Public Chatter

Dealing with New Lines of Business & Evolving Segments

By Allison Handy | Partner

CONTENTS

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- ***by Allison Handy***

This guidebook about “Dealing with New Lines of Business & Evolving Segments” is meant to be practical. I’m hoping its quasi-conversational nature helps you more easily consume the lessons imparted. Enjoy – and please share your own practice tips or your own anecdotes, for the next edition of this Guidebook!

1. DABBLING WITH A NEW BUSINESS LINE? FIRST STEPS FOR THE SEC DISCLOSURE LAWYER

There’s nothing as constant as change. Like a company’s decision to try something new to offer to customers. This type of thing pops up eventually for every company. And it can happen often, too. Maybe even once or twice per year.

Disclosure lawyers can get pretty comfortable. Perhaps too much so. We can get lazy when we review nice, clean redlines, with few significant updates and changes from one quarterly filing to the next.

But then the business team starts to innovate, and you start seeing something new: an investment in a new technology, a press release about an exciting new product, or an acquisition of a company that might seem at first like a square peg in a round hole.

Where do you start as the disclosure lawyer?

Sometimes the change in operations is subtle. Starts very small. There’s no press release. There’s no acquisition or merger. But the new business has very different characteristics from the company’s existing business - different industry, different margins, and different seasonality.

And sometimes there’s a seemingly big change that makes you stop and ask whether it’s truly a new line of business. Because it really isn’t. It’s a new feature or add-on product - developed internally or acquired through M&A - that becomes an integral part of the existing line of business and fits squarely within the company’s existing financial model and go-to-market strategy.

As the securities lawyer, you obviously should check what the auditors are saying about this new line of business – how close is it to becoming a “segment” under the accounting literature? That can become quite an involved conversation and determination – but it often transpires down the line from auspicious beginnings.

You may need to dig further by checking out recent board minutes, materials, and presentations. Talk to those who might have a good perspective on what is happening on the ground. It’s a total mix of information, akin to the “materiality” determinations that sometimes can be quite subjective. If you don’t start thinking hard about this new business from the start – and how you want to introduce it in your periodic filings – you may be surprised by how quickly it’s gone from a minor blip to a significant driver of the company’s strategy.

This topic leads me back to another role in my life—that prized one that I treasure as a mom. It feels like yesterday that my kids would squeeze into my bike trailer together for a big “adventure” to inspect crabs at low tide. And now my oldest kid commutes by bike to school all on her own, and my youngest will be joining her to ride to kindergarten in the fall. How in the world did that happen?

2. "WE'VE GOT A NEW LINE OF BUSINESS." THE REAL-WORLD DISCLOSURE RAMIFICATIONS

The company is trying its hand at something new? Is it a big deal? Or a little deal?

Sometimes you want to preserve the reputation of your primary line of business when getting into something new. That's because you don't want your employees, investors, and customers to worry that you're going to forget your bread and butter.

Or the new business may be highly uncertain and unproven - like a high growth startup company within a mature company. Or within the same industry, but with a completely different business model and financial profile.

So you make a concerted effort to brand the new business as being separate. When doing so, here are a few items to consider:

1. **How to present relative to other disclosures**: Part of that branding is how information related to the new line is presented in earnings releases, SEC filings and other communications.

2. **The art of making projections**: Making projections – ones that are provided publicly – can be the biggest issue you need to tackle. If you're on the wrong side of being wrong about them, it can really ding management's reputation (not to mention bringing potential liability). Forward-looking information is always dicey and you might consider a more tempered approach for a new business or technology than the rest of the business (or no projections at all).

3. **The inevitable risk factors**: Anything forward-looking usually comes paired with some risk factors. Whether the venture is considered a whole new business "segment" or just the beginning of a potentially large innovation, you will want to craft the appropriate risk factors.

4. **Possible voluntary "segment" disclosure**: You may voluntarily report something as a "segment" before it might technically be required. Yeah, that happens.

5. **An 8-K "recast" ahead of raising capital**: If you expect to do a capital markets offering soon after a segment change - and before the next Form 10-K - you may need to file the "recast" on Form 8-K to include periods that would not otherwise be included in your 10-Q filings.

6. **Don't forget your employees**: An important issue to consider is employee morale. If going into a new line of business means that you'll be focusing less on an existing line – perhaps even getting out of it entirely – that may catch some employees working on that line by surprise.

3. THE IN-HOUSE LAWYER AND THE NEW BUSINESS LINE'S MARKETING MACHINE

Broc and I were mulling over the important question: "how does the publicity about a new line of business look in SEC filings compared to the marketing machine?"

Obviously, the two different communication channels serve different customers and different needs. Drafted by two distinct sets of scribes with widely divergent mandates and skill sets. It comes as no surprise that the disclosure in SEC filings is going to be less on the flashy side. By a wide mile.

That then begs the question: "Do in-house people look at the marketing stuff?" In most cases, the answer would be, "Yes, the in-house lawyers have readily available access to the company's social media channels." And those tweets and Facebook posts provide links to the panoply of marketing messages that companies pump out.

This is a far cry from the days of yore when it was unlikely that in-house lawyers got much of a taste of what was happening on the other side of the building. Today's lawyers don't have such excuses. So, when a company enters into a new line of business, in-house lawyers unfortunately can't claim they didn't see what the marketing department was doing if they happen to cross a line.

But, fortunately, that line tends to be a big thick gray one so long as those messages aren't made part of a SEC filing stream. Consumers of marketing messages expect a bit of hyperbole.

4. "WELL, THAT DIDN'T WORK." HANDLING THE DISCLOSURE IMPLICATIONS OF GETTING OUT OF A BUSINESS LINE

No one hits a home run every time. Not even the best of companies. Sometimes a line of business will be shut down. Perhaps the assets are sold, or perhaps they are salvageable to be used internally.

As the in-house disclosure lawyer, what do you do? What does the disclosure look like when a company announces it's getting out? Match what you did when you got into the business in the first place?

Here are a few things to consider:

1. **Press release**: If you issued a press release going in, do you issue a press release going out? If so, you're probably going to be filing the press release as an exhibit to a Form 8-K.

2. **Form 8-K**: Is an SEC filing necessary? Oftentimes one or more of the 8-K boxes winds up being ticked. Disclosure under Item 2.01 (Completion of Acquisition or Disposition of Assets) or Item 2.05 (Costs Associated with Exit or Disposal Activities) may be required. Or Item 2.06 (Material Impairments) may also be implicated.

   In some cases, a company may even want to voluntarily file an 8-K even if not required. Public reaction to the announcement of your departure from what might have been a promising business opportunity may result in a bang or a whimper. Maybe it was a slow death. Or the company pretty quickly recognized it as fool's gold. The public's perception may help guide your decision about whether to file a voluntary 8-K.

3. **Updating financials for a takedown**: As with recasting segments when you build out a new business line, exiting a business might require an 8-K with updated financial disclosures recasting the business disposed of as discontinued operations, if a capital markets transaction is contemplated before the next Form 10-K is filed.

4. **Board discussions**: How do you handle this wind down and exit in your board discussions? Don't forget to document it as necessary in the board minutes.

This reminds me of why I'm so glad I signed up for an Armoire account last year - new, fun clothes to try every month, and I get to send them back for reuse with no regrets (or worries about making excuses)!