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Considerations Before Your Next Equity Offering

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Many companies provide annual earnings guidance and quarterly updates to the analyst and investor communities. Guidance is also frequently updated during industry conferences and in nondeal roadshows. A failure to meet the market's earnings expectations can negatively impact management's credibility and, in turn, the price of the company's common stock.

The importance of earnings guidance is heightened during an equity offering when a company is actively soliciting investors. Based on our experiences, decisions with respect to disclosing, updating or discussing earnings guidance are among the most difficult for the bankers, chief financial officers, lawyers, equity capital markets desks and investor relations departments working on the offering.

These decisions are addressed from varying "risk assessment" perspectives and often, it can be difficult to arrive at a consensus. Disclosure of earnings guidance in the context of an equity offering goes to the heart of the (sometimes contradictory) sensitivities of the marketing team and the legal team.

On the one side is a desire to provide potential investors with the most current information (including management's judgments and expectations, much of which is inherently uncertain) in order to facilitate the selling process and set a good price. On the other side is the need to limit potential liability for the issuer and underwriters.

This article attempts to flag some of the issues involved in dealing with earnings guidance in the context of an equity deal and suggest practical approaches to meeting the parties' goals. As lawyers are fond of saying, dealing with guidance is "a facts and circumstances" exercise. That means there are few easy answers or risk-free solutions.

It should be universally agreed, however, that one of the first orders of business when contemplating an equity issuance is for management and underwriters to develop a plan for addressing the issues and questions that will arise relating to guidance.

Liability for Earnings Guidance. Section 11 of the Securities Act of 1933 (the Securities Act) imposes liability on issuers, their officers and directors, and their underwriters for misstatements of material facts in the registration statement or omissions of material facts required in the registration statement or necessary to make the statements included in a registration statement not misleading.

Section 12 of the Securities Act imposes liability on those who offer securities through prospectuses or oral communications that include untrue statements of material facts or omissions of material facts necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.

Rule 10b-5 under the Securities Exchange Act of 1934 (the Exchange Act) imposes liability on any person who, in connection with the purchase or sale of a security, makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

If guidance is included (or incorporated by reference) in a prospectus for an equity offering, a plaintiff will generally have three avenues to allege a claim: (1) Section 11, (2) Section 12 and (3) Rule 10b-5. If guidance is not included (or incorporated by reference) in a prospectus (or in the roadshow for the deal),[1] a plaintiff normally will only be able to allege a claim for faulty guidance under Rule 10b-5.

Being limited to the Rule 10b-5 liability standard is desirable because Rule 10b-5, unlike Sections 11 and 12, requires the plaintiff to prove the additional element of "scienter," which includes an intent to defraud, a reckless disregard for the truth or "an extreme departure from the standard of ordinary care." Depending on the circumstances, it could be substantially more difficult for a plaintiff to succeed on simply a Rule 10b-5 claim, as opposed to a claim under Section 11 or 12.

Guidance is material information, but typically excluded from the prospectus. There is no doubt that earnings guidance is material information to equity investors. Indeed, it is hard to imagine information that equity investors would consider more important than management's expectations of performance.

Although the U.S. Securities and Exchange Commission generally encourages issuers to disclose forward-looking information, issuers are not required to disclose earnings guidance in the prospectus for an equity deal. This can sometimes be a difficult concept for nonsecurities lawyers; after all, if guidance is material, doesn't it need to be included in the prospectus?

On the contrary, the applicable SEC disclosure rules do not require management to predict earnings, but only to identify known trends as a component of management's discussion and analysis of historical financial results.

Another question that issuers often ask is: If earnings guidance is important to investors, why shouldn't it be disclosed? In the context of an equity offering, the answer requires a weighing of potential benefits and potential liabilities by the company and underwriters.

Because of its uncertain nature, guidance is inherently risky from a liability standpoint. Companies and underwriters are reluctant to accept the risk of claims of misleading guidance when earnings projections fail to be realized. This risk is especially prevalent in equity deals because, as opposed to investment grade utility bonds, equity is much more volatile. Losses that are the result of market price fluctuation may lead investors to look for opportunities to claim they were misled.

Given this concern, most companies choose not to include guidance in equity offering documentation. Instead, most provide guidance via press releases at regularly scheduled intervals, usually the quarterly "earnings releases" that announce results to the market, or

investor slides in connection with industry conferences or nondeal roadshows.

These press releases and investor slides are typically "furnished" and not "filed" with the SEC and, as a result, are not incorporated by reference into the prospectus. By excluding guidance from the prospectus, liability surrounding the guidance should be typically limited to claims under Rule 10b-5. As discussed below, the proximity of guidance releases to an offering can create issues for this separation.

Guidance should be current at the time of an offering. As a general matter, under applicable case law, there is no affirmative duty to update earnings guidance in most circumstances. When selling equity, however, if a company chooses not to update/reaffirm guidance at the time of the issuance, management should be comfortable that guidance remains current.

In the context of an equity deal, if management knows that guidance will need to be adjusted downward when next addressed, management must consider the consequences of proceeding with an equity deal in the context of such "stale" guidance — namely, that their equity is likely to lose value upon disclosure of the revised guidance.

At the very least, that scenario would risk alienating investors who purchased in the context of the old guidance and could lead to claims of disclosure omissions in the actual offering documents. If guidance is not current at the time of an equity offering, management has two options: (1) adjust guidance contemporaneously with the offering or (2) delay the offering until guidance is updated in the ordinary course.

Press releases that update guidance and are contemporaneous with an equity offering may be deemed offering documents, but Rule 168, if available, provides significant flexibility. If guidance is revised in proximity to an equity offering, there is a risk that it may be deemed to be included in the offering materials, even if it is not included in the prospectus.

Any written communication (including, depending on circumstances, certain electronic communications such as webcasts) that "conditions the market" for an offering of securities could be deemed to be a prospectus under the broad definitions of "offer" and "prospectus" in the Securities Act.

Even a statement that doesn't mention the offering, such as a description of the company's business, new opportunities, corporate developments or a guidance announcement, may be considered a prospectus if it "conditions the market" for an offering. If deemed a prospectus, the communications will be part of the offering package for which both the issuer and the underwriters will have liability, which may include Section 12 liability.

These issues are avoided for a communication that can meet the standards of Rule 168, a safe-harbor rule that allows certain issuers to launch an equity deal contemporaneously with a regularly scheduled release of guidance.

Specifically, most companies could utilize the safe harbor of Rule 168 in an equity offering if (1) the company has previously disseminated guidance in the ordinary course of business and (2) the timing, manner and form in which the guidance is released is consistent with the past such

releases.

For some issuers, such as those in the utility industry, Rule 168 is extremely helpful because there are many regularly scheduled industry conferences and investment banking events at which utilities regularly present and reaffirm/update earnings guidance.

In the case of such issuers, these events are in addition to the other regularly scheduled occasions — such as quarterly earnings calls — where utilities announce guidance. To the extent an equity deal is launched contemporaneously or soon after one of these events that the issuer has traditionally utilized to present guidance, the guidance should meet the "timing, manner and form" test of Rule 168.

Rule 168 does, however, have some very rigid restrictions. Rule 168 is expressly not available for communications that contain information about the offering or that are disseminated as part of the offering activities. Practitioners should pay special attention to the quarterly earnings releases and webcasts containing or referencing guidance when an offering is to be made contemporaneously or shortly thereafter.

Ideally, there should be no references to the offering in either the earnings release or the webcast. If circumstances make that impossible, counsel should be consulted as to what may be said about an offering. Counsel will often give company officers a "script" of exactly what may be said about the offering during these events, and advise the officers to avoid going "off-script."

The toughest issues often arise during the part of the event that cannot be scripted: the question-and-answer session with analysts. Analysts will often want to know about plans for equity issuances.

A review of historic transcripts from companies during these events will reveal that the vast majority of CEO/CFOs will respond to questions about a contemporaneous equity deal with a terse suggestion to look at the company's SEC filings or even refuse to answer any such questions due to securities law concerns. Careful lawyers will prepare management regarding what they can and cannot say in response to such questions.

If earnings guidance is included in the prospectus, take steps to limit liability. Some transactions will inevitably occur when the Rule 168 safe harbor is not available and guidance must be updated because management's expectations are materially different than previously announced guidance.

Under these circumstances, companies may have little choice but to include (or incorporate by reference) guidance in the prospectus. In such situations, companies should seek to comply with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

The PSLRA provides a safe harbor from liability under the Securities Act and the Exchange Act for guidance that is identified as a "forward-looking statement" and is accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statements." By accompanying the guidance with meaningful cautionary statements, both companies and underwriters can limit their liability

under securities laws.

Most prospectuses or underlying Exchange Act documents contain disclosure designed to be responsive to the PSLRA and provide generic coverage for forward-looking statements contained in the entire disclosure package. However, the company should also include key assumptions and factors specifically underlying the guidance. The courts and the SEC have stressed that only meaningful and focused cautionary statements can be relied on to make the safe harbor available.

Regularly released guidance should be provided in a manner that minimizes pressure to update at the time of the transaction. Accompanying earnings guidance with key drivers that are assumed in formulating such guidance can minimize or avoid the need for unscheduled updates. Disclosure of these assumptions and qualifications emphasizes the uncertain nature of the projection, and, along with certain other cautionary statements, can entitle the company to statutory defenses from liability claims (as discussed above).

A sensitive driver that would need to be addressed would be number of shares outstanding. Certainly, by assuming a level of outstanding shares that contemplates additional equity as a "driver" of the guidance, the pressure to update for the issuance would be minimized.

Disclosure of future equity issuances, however, is highly sensitive, as such statements may have a dilutive "overhang" effect on stock price and are subject to many uncertainties. Management and underwriters would be wise to discuss this issue early in the transaction process.

Any decision to include (or incorporate by reference) guidance in the prospectus must be made in consultation with underwriters, and underwriters will need to use diligence for such guidance. Management and the underwriters should have an understanding of what diligence the underwriters would expect to do with regard to guidance included in the prospectus.

Guidance is typically not addressed by the accountants in the comfort letter. Although comfort alone would not suffice as "reasonable due diligence," the absence of comfort on guidance enhances the need for the underwriters to do diligence on the projections themselves, with assistance from counsel.

Reasonable diligence could include discussions with management as to the assumptions made in formulating guidance, a management representation letter or certificate, a review of reconciliations to historical numbers, or other actions to evidence the reasonableness of the projections. Understanding what will be required in regard to diligence and completing the process as early as possible will minimize the possibility of delay or disruption.

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[1] Note that under Securities Act rules, the roadshow is deemed to be a free writing prospectus, which is not a component of the registration statement. However, if guidance is disclosed in a roadshow, participants may still be subject to liability under Section 12 in addition to Rule 10b-5.