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Coping with the Credit Crisis: Certain Considerations for Boards of Directors and Senior Management of Non-U.S. High Yield Issuers

The evolving credit crisis is having an impact not only on the financial markets, but across the general economy as well, adversely affecting otherwise healthy companies outside the financial services industry in a number of ways. Boards of directors and senior management teams of companies affected by the credit crisis have had a range of issues to address, both in respect of their own access to capital (current or future) and in relation to third parties on whose operations or financial well-being the companies depend (including lenders as well as key customers or suppliers). Public reporting companies have an additional layer of considerations, as the issues they face and the actions they may need to take, or do in fact take, need to be viewed in the context of their public disclosure obligations.

We have prepared this memorandum to provide directors and senior management teams of non-U.S. high yield issuers with a checklist of issues that they should be addressing. We note that high yield issuers will likely have disclosure obligations arising under their indentures and provide bondholders with regular updates through quarterly conference calls. We also note that non-U.S. high yield issuers may have listings in their home jurisdictions and, if that is the case, local disclosure standards also need to be considered, which are beyond the scope of this memorandum.

Checklist of Issues to Consider

Take stock of the state of the business

- Re-evaluate the company's business plan for the coming 12 months and consider the impact on the business plan of projected cash flow, the limited availability of bank debt, the potential limited ability to raise equity or debt through the capital markets and the fixed component of the company's cost structure.
- Consider whether capital expenditures can be deferred.
- Consider whether elements of the company's growth strategy should be deferred and the potential impact of doing so.
- If capital expenditures and other growth activities should not be deferred, consider the adequacy of projected cash flows to fund them, potential sources of funding if there is

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a shortfall and contingency plans in the event planned sources are or become unavailable.

- Consider whether there are opportunities to cut costs and the implications of implementing cost cutting measures.
- Consider possible factors that could contribute to adverse ratings action. Were an adverse ratings action to occur, what implications would there be under the company's credit facilities, derivatives positions or other instruments?

Focus on the company's current and projected liquidity needs

- Analyze the company's liquidity needs and potential sources of capital.
 - 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, consider the funding implications of the current state of the market.
- Consider whether there are alternative sources of equity and debt capital.
- Consider whether there are potential covenant compliance issues in respect of any senior debt.
 - Is there a likelihood that an amendment or waiver will be required from lenders under senior bank credit facilities?
 - 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 (see below) on debt covenant compliance.
 - Review any material adverse change clauses.
- Consider whether assets deemed to be liquid have the expected realizable value under current market conditions.
- Consider the potential impact 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.

- Consider whether there are potential covenant compliance issues in respect of the high yield bonds.
 - Are there any actions that the company is contemplating that could require a consent solicitation?
- Note the impact of accounting issues (see below) on debt covenant compliance.

Consider the company's risk profile

- Does the company conduct stress tests or other sensitivity analyses? If so, do the parameters need to be adjusted in light of recent events?
- Consider the impact of exposure to derivatives. Is the company invested in credit derivatives (e.g., CDOs), or does the company issue or buy/sell synthetic credit derivatives (e.g., credit-linked notes) or financial risk transfer products (e.g., CDSs)?
- Consider whether the company has increased counterparty default risk. This risk could arise in the context of lending arrangements or in the context of the company's operations.
- Consider what options the company would have if a lender were unable to fund its revolving commitments or a letter of credit ("LC") issuer were unable to issue new LCs or fund existing LC draws.
- Similarly, consider the extent to which the company could be adversely affected by liquidity issues affecting key suppliers, customers or other third parties. For example, a supplier might be unable to deliver raw materials or other essential supplies, or a key customer might cancel or materially decrease its long-term delivery obligations. In addition to effects on operations covered by the events noted above, liquidity issues could result in reduced revenue or delays in collection of accounts receivable.
- Consider whether there are counterparty risks arising from any hedging arrangements.
- Consider the impact of the current environment on any outsourcing arrangements.
- Will constraints on the issuances of LCs impact the company's operations, for example its transportation of goods?
- Consider whether suppliers and vendors may require changed terms because of actual or perceived changes in the company's financial condition or results of operations.
- Monitor the financial strength and credit ratings of providers of insurance – both in respect of the company's operations and for D&O coverage. Ratings downgrades of insurance providers could also trigger affirmative obligations under credit instruments to change insurers.
- Monitor the register of lenders under existing credit facilities to assess the financial strength and credit ratings of members of the lending syndicate. Ratings downgrades of lenders could trigger "yank-a-bank" rights under credit facilities to enable the company to manage increased counterparty risk by replacing struggling lenders.

- What exposure does the company have to foreign exchange movements (in particular a strengthening of the U.S. dollar)? Has this exposure been adequately hedged or do current market conditions render those arrangements inadequate?

Consider accounting issues

- Consider the impact of mark-to-market accounting. Consider whether additional training or updates on application of mark-to-market accounting rules or other risk metrics would be useful for the audit committee members and the internal audit team.
- Consider the impact of projected results on current and future compensation arrangements.
- Consider the adequacy of reserves.
- Consider any impairment issues.
- Consider the impact of declines in the value of investment securities and pension plan assets.
- Monitor changes to the accounting standards affecting the company generally and consider the impact of any such changes on covenant compliance. Note that some indentures provide that accounting principles are to be applied as in effect from time to time, while others fix the accounting principles at the date of issuance.

Consider if any changes should be made to internal systems, operations, controls or procedures

- This would be a good time to consider whether existing corporate governance structures are adequate, particularly in respect of risk management. Should additional board or committee meetings be scheduled? Should the board or any of the committees be reaching out to external advisers?
- Consider whether the board should increase communication with senior management to keep the board attuned to early warning signals of adverse effects of the market turmoil on the company? Confirm that the lines of communication between senior management and the board, generally, and the audit committee, in particular, are effective.
- Are the board committee responsibilities the appropriate ones? For example, should a separate risk committee assume certain of the responsibilities of the audit committee or should certain risk-related responsibilities that have been delegated to other committees be re-allocated to the audit committee?
- Are monitoring procedures adequate, or should they be enhanced? For example, if covenant compliance is now more of an issue, are systems in place to more closely track the relevant measures, and to provide early warning of adverse developments? Consider whether employees monitoring developments have the appropriate skills and level of experience.
- Confirm that the company's disclosure controls and procedures are effective in the current environment.

- Revisit contingency plans, including crisis management procedures. Is the company prepared for public disclosure of a significant development involving its liquidity or operations (based on stress testing or otherwise)? Also, see below under “Consider communications with stakeholders.”

Consider the Company’s disclosure obligations under the indenture

- **MD&A.** Consider whether changes need to be made in the overview of trends or other factors affecting results. Remember that boilerplate disclosures are not what either investors or the SEC expects to see. The MD&A is the opportunity for investors to see the company through the eyes of management. Disclosure is to be tailored to the circumstances at hand and be reflective of known trends, events and uncertainties.
- Review the liquidity and capital resources disclosure. Does the disclosure in respect of sources of liquidity and capital resources need to be revised in respect of sources of current funding, potential need for new sources of funding, potential events of default, potential calls for deposit of collateral or the like? Does the disclosure in respect of uses of capital need to be revised to reflect changes in the business plan, planned capital expenditures or commitments? Consider the impact of market and other events on the qualitative and quantitative disclosures about market risk. See the discussion below under “Drafting Considerations for Reports to Bondholders.”
- In considering the MD&A, note that what may have been sufficient disclosure for the prior year, as reflected in the last annual report, may need to be updated for the next required quarterly or annual report given the further deterioration in the credit markets and the broader economy.
- **Risk factors.** Consider whether the existing risk factors in the last annual report are adequate or need to be updated. Changes in the MD&A may well result in corresponding changes to the risk factors. 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.
- **Forward-looking statements.** 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.

Review opportunities and pending transactions

- Consider whether the current crisis presents opportunities to acquire assets from distressed sellers.
- Are there pending transactions that the company may be able to renegotiate on terms more favorable to the company?
- Are there any pending transactions that are no longer in the best interests of the company to pursue?
- Are there opportunities for the company to take advantage of market conditions by repurchasing its debt (either through individually negotiated transactions or tender

offers)? Even if there are opportunities, consider whether it is an appropriate use of cash at the time. Debt agreements governing debt that will remain outstanding after any such repurchase would need to be reviewed to determine whether buy-backs by the company or its affiliates are permissible. Exchange control approval may be needed (where applicable).

- Are there opportunities for asset sales? If so, asset sale covenants in any debt that will remain outstanding after the asset sales will have to be complied with. Note, for example, that asset sales typically need to be for fair market value and at least a minimum percentage of the consideration must be in the form of cash or cash equivalents. Note too that net cash proceeds from asset sales typically need to be applied to permanently reduce senior debt or to acquire new assets or businesses. It may or may not be advantageous in this environment to repay senior debt, and there may not be attractive acquisition opportunities available at this time. Because of these restrictions, it may be the result that the issuer would be obligated to offer to buy back high yield bonds at par, even though they may well be trading currently at a significant discount.
- For those with potential indenture covenant issues, consider exchange offers (debt for equity, debt for new debt or for a combination of new debt and cash). If the offer is for a substantial portion of the outstanding series of debt, consider whether a so-called covenant stripping exercise would be appropriate. To the extent the company wishes to reduce its debt service requirements or needs to address close-in maturities, consider also whether credit enhancements (such as subsidiary guarantees or security) could be offered to induce bondholders to accept an exchange offer at a discount to the face amount of the existing debt.
- Consider whether there are opportunities to incur debt under one of the specialized debt incurrence baskets under the indenture (such as the capitalized lease obligations/mortgage basket).
- Consider cash infusions from a sponsor, major shareholder or possible private equity investor. Equity infusions can generally be applied (100%) to the restricted payments “build-up” basket in high-yield style restricted payments covenants. Note that unless there are specific provisions allowing restricted payments to be made directly using the proceeds of such infusions, if the company has had losses, they will reduce the effectiveness of equity infusions.
- Note that transactions with affiliates of the company may well need to comply with the transaction with affiliates covenant in the relevant debt agreements.

Consider communications with stakeholders

- Consider what messages need to be conveyed to bondholders, lenders, suppliers, key customers and other stakeholders. Be sure the messages are consistent.
- Be prepared for an increased focus on risk profile and risk management frameworks.
- Consider, if applicable, whether it is still appropriate to provide guidance to the market or whether it is appropriate to revise existing guidance in light of current conditions.

- Remember the company's and management's responsibilities to avoid selective disclosure under applicable market abuse rules. Companies not subject to market abuse rules should nonetheless also avoid selective disclosure of material non-public information and should treat bondholders equally in terms of access to information.
- Review the company's external communications guidelines.

Other considerations

- Consider where and how cash on hand is invested.

Drafting Considerations for Reports to Bondholders

As high yield indentures typically require that reports to bondholders contain disclosures similar to those that would be contained in reports filed with the SEC, we analyze the disclosure obligations the same way we would for SEC reporting companies. Although the MD&A has been required for many years (the origins date back to 1968 and the current framework dates back to 1980), in times such as these it is useful to review what the SEC expects in the MD&A and why.

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."

With respect to liquidity and capital resources disclosure, the SEC notes that this information 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.

Moreover, 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.

By way of example, in discussing use of operating cash flows to fund short-term liquidity needs, a company should address the extent to which a decrease in demand for the company's products or services would reduce available cash flow. For a company that relies on commercial paper or securitization, lack of liquidity in the market as well as the impact of a ratings downgrade or deterioration of financial ratios and other measures of financial performance would need to be addressed. (See the 2002 Release.) The SEC notes that identification of circumstances that could materially affect liquidity is necessary if they are "reasonably likely" to occur, which is lower than the standard "more likely than not."

To identify trends, demands, commitments, events and uncertainties relating to liquidity, management is to consider, by way of example, 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. Consideration of circumstances that could impair fundamental operations or that are otherwise financially or operationally essential would also be relevant to identifying trends. (See the 2002 Release.)

With respect to financing, a company should discuss and analyze, to the extent material (as outlined in the 2003 Release):

- its external debt financing;
- use of off-balance sheet financing arrangements;
- issuance or purchase of derivatives linked to its stock;
- use of stock as a form of liquidity; and
- the potential impact of known or reasonably likely changes in ratings or ratings outlook.

This discussion is not to be limited to historical items, but rather should also focus on financings that are, or that are reasonably likely to be, available (or are of the type or types of financing that the company would want to use but that are, or are reasonably likely to be, unavailable), and the impact on cash position and liquidity should also be considered. A company is also to focus on covenants where it is, or is reasonably likely to be, in breach and the impact of covenants on the company's ability to raise additional debt.

Note that the SEC does not recognize for disclosure purposes a concept equivalent to judicial notice. This means 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.

Finally, to the extent that any solutions involve related parties, management needs to consider the disclosure obligations under Regulation S-K Item 404 as well as the general disclosure obligations for the MD&A in respect of material related party transactions. (See the 2002 Release.)

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The foregoing list of issues is not intended to be an exhaustive list of risks and other considerations resulting from current market conditions. In particular, companies facing financial difficulties will have a range of other issues to consider, which are beyond the scope of this memorandum. Regulated entities will have additional issues, which also are beyond the scope of this memorandum.

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.