DAY PITNEY LLP

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CORPORATE EXECUTIVE ESSENTIALS

Regulation FD Troubles Hurt in More Ways Than One

On October 21, 2010, the SEC announced enforcement actions brought against Office Depot, Inc. and two executives for alleged violations of SEC fair disclosure rules.

The SEC charged that near the end of Office Depot's 2007 second quarter, its CEO and CFO discussed how to encourage analysts to revisit their financial expectations concerning the company, which the SEC alleged led to a series of one-on-one calls to analysts by a company investor relations executive. In these calls, the SEC noted that the company officials never directly stated that the company would not meet the analysts' financial expectations; instead, the company was alleged to have relayed sufficient indirect references about the slowing economy and recent public statements by comparable companies to lead analysts to a conclusion that the company would not meet analysts' published estimates.

Regulation FD Allegations

According to the SEC complaint, during its publicly broadcast earnings conference call in February 2007, Office Depot management described the company's business model, which contemplated mid- to upper-teens earnings per share ("EPS") growth over the long term. During a subsequent public conference call in late April 2007, company management warned investors that its largest business segments were facing a softening in demand that was continuing into the second quarter. Shortly after this second public conference call, company management apparently reiterated during a publicly available investor conference in early May 2007 that the company's business model contemplated mid- to upper-teens EPS growth over the long term and that the company faced a softening demand environment.

At the end of May 2007, the company's CEO is alleged by the SEC to have advised the board of directors and the executive committee that the company would not likely meet analysts' published consensus estimate of $0.48 EPS for the 2007 second quarter and that senior management was discussing a strategy for advance communication to avoid a complete

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surprise to the market. Notably, the SEC included in its complaint that the company did not have a written Regulation FD policy or FD procedures at that time, nor had the company conducted any formal Regulation FD training up to that point.

In early June 2007, in response to the CEO's advice to the board of directors, the CFO is alleged to have instructed the investor relations director and his immediate supervisor to prepare a draft press release previewing second-quarter earnings information should the company later decide to issue a press release. By mid-June 2007, certain of the company's preliminary internal estimates are alleged to have forecast EPS up to $0.44 for the quarter. According to the SEC complaint, the CEO and CFO were apparently uncomfortable with issuing a press release at that time, because the company's internal estimates were still incomplete.

Later in June 2007, the CEO and CFO are alleged to have discussed a way to encourage analysts to revisit their financial expectations of the company. The CEO allegedly proposed to the CFO that the company (A) orally contact analysts and refer them to recent earnings announcements by two comparable companies that had recently publicly announced results impacted by the slowing economy and (B) point out on these analyst calls what the company had earlier publicly said in April and May 2007. According to the SEC complaint, the CEO apparently believed that if the analysts considered the company again in this light, they would come to their own conclusions that their estimates were too high and would likely lower these estimates. Following this, various "talking points" were alleged to have been drafted to use as a guide for the calls to analysts. These talking points, as set out in the SEC complaint, were as follows:

- Haven't spoken in a while, just want to touch base.
- At beg. of Qtr we've talked about a number of head winds that we were facing this quarter including a softening of the economy, especially at small end.
- I think the earnings release we have seen from the likes of [Company A], [Company B], and [Company C] have been interesting.
    - On a sequential basis, [Company A] and [Company B] domestic comps were down substantially over prior quarters.
    - [Company C] mentioned economic conditions as a reason for their slowed growth.
- Some have pointed to better conditions in the second half of the year – however who knows?
- Remind you that economic model contemplates stable economic conditions – that is midteens growth

These talking points are important to consider, from a corporate executive's viewpoint, in connection with the reach of Regulation FD. On their face, these talking points appear to try to walk a fine line by simply

identifying previously disclosed, publicly available information, and you might ask, “What’s wrong with that?” As lawyers, we would understand that while the words used may in fact comport with that thinking, the spirit and purpose of such a communication would likely be a signal to analysts to re-examine their estimates. It is this dichotomy between what a business executive may view as “rational” or “permitted” and the legal impact and true import of those words that is really the gravamen of this SEC enforcement action.

This conclusion is particularly heightened by the result of these communications. Among other things, the SEC complaint noted that “[w]ord of these calls quickly spread among analysts, some of whom believed that Office Depot was ‘talking down’ analysts’ earnings estimates.” According to the SEC complaint, these calls influenced many analysts to revise and lower their second quarter forecasts. By the close of the second day of the calls, 15 of the 18 analysts contacted had lowered their estimates and brought the consensus estimate down from $0.48 to $0.45. It was also alleged that following the analyst calls, the investor relations director was asked to call the company’s top 20 institutional investors and relay the same talking points, which was done the following day. At least one analyst apparently expressed concern to the company about the lack of a company press release.

After the close of market on June 28, 2007, six days after these calls had commenced, Office Depot filed a Form 8-K publicly disclosing that its earnings would be “negatively impacted due to continued soft economic conditions.” Between the date when the calls first commenced and the market close on the day immediately before the company filed its Form 8-K, the company stock had dropped 7.7%.

On the same date that the SEC announced its enforcement actions, Office Depot and each of the two executives agreed to settle the SEC charges, without admitting or denying any of the SEC findings or allegations. Office Depot agreed to a $1 million penalty, and the two executives agreed to pay $50,000 each and to consent to the entry of administrative orders requiring the executives to cease and desist from causing any violations or future violations of Regulation FD and Section 13(a) of the Securities Exchange Act of 1934.

Executive Takeaways

Company executives facing issues about how to handle changed estimates and expectations need to continue to recognize the severe hammer of any violations of Regulation FD. The damage to corporate and individual reputations can be severe and often outstrips any monetary penalties. Whether or not their departures were related to these circumstances, each of these executives left the company. Further, the time, energy and resources expended in response to any SEC investigation or SEC inquiry can be enormous, diverting valuable resources from the mission of the company.

Regulation FD training continues to be extremely important. Business executives, who are one step removed from legal standards and legal analysis, and who often believe they are within the bounds of legal

requirements, need to recognize that rules and regulations such as Regulation FD are strictly interpreted and rigidly enforced.

It is also notable that on October 15, 2010, a Florida federal court issued a ruling in an insurance coverage litigation involving Office Depot and in part related to this same SEC investigation. One significant issue in the litigation was whether the company's very substantial costs incurred in voluntarily responding to the SEC investigation were covered "claims" under its D&O policy as "administrative or regulatory proceeding[s] against, or investigation of, [the company]." The court upheld the insurer's position that the costs incurred by Office Depot relating to the company's voluntary response to an SEC investigation fell outside of the policy's definition of "claims." Office Depot had requested reimbursement from its insurer of over $23 million in legal fees and expenses that it had incurred in responding to and settling with the SEC related to this Regulation FD investigation (as well as a contemporary accounting restatement issue for alleged vendor rebate timing misrepresentations identified by a whistleblower), including indemnification against defense costs and conducting an internal investigation and audit triggered by its whistleblower complaint concerning the vendor rebate issue.

Caution is the absolute key in this context. Mistakes, even well-intentioned, in the area of selective disclosure can have substantial and far-reaching consequences, to both companies and their senior executives.

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