuance can be successfully repriced.

What’s the Applicable Time?

If the transaction moves successfully toward closing, participants need to consider if the “applicable time” set forth in the underwriting agreement should be revised. Although liability under Section 12(a)(2) is evaluated as of the time of sale to each investor, issuers and counsel prefer to give representations and opinions as of a particular time. As a result, the practice has developed to have the issuer and underwriters designate a specific, “applicable time” in the underwriting agreement at which certain disclosure representations and opinions are provided. It is generally set after pricing, when underwriters are first in a position to begin to obtain investors’ commitments. If the securities are repriced or commitments reconfirmed after the MAC Event, it seems clear that the original applicable time needs to be updated. In the case of a repricing, the new commitments to purchase (i.e., “time of sale”) will not occur until the new price is established. As such, an applicable time should be chosen that closely approximates the time at which the first sales are made after the new disclosure has been conveyed to investors.

Even if a repricing is not necessary, we believe that it still is preferable to amend the applicable time. This formality will serve as evidence of the investors’ reevaluation of the

transaction in the light of revised disclosure package and, in effect, documents the highly unusual fact pattern (i.e., the reconfirmation process).

What to Consider

When faced with this scenario, some (but certainly not all) issues to consider are set out below:

1. **Get the facts**. The issuer, book-running managers and both sets of counsel (internal and external) should schedule a call so that the issuer can explain the situation directly to the group.

2. **Make an initial determination as to whether the deal can proceed**. There will most certainly have to be some sidebar conversations amongst deal team members to make this initial recommendation and it will clearly be made on inadequate information (e.g., predicting investor reaction) — but time will be of the essence. If there is a possibility that the deal can be saved, a number of crucial decisions will need to be made promptly, as discussed further below. If the deal is dead, consider the methods by which to inform the market and investors (Form 8-K, press release, Bloomberg or some combination thereof).

3. **Underwriters need to determine how many accounts committed to buy the securities**. The greater the number of accounts, the more difficult the process becomes.

4. **The issuer should prepare disclosure on the event**. Because a MAC Event is material, an Item 8.01 Form 8-K is probably the appropriate method of disclosure. Underwriters and their counsel (internal and external) need to review and be comfortable with the language.

5. **Prepare a script**. Counsel, underwriters and the issuer should prepare a script that sales agents will use to inform accounts of the MAC Event. The script should stick to the facts and generally match the issuer's disclosure regarding the event.

6. **Determine the amount of time needed to talk to accounts**. Underwriters need to predict the amount of time that they will need to contact accounts and explain the situation.

7. **Sequence the events that need to happen to close**. Depending on the number of accounts, the time needed to contact them, when the Form 8-K can be filed and whether the securities will need to be re-priced, settlement may need to be extended. If so, the billing-and-delivering bookrunner's back office will need to coordinate with DTC and the trustee/transfer agent, as appropriate.

8. **Contact the rating agencies**. The reaction of the rating agencies could be critical in either an equity or fixed income transaction. Standard underwriting agreements will have a termination event upon the downgrade (or placing on credit watch) of an issuer's credit rating between pricing and closing. Furthermore, if debt is to be issued, the rating agencies will need to be informed of the event and confirm that the event will not impact the delivery of the ratings letters (with the original ratings) at closing.

9. **Reg FD should not be an issue**. In a registered takedown and/or if a Form 8-K is timely filed, FD should not be an issue. If the transaction is a 144A issuance, however, issuers will not have the Reg FD exemption available to shelf takedowns and will have to file a Form 8K to avoid any Reg FD concerns.

10. **Revise documents**. Counsel need to determine which documents need to be amended to reflect new pricing terms, new "applicable time" or any other terms that have changed due to the post-pricing event.

11. **Staff appropriately**. If there are multiple bookrunners, underwriters' counsel should consider staffing its team appropriately with seasoned securities lawyers to ensure that internal counsel at each bookrunner is engaged and kept informed in a timely and accurate manner.

Conclusion

Although the 2005 updates to the securities laws placed a greater focus on the time of sale disclosure, the practical effect of the securities laws has not changed. When a material negative event occurs after pricing, investors will need to be given an opportunity to both digest the new information and decide whether to remain in the transaction, whether at the original or some modified price.

Big Accounting Changes (Maybe): PCAOB Proposed Auditor Report Changes and Update on IFRS Convergence

PCAOB's Proposed Changes to Auditor's Report

On August 13, 2013, the Public Company Accounting Oversight Board ("PCAOB") proposed two new auditing standards that would significantly expand the scope and content of the auditor's report and would heighten the level of the auditors' responsibility in providing information to investors regarding their audit.[1] The two proposed changes are: (i) The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (the "Proposed Auditor Reporting Standard") and (ii) The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (the "Proposed Other Information Standard"). In addition, the PCAOB has proposed amendments to other PCAOB auditing standards. The comment period for the proposed changes is scheduled to expire on December 11, 2013. The PCAOB release states that if the proposed changes are adopted, they would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2015, subject to approval by the SEC.

Proposed Auditor Reporting Standard

Investors rely on the auditor's report to assess whether a company's financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the company in conformity with the applicable financial reporting framework. This structure is commonly referred to as the pass/fail model (i.e., whether the financial statements are fairly presented (pass) or not (fail)). The basic elements of the existing auditor's report include (i) identity of the financial statements that were subject to the audit; (ii) description regarding the nature of the audit; and (iii) the auditor's opinion as to whether the audited financial statements pass muster under the pass/fail framework. As it exists today, the auditor's report does not provide any information specifically tailored to a particular audit. The familiar language is largely boilerplate.

[1] PCAOB Release No. 2013-005 (August 13, 2013) ("PCAOB Release"). If adopted, the proposed amendments would be one of the most significant changes to the auditor's report since the 1940s.

The Proposed Auditor Reporting Standard would require the auditor to include discussion in the auditor's report regarding "critical audit matters". The PCAOB explained that "critical audit matters" are those matters the auditor addressed during the audit of the financial statements that (i) involved the most difficult, subjective or complex auditor judgments; (ii) posed the most difficulty to the auditor in obtaining sufficient evidence; or (iii) posed the most difficulty to the auditor in forming an opinion on the financial statements. The PCAOB argued the new discussion does not impose new audit performance requirements nor amend the objective of the audit of the financials, with any critical audit matters already being known to management and to the auditor due to its performance of the audit. Under the proposed standard, the auditor's report would need to (i) identify critical audit matters or determine and disclose the absence thereof; (ii) describe the considerations that led the auditor to determine that a particular matter amounted to a critical audit matter; and (iii) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable. The PCAOB expects that most companies will have at least one critical audit matter.

The proposed changes would also require the auditor's report to include: (i) a statement regarding the auditor's independence and (ii) the year the auditor began serving as the company's auditor.

Proposed Other Information Standard

The Proposed Other Information Standard is intended to increase the auditor's responsibility with respect to "other information" that is separate from the financial statements, but that may be relevant to an audit of the financial statements or to the auditor's opinion with respect to the financial statements. According to the PCAOB Release, "other information" is information, other than the audited financial statements and the related auditor's report, included in a company's annual report on Form 10-K that is filed with the SEC. "Other information" in a company's Form 10-K would include (but not be limited to) items such as (i) Selected Financial Data; (ii) Management's Discussion & Analysis; (iii) exhibits; and (iv) certain information incorporated by reference in the Form 10-K.

Under the current auditing standards, auditors have no reporting obligation to disclose their responsibility with respect to "other information"; the existing standards merely require the auditor to "read and consider" such other information in certain documents, such as the Form 10-K. The proposed changes would not only require auditors to perform procedures in order to evaluate the other information but would also require them to describe their responsibilities with respect to such information and the results of their evaluation in the auditor's report. The proposal is designed to ensure consistency between the audited financial statements and the "other information," and could enhance the amount and quality of information provided to investors.

If adopted, the proposals could have the potential to substantially change the audit process, increase the length of the audit period and expand the scope and content of the related auditor's report, which would, in turn, have cost implications for both issuers and auditors. The proposed changes also have the potential to increase liability for auditors. In light of these concerns precipitated by the proposals, issuers are encouraged to review the PCAOB release, evaluate how the proposed standards would affect their financial reporting process and consider providing comments on the proposals by the December 11 deadline.

Update on the Status of Incorporation of IFRS into the Financial Reporting System for US Issuers

Efforts to converge US GAAP and IFRS have been underway for many years. In this effort, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") have worked together to achieve the goal of convergence. In 2002, the FASB and the IASB entered into the Norwalk Agreement in which they pledged to use their efforts toward the international convergence of accounting standards by minimizing differences between the two accounting standards in order to make them fully compatible.[2] In accordance with the Norwalk Agreement, both boards have combined their efforts and have made significant progress on several convergence projects, including, but not limited to, revenue recognition, lease accounting and financial instruments.

In February 2010, the SEC published the Commission Statement in Support of Convergence and Global Accounting Standards, noting, among other things, that it had directed the staff of the Office of the Chief Accountant of the SEC ("Staff") to develop and execute a work plan; both were meant to assist the SEC in evaluating (i) the effect of incorporating the IFRS into the financial reporting system for US issuers or (ii) how any such incorporation should be implemented. On July 13, 2012, the Staff published a final report ("Final Report") on its work plan ("Work Plan"), which summarized key areas of focus and issues surrounding the potential incorporation of IFRS into US GAAP, including the fundamental differences between US GAAP and IFRS; the potential cost to US issuers in the event of convergence; investor understanding and education regarding IFRS; and governance. Findings provided in the Work Plan would assist the SEC in assessing whether, when and how the current financial reporting system for US issuers should be transitioned to a system incorporating IFRS. However, the Work Plan was not designed to find an answer to the threshold question of whether transitioning to IFRS is in the best interests of the US securities markets generally and US investors specifically. The Staff stated that additional analysis and consideration of this threshold question is necessary before any SEC decision regarding the incorporation of IFRS into US GAAP.

One fundamental difference between IFRS and US GAAP is that IFRS lacks guidance with respect to certain industries or types of common transactions (e.g., utilities). Instead, the IASB supports the use of industry-neutral accounting principles. For example, US GAAP permits a utility company to accrue assets or liabilities based on future cash flows or outflows permitted or required by the utility's regulator. The IFRS, however, does not include such a standard for rate-regulated activities, which suggests that the recognition of rate-regulated assets or liabilities is not permitted under the IFRS. The absence of such standards under IFRS obviously raises concern for regulators and rate-regulated issuers.

Much work remains in order to establish high-quality global accounting standards, including eliminating or minimizing the fundamental differences between US GAAP and IFRS. We know that many of the issuers with which we work are closely monitoring these developments. But it is unclear when the SEC will reach a decision, given the absence of any timeline provided by the Staff and the lack of any staff recommendation outlined in the Work Plan with respect to convergence.

[2] The two boards also signed the Memorandum of Understanding in 2006, which was subsequently updated in 2008 and 2010, respectively.

144A Changes TODAY: What to Know Before Your Next 144A

The SEC on July 10, 2013, adopted rule changes that permit general solicitation and general advertising in private offerings made in reliance on Rule 144A. These changes implement Section 201(a) of the Jumpstart Our Business Startups Act (the “JOBS Act”), enacted in April 2012. The new rules go into effect on September 23, 2013.

Rule 144A is a safe harbor that permits a person other than the issuer to resell securities without registration if certain specified conditions are met. The changes now permit *offers* to persons other than qualified institutional buyers, or QIBs (as defined in Rule 144A), provided the securities are *sold* only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Before the new revisions, Rule 144A required that both offers and sales be only to persons the seller reasonably believed was a QIB. Under the rule as revised, issuers and their agents may communicate with investors without restriction on the method of communication or the number or type of investors reached. This is as long as the final sales are made to investors reasonably believed to be QIBs.

These changes will likely lead to a liberalization of the information contained in the press releases used in connection with a Rule 144A offering. Such press releases and other communications will no longer need to comply with the requirements of Rule 135c[1] under the Securities Act or other similar safe harbors, though issuers will still likely prefer to limit the content of the press release to what is included in the offering memorandum. One piece of additional information that is likely to be added are the names of the initial purchaser banks for the offering. The names of the initial purchaser banks are currently not permitted under Rule 135c.

Changes to the Documentation

Purchase agreements in Rule 144A transactions typically contain a representation by the issuer and the initial purchasers that the securities have not been and will not be (a) offered or sold in the United States to anyone not reasonably believed to be a QIB or (b) offered or sold in the United States by any means of general solicitation or general advertising. With the new rule now in effect, it is expected that parties will eliminate the second prong of this representation entirely. As for the first prong, the reference to offers should no longer be necessary. As for the Rule 144A offering memorandum, any references to a prohibition on offers will also likely be removed.

Regulation FD

Regulation FD prohibits the communication of material nonpublic information to certain specified persons, subject to certain exceptions, unless the information is simultaneously (or in the case of nonintentional disclosure, within 24 hours) widely disseminated to the public. The exceptions in Regulation FD for certain types of registered offerings are not available for a Rule 144A transaction. Issuers need to keep in mind that although the prohibition on general solicitation has been lifted for Rule 144A transactions, nothing in the rule changes the requirement for issuers to comply with Regulation FD.

The Blue Sky Wrinkle

Section 18 of the Securities Act preempts state “blue sky” laws for offerings of “covered securities.” Section 18 includes as covered securities those sold in Rule 144A transactions, but only securities of reporting issuers — those that file reports with the SEC pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Although states exempt offers and sales to sophisticated institutional investors, the general solicitation conducted in connection with a Rule 144A offering could constitute offers to noninstitutional investors. As such, the use of general solicitation in Rule 144A offerings by nonreporting issuers could require registration under most state blue sky laws. It is expected that practitioners will request that the SEC use its authority under Section 18 of the Securities Act to preempt blue sky laws for both offers and sales made pursuant to Rule 144A. But it’s unknown when the SEC might clarify the blue sky situation by using such exemptive authority.

[1] Rule 135c deems a press release that satisfies its requirements not to be an offer for Section 5 purposes.

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