"Breaking Bad"

How to Deliver Disappointing News, Maintain Credibility and Avoid Litigation

Top Ten Takeaways

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1. Most public companies miss guidance at some point
2. Adopt an appropriate guidance policy, including what kind of guidance will be provided and when – and follow the policy
3. Management credibility is key to investor confidence in leadership and recovery from a disappointment
4. Provide a clear, credible go-forward plan with milestones
5. Show confidence and directness in the conference call following a disappointment
6. Disclose guidance and other material information in a Reg FD compliant manner
7. Provide disclosure of risks that may affect current expectations – tailored, not boilerplate
8. Involve legal counsel in earnings disclosure and crisis communications
9. Prepare a crisis communications plan in advance based on assessment of corporate vulnerabilities, including identification of team members and an action plan
10. A written disclosure statement is the most effective way to communicate quickly, broadly, and consistently – but don't quantify before you know the facts

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Financial Profiles
Investor Relations & Corporate Communications

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Panelists

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Pamela Palmer, a partner in Pepper's Commercial Litigation Practice Group, has extensive experience in securities litigation, derivative suits, merger litigation, corporate litigation, and internal investigations. Ms. Palmer represents companies, officers, directors and professional firms in fiduciary and business judgment cases and government enforcement matters. She advises boards and special committees in internal investigations involving whistleblowers, shareholder demands and auditor-initiated investigations. She also advises clients on corporate governance, disclosure, indemnification and D&O coverage.

JULIE MacMEDAN

Sr. Vice President, Financial Profiles

Julie MacMedan is a senior executive with more than 20 years of experience in investor relations, strategic corporate positioning and financial analysis. She has extensive experience leading investor relations programs for both pre-IPO and post-IPO companies in a broad range of industries, particularly internet, digital media, interactive entertainment and technology. Nominated for Best Investor Relations, Small Cap, by Investor Relations Magazine in 2011, Julie applies strong problem solving skills and innovative solutions to address rapidly changing business environments.

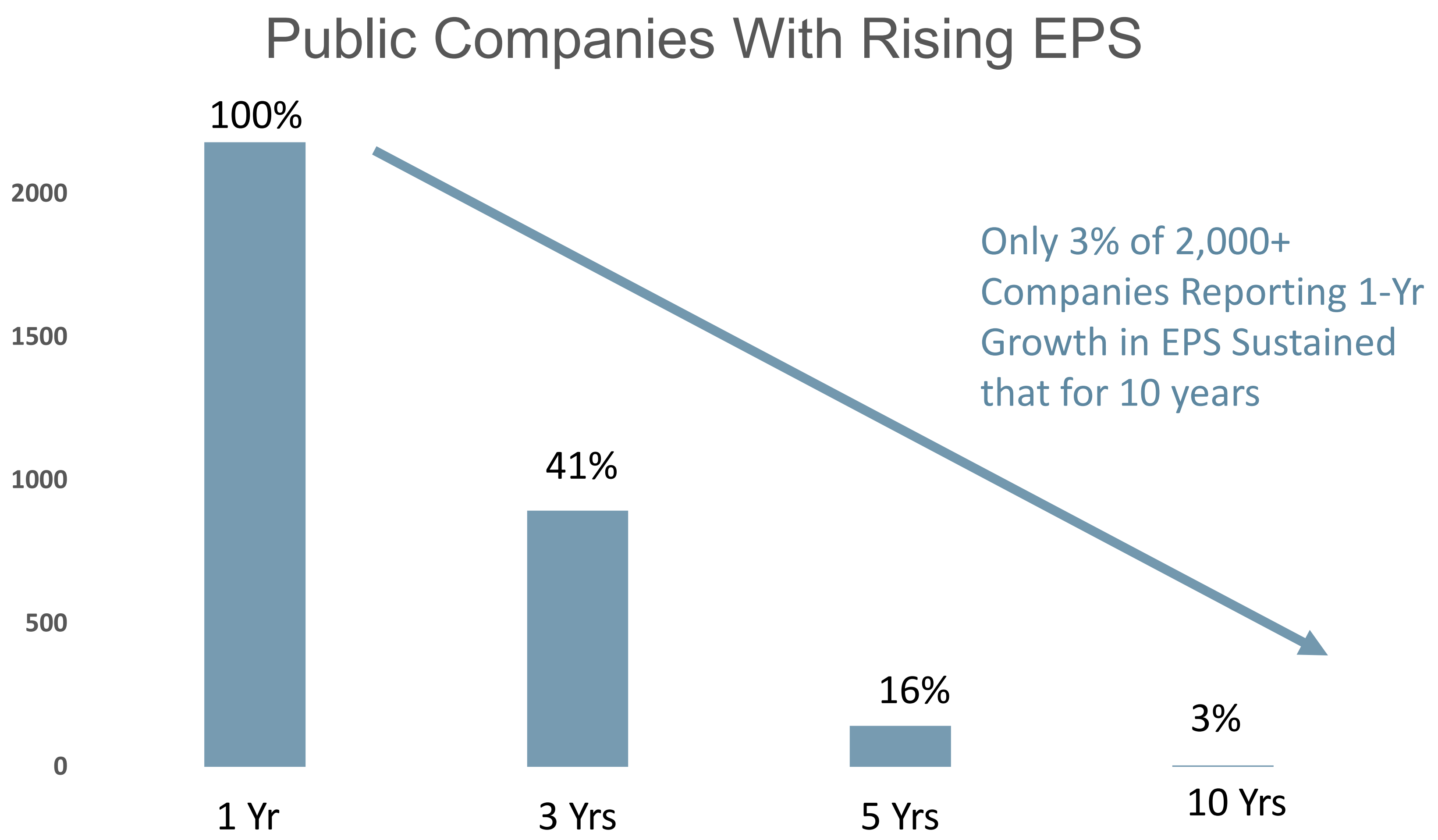
Today's Agenda

- Earnings disappointments:
  - Not the end of the world
  - Updating guidance
  - Managing street expectations
  - Avoiding legal missteps
  - Best practices
- Restatements! Data breaches! Media exposés! Oh my!
  - Planning in advance
  - Timing the disclosure
  - When in doubt, leave it out
  - Updating the market
  - Prepare to defend

Scenario 1:

REVENUE AND EARNINGS DISAPPOINTMENT

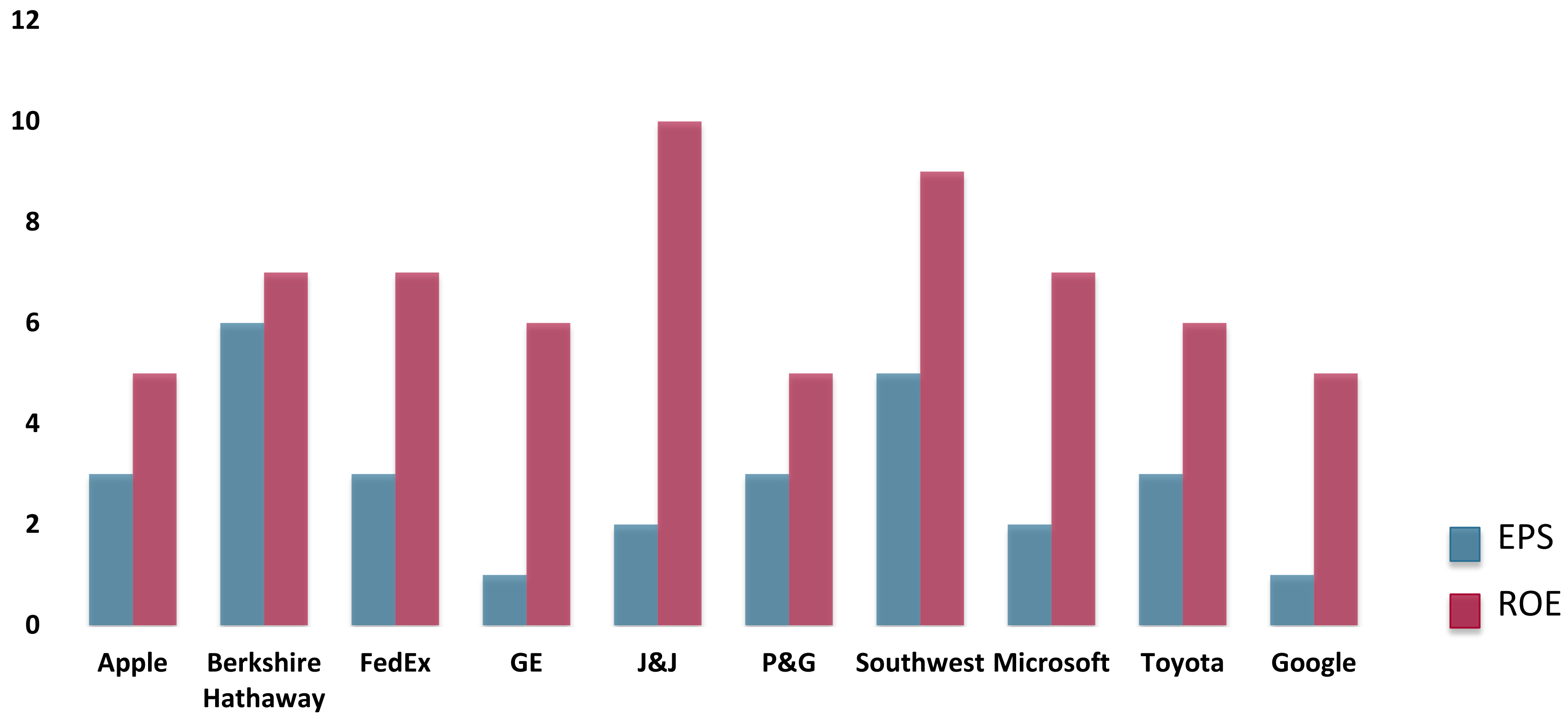
Context: All Companies Go Through Cycles



Source: Morningstar: Baruch Lev *Winning Investors Over* 2012

Context: All Companies Go Through Cycles

Number of Year-to-Year Decreases in EPS and ROE from 2004-2008 for the 2008 *Fortune Most Admired Companies*



Source: Compustat Database; Baruch Lev *Winning Investors Over* 2012

Avoid Short-Term Tactics to Manage a Miss

- Don't try to avoid a miss through last minute sales incentives or crisis cost-cutting that only worsen the company's predicament:
  - Customers learn to wait for a lower price, thus reducing future revenue
  - Cost cuts may push expenses into future quarters
- Don't try to "manage earnings" through accounting
  - Using accounting to make the numbers is viewed by the SEC and plaintiffs as earnings manipulation…and it doesn't work:
    - Studies found companies that managed earnings through accounting to beat consensus by $0.01 lost any increase in stock price by year end.
    - Whereas companies that missed by $0.01 and did not manage earnings had significant price increases one year after the miss.

Why Some Earnings Disappointments Are Punished Severely and Others Not

- Higher expected growth stocks punished more severely – the bigger the run up, the harder the fall on a $0.01 miss

- Momentum investors exit at first sign of slowing growth, exacerbating the hit for growth stocks

- If you think your stock is overvalued, outstripping the fundamentals, riding the wave is risky; instead, cool off investor expectations.

- How?

Managing Investor Expectations

- A miss is failure to achieve expected and predicted corporate performance
- Tools for managing a miss depend on who's prediction was missed
  - Company guidance?
  - Street consensus?
- Adopting or commenting on Street consensus may be viewed as giving the company's own guidance

Fundamentals: Giving Guidance

- Giving company guidance in the first place – think twice
  - No law requires companies to give financial guidance
  - Consider the pros, cons, and alternatives
- If you give guidance, have a policy and stick to it
  - What financial metrics can you reliably predict?
  - Ranges or data points? Annual or quarterly?
  - When will guidance be updated?
- According to the 2014 survey by the National Investor Relations Institute:
  - 86% of public companies provide financial guidance
  - The most common time horizon is annual guidance updated quarterly
  - The primary reason: ensuring that sell-side consensus and market expectations are reasonable

Fundamentals: Updating Guidance

- When should the company update guidance?
- Is an update legally required or investor relations driven?
- What are the circumstances?
  - Is the change or development material?
  - Can it wait until the quarterly report?
  - What are the Regulation FD risks?
  - Is the company trading its own stock?
  - Should insiders be barred from trading?
  - Is there an industry conference coming up?

Legal Perspective: Prepare Defenses

- Two primary defenses to securities liability under section 10(b) based on a missed forecast:
  - Bespeaks Caution Doctrine – forward looking statements are not misleading if accompanied by cautionary specific risks
  - 1995 Reform Act Safe Harbor – forward-looking statements are not actionable if accompanied by meaningful cautionary warnings
- Identify actual factors that may cause results to differ
  - Include critical assumptions
  - Avoid boilerplate
- If a miss is likely, consider a trading blackout, delay stock repurchases and stock offerings

Best Course of Action – Act Quickly and Start Rebuilding Credibility & Confidence

- Consider pre-announcing the bad news via news release
- Outline a clear, detailed, credible remedial action plan
- Communicate action plan milestones that can be measured by investors
- Update progress quarterly – whether successful or not
- Internally, focus on improving the business as well as internal controls – deliver on your promises

Legal & IR Perspective: Best Practices on How to Update Guidance

- Control the message –
  - Craft the press release to optimize wire service messaging, clearly communicate any accounting items and include a frank, strategic quote from the CEO
  - Script the conference call
  - Anticipate questions – including those the company will decline to answer ("no comment")
- When you do disclose, what will you say?
  - Company specific or industry wide?
  - Controllable, macro, or outside factor (e.g., weather, port strike)?
  - One time or systemic? Long-term outlook?
  - Operational performance?
  - Shifting competitive landscape? How addressed?

Rebuilding Confidence – Conference Call

- The conference call is a critical communications vehicle
- Exude a confident tone – show your command of the business, admit shortfall and build confidence in action plan
  - Shielding yourself with vagueness increases uncertainty and volatility
  - Give qualitative and quantitative information
  - Honesty and specificity
- Engage in Q&A with analysts and be as direct as possible
  - Provide new information and original insights on the business
  - Don't be overly cryptic or bland in prepared remarks and Q&A
- Consider adding key executives responsible for the affected area of the business to the conference call – and script everyone

Revenue and Earnings Disappointment Recap

- Most companies experience a miss at some point
- Establish a guidance policy and stick to it
- Unless giving guidance outside of policy is the right thing to do
- Control the message in news release, script and Q&A
- Preserve management credibility by being direct and confident
- Outline a clear, detailed, credible action plan that can be measured by investors

Scenario 2:

CRISIS COMMUNICATIONS

How Do You Prepare for a Crisis?

- To successfully manage a crisis tomorrow, start planning today
  - Regularly test/audit your vulnerabilities, e.g.
    - Restatement
    - Data breach
    - Sanctions, fines and penalties
    - FDA/unfavorable clinical trial results
  - Know your investors, reporters, customers – keep key relationships warm
  - Role play scenarios with top management
  - Define your crisis team, and meet with them

Develop a Crisis Communications Plan and Update Regularly

Job One in a Crisis

- Maintain management's credibility – it's the basis for leadership and recovery
  - Once lost, credibility is difficult to regain
  - Credibility results from saying things that prove true over time **and** are believable today
- Gather the facts quickly
  - What are the facts?
  - Who is involved?
  - What is the threat to the company's reputation?
  - Is this disruptive to the company's operations?
  - What is the current awareness/reach of the issue?
- Assemble crisis communications team
- Develop a public statement

Crisis Messaging/Media Tips

- A prepared statement is often the most effective way to get your message out broadly, quickly and safely
  - What happened?
  - When did it happen?
  - What details can you confirm?
  - What are you doing about it?
  - Show concern
- Do not speculate! When in doubt, leave the information out
- Social media
  - Speak to customers/media where they are active – stick to prepared statement/messages
  - Monitor social channels
  - Take the conversation offline

Legal Perspective: Disclosure Liability

- Disclosure liability exposure under Section 10(b)
  - Plaintiffs will compare the crisis development with past disclosures
  - Plaintiffs will analyze whether early crisis disclosures are themselves (turn out to be) allegedly misleading
- Disclosure: Not too early, not too late, get the facts and timing just right
  - Do not sugar coat or put a cap on the problem prematurely – E.g., How big is the restatement? How extensive the data breach?
  - Avoid committing to “continuous narrative” of incremental updates
  - Should a Special Board Committee be formed to investigate?
  - Manage third-party communications with regulators, financial statement auditors, customers, and employees

Liability Risk Backdrop

- Other balls in the air:
  - Situations brought to light by a whistleblower
  - Insider trading blackout
  - Regulation FD – no advance “heads up” to key analysts
  - The company may lose certain SEC reporting privileges
  - The company’s credit rating and credit availability may be affected
  - Third-party contracts may also be affected – negotiate
  - Internal control deficiencies must be analyzed, disclosed and fixed
  - Litigation and communications backdrop – class actions, derivative suits, consumer actions, regulatory investigations, financial auditors

Crisis Communications ReCap

- To successfully manage a crisis tomorrow, start planning today
- Identify team in advance, including legal counsel
- Regularly test/audit your vulnerabilities
- Establish goodwill and credibility with key constituents
- Maintain management's credibility – it's the basis for leadership and recovery
- Gather the facts quickly
- Develop a public statement
- Identify spokespersons for all constituencies

QUESTIONS?

Contact

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Financial Profiles is a strategic financial communications firm. As a specialized resource, we help our clients address issues that affect valuation and corporate reputation. We partner with our clients to communicate growth and value creation strategies and build support among key constituents – investors, employees, customers and media. Our team offers clients a breadth of expertise in investor relations, and transaction, corporate and crisis communications.

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