Inflation and Market Turmoil: How Directors, Officers and Other Fiduciaries Can Stay Ahead in Uncertain Times

Skadden

09 / 21 / 22

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Van C. Durrer II
Partner / Los Angeles
213.687.5200
van.durrer@skadden.com

This article was published in the September 2022 issue of *Insights*.

One Manhattan West
New York, NY 10001
212.735.3000

Key Points

- In light of current economic uncertainty, directors, officers and other fiduciaries should stay abreast of material information, even absent a specific actionable transaction.
- An analysis of audits of financial statements that occurs more frequently than once a year can help fiduciaries identify problem areas for businesses.
- Fiduciaries should request periodic updates on future as well as current liquidity and ask management to develop alternative strategies in the event that existing liquidity sources dry up.
- Seeking such details now will help fiduciaries make timely, informed decisions should market conditions worsen.
- The information can be stored in a format conducive to fiduciary decision-making — for instance, uploaded to a secure site on the company's intranet.

Directors, officers and other fiduciaries (together, "fiduciaries") owe two primary duties to a corporation and its shareholders: the duty of loyalty and the duty of care. The duty of loyalty requires that fiduciaries make business judgments in the honest and good faith belief that the judgments are in the best interests of the organization, without personal motivations. The duty of care calls for fiduciaries to act with the same care that a prudent person would use in similar circumstances. Fiduciaries are entitled (and encouraged) to seek information from management and outside advisers in the performance of their duties.

An important foundation of the duty of care requires that fiduciaries inform themselves of all reasonably available material information that might impact a particular business judgment, including potential alternatives to such judgment. Ordinarily, fiduciaries are called upon by management to evaluate a specific transaction or alternatives to a transaction. Especially in times as volatile as the current economic climate, however, fiduciaries should expand their roles to include understanding and evaluating the overall headwinds — and opportunities — available to a business, even in the absence of a specific transaction.

Below, we discuss the factors contributing to the economic uncertainty and provide a checklist of suggested areas where fiduciaries can actively seek information from management and subject matter experts in order to carry out the duty of care.

Current Economic Environment

Inflation is nearly double its peak earlier in this century (and in much of the final 25 years of the previous century), based on the consumer price index. Recently, to bring the price of goods under control, the Federal Reserve has raised its benchmark interest rates at the fastest pace since the 1980s (although the current benchmark rate occupies the same range as in the middle of 2019, before the pandemic). 2022 projections suggest that rising rates have already cut the market for high-yield bonds to less than half the volume of 2021, among other consequences.

Retailers in the discretionary spending category have cut their forecasts as consumers tighten their belts. Some retailers are pursuing multilateral strategies to address consumers' reaction to the economy, including opening new distribution channels and passing on increased costs to customers. Supply chain woes that began with the pandemic have worsened, partly due to the conflict in Ukraine. Large corporates have initiated layoffs. Following a U.S. IPO boom earlier in the pandemic, the market has recently decelerated to its slowest pace in decades.

Taking Stock of Business Model Systems and Controls

An annual audit of financial statements is a valuable tool for any business to identify problem areas, particularly those that may be looming up to 12 months into the future. In an economy full of unpredictability and contradictory signals, more frequent analysis and review of the foundations of the audit may be prudent. (Such analysis typically occurs annually.) Fiduciaries are entitled to request a review of the building blocks of an audit more often to speed reaction to negative trends as well as to opportunities.

Areas for fiduciaries to focus on include:

- How is the business plan developed, and how frequently is it tested against performance?
  - Consider whether the plan is developed top-down (by senior management) or bottom-up (by various departments for review and approval by senior management). A truly informed understanding of the plan includes how it was developed.
- Is there a reliable way to verify that the plan is sufficiently predictive?
- How is the business performing relative to budget on a monthly or quarterly basis?
- What are the key components of any material variances from budget (positive or negative)?
- From a legal perspective, what is the company's current and projected compliance with covenants in material contracts as well as credit agreements and other financing obligations?
  - Rising interest rates implicate required debt coverage and related ratio testing.
- What assumptions underlie the business model, including regarding:
  - price of fuel and other energy costs;
  - the company's ability to pass increased costs to customers; and
  - potential supply chain disruption.

Evaluating Alternative Strategies: Prepare for the Worst, Hope for the Best

In times of economic turmoil, liquidity and access to cash is vital. Fiduciaries should request periodic updates on not only current liquidity (amounts and sources) but also future liquidity, or the "runway" that a company maintains to implement strategic alternatives. This analysis should include the same rigorous review of the underlying assumptions as noted above. Conducting a reasonable examination of and inquiry into the company's liquidity runway will protect fiduciaries from litigation if there is an unforeseen deterioration of cash.

It is also wise to ask management to develop alternative strategies in the event existing liquidity sources dry up. For example, if a default waiver may become necessary:

- What percentage of lender consent is required?
- What opportunities to raise additional capital does the company have within the requirements of its existing financing?
- Do certain capital-raising transactions require consent of various equity holders, or does that power rest exclusively with the board of directors?

Takeaways

If market conditions worsen, fiduciaries who have sought answers to these questions in advance will have resources ready to make timely decisions with comfortable reliance on relevant factors. This is obviously preferable to spending valuable time developing such background information on a reactive basis.

Advisers can be tasked with developing this foundational intelligence in a format conducive to fiduciary decision-making. The information can be uploaded to a secure share site on the company's intranet or a comparable platform. Fiduciaries can best impact outcomes by being proactive and using their knowledge and expertise to prepare for uncertain times now.