THE IMPACT OF SARBANES-OXLEY ON M&A PRACTICES (WITH SAMPLE LANGUAGE)

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COMPLYING WITH THE SARBANES-OXLEY ACT IS CHALLENGING ENOUGH

WHEN THERE IS ONLY ONE CORPORATION TO DEAL WITH.

WHEN THERE IS A MERGER OR ACQUISITION, LIFE GETS EVEN MORE COMPLICATED.

A MOUNTAIN OF LAW FIRM CLIENT ALERTS ON THE SARBANES-OXLEY ACT OF 2002 ("SARBANES-OXLEY") REVEALS A NATURAL FOCUS ON CORPORATE GOVERNANCE AND DISCLOSURE ISSUES AND RELATIVELY LITTLE CONSIDERATION OF HOW THE ACT AFFECTS MERGER AND ACQUISITION TRANSACTIONS. HOWEVER, SARBANES-OXLEY AND THE RECENT CORPORATE GOVERNANCE INITIATIVES OF THE NEW YORK STOCK EXCHANGE, AMERICAN STOCK EXCHANGE, AND NASDAQ ARE LIKELY TO HAVE (OR AT A MINIMUM SHOULD HAVE) A SUBSTANTIAL IMPACT ON:

- THE DUE DILIGENCE PROCESS FOR M&A TRANSACTIONS INVOLVING AT LEAST ONE PUBLIC COMPANY;
- THE NEGOTIATION AND DOCUMENTATION OF THESE TRANSACTIONS; AND
- (PERHAPS MOST FUNDAMENTALLY) THE STRUCTURE AND NATURE OF M&A TRANSACTIONS.

THIS ARTICLE OUTLINES KEY ISSUES FOR CONSIDERATION IN EACH OF THESE AREAS, WHICH SHOULD BE OF INTEREST TO PUBLIC COMPANIES THAT ARE ACQUIRING EITHER PUBLIC OR PRIVATE COMPANIES.

COMPLIANCE AND THE COMBINED ENTITY • IN A PUBLIC COMPANY ACQUISITION OF ANOTHER PUBLIC COMPANY, SOME COMFORT MAY BE DRAWN FROM THE FACT THAT THE TARGET HAS BEEN SUBJECT TO SARBANES-OXLEY BEFORE CLOSING. NONETHELESS, THE ASSUMPTION OF SARBANES-OXLEY COMPLIANCE SHOULD BE RIGOROUSLY TESTED AND DOCUMENTED. FURTHER, THE COMBINED ENTITY'S COMPLIANCE WITH SARBANES-OXLEY AFTER THE ACQUISITION IS CONSUMMATED MUST BE PLANNED FROM A SUBSTANTIVE AND TIMING

STANDPOINT.

PUBLIC-PRIVATE COMBINATIONS

THE ACQUISITION OF A PRIVATE COMPANY (OR A FOREIGN PUBLIC COMPANY THAT HAS NOT ENTERED THE U.S. MARKET) BY A PUBLIC ACQUIROR MAY CREATE EVEN MORE DIFFICULT ISSUES SINCE THE TARGET PROBABLY WILL HAVE NO HISTORY OF SARBANES-OXLEY OBSERVANCE AND MAY HAVE LESS ROBUST REPORTING AND INTERNAL CONTROLS. IN THIS SITUATION, THE PRO FORMA COMPLIANCE ISSUES MUST BE ORCHESTRATED CAREFULLY. THE ENACTMENT OF SARBANES-OXLEY, COMBINED WITH THE FLOOD OF SEC, STOCK EXCHANGE, AND NASDAQ PRONOUNCEMENTS MAKE THIS PROCESS MORE CHALLENGING THAN IT LIKELY WILL BECOME WHEN BEST PRACTICES ARE MORE CLEARLY ESTABLISHED.

ENTITIES THAT BECOME ISSUERS

MOREOVER, SARBANES-OXLEY WILL HAVE AN IMPACT ON SOME ACQUISITIONS THAT AT FIRST GLANCE DO NOT APPEAR TO INVOLVE PUBLIC COMPANIES. A PRIVATE EQUITY BUYER ENGAGED IN THE LEVERAGED ACQUISITION OF A PRIVATE COMPANY MAY CONCLUDE THAT A POSSIBLE EXIT THROUGH AN INITIAL PUBLIC OFFERING IS SUFFICIENTLY FAR IN THE FUTURE THAT IT NEED NOT AFFECT THE MANNER IN WHICH THE ACQUISITION IS CONSUMMATED. (PRIVATE EQUITY BUYERS ARE RARELY WILLING TO EFFECT ACQUISITIONS IN A MANNER THAT EXCLUDES THE POSSIBILITY OF AN INITIAL PUBLIC OFFERING IN THE NEAR TERM SINCE MARKET CONDITIONS MAY BECOME UNEXPECTEDLY FAVORABLE.) HOWEVER, IF THE ACQUISITION FINANCING INCLUDES A TRANCHE OF HIGH-YIELD DEBT, THE COMPANY WILL BECOME AN "ISSUER" SUBJECT TO AT LEAST SOME OF THE REQUIREMENTS OF SARBANES-OXLEY A FEW MONTHS AFTER THE CLOSING UPON THE FILING OF THE REGISTRATION STATEMENT FOR THE A/B EXCHANGE OFFER. IT IS ALSO POSSIBLE TO AVOID SARBANES-OXLEY "ISSUER" STATUS BY ELIMINATING THE A/B EXCHANGE OFFER; THE DEBT SECURITIES COULD STILL BE TRADED UNDER SEC RULE 144A, 17 C.F.R. §230.144A, BUT THE ABSENCE OF REGISTRATION WILL OFTEN INCREASE THE REQUIRED YIELD.

SET FORTH BELOW ARE RECOMMENDATIONS REGARDING APPROPRIATE SUPPLEMENTS TO THE DUE DILIGENCE PROCESS FOLLOWING SARBANES-OXLEY'S ENACTMENT. THERE FOLLOWS AN ANALYSIS OF CONTRACTUAL REPRESENTATIONS, COVENANTS, AND CONDITIONS THAT SHOULD BE CONSIDERED WHEN NEGOTIATING THE PURCHASE BY A PUBLIC ACQUIROR (AS WELL AS PERHAPS THE TARGET IN TRANSACTIONS IN WHICH THE TARGET SHAREHOLDERS OBTAIN EQUITY IN THE ACQUIROR). THE ARTICLE CONCLUDES WITH OUR THOUGHTS ON SARBANES-OXLEY'S IMPACT ON THE FUNDAMENTAL STRUCTURE OF M&A TRANSACTIONS.

DUE DILIGENCE UNDER SARBANES-OXLEY • SARBANES-OXLEY—AND THE SEC RULEMAKING IN ITS AFTERMATH—CLEARLY HAVE SIGNALED THE NECESSITY OF TRANSPARENT FINANCIAL REPORTING FOR PUBLIC COMPANIES. THIS SIGNIFICANTLY EXPANDS THE SCOPE OF FINANCIAL DUE DILIGENCE.

FINANCIAL CONDITION

UNDER SARBANES-OXLEY, DUE DILIGENCE MUST INCLUDE NOT ONLY THE CONSISTENCY OF FINANCIAL REPORTING UNDER GENERALLY ACCEPTED

ACCOUNTING PRACTICES ("GAAP"), BUT ALSO ALL TRANSACTIONS, LIABILITIES, AND OBLIGATIONS (INCLUDING OFF-BALANCE SHEET TRANSACTIONS) THAT AFFECT THE TARGET'S FINANCIAL CONDITION, RESULTS OF OPERATIONS, AND PROSPECTS, REGARDLESS OF THEIR GAAP TREATMENT. SEE §401(A), 15 U.S.C. 78M(J); SEE FINAL RULE: DISCLOSURE IN MANAGEMENT'S DISCUSSION AND ANALYSIS ABOUT OFF-BALANCE SHEET ARRANGEMENTS AND AGGREGATE CONTRACTUAL OBLIGATIONS, RELEASE NOS. 33-8182, 34-47264, FR-67, INTERNATIONAL SERIES 1266 (JANUARY 28, 2003), AVAILABLE AT WWW.SEC.GOV/RULES/FINAL/33-8182.HTM. THE ACQUIRING COMPANY MUST THOROUGHLY UNDERSTAND THE TARGET'S CRITICAL ACCOUNTING POLICIES, WITH AN EMPHASIS ON SIGNIFICANT ACCOUNTING ESTIMATES.

CONSISTENT PROCEDURES

IF THE ACQUIROR AND TARGET ARE IN THE SAME BUSINESS SEGMENT BUT EMPLOY VARIANT POLICIES OR ESTIMATION METHODOLOGIES, A PLAN FOR THEIR RATIONALIZATION SHOULD BE DEVISED PRE-CLOSING. THE FINANCIAL DUE DILIGENCE WILL OFTEN INCLUDE A REVIEW OF THE TARGET'S AUDITORS' WORKPAPERS (A PROCESS THAT INEVITABLY RESULTS IN A NEGOTIATION WITH THE TARGET'S AUDITORS), AND SHOULD INCLUDE A REVIEW OF THE IMPACT THAT ACQUISITION-RELATED CHARGES, INCLUDING WRITE-DOWNS, MAY HAVE ON THE ACQUIRING COMPANY'S FUTURE FINANCIAL STATEMENTS. THE SEC'S FINAL RULE ON CONDITIONS FOR USE OF NON-GAAP FINANCIAL MEASURES, WHICH BECAME EFFECTIVE ON MARCH 28, 2003, PROVIDES THAT NEW REGULATION G DOES NOT APPLY TO A NON-GAAP FINANCIAL MEASURE INCLUDED IN DISCLOSURE RELATING TO A PROPOSED BUSINESS COMBINATION, THE ENTITY RESULTING THEREFROM OR AN ENTITY THAT IS A PARTY THERETO IF THE DISCLOSURE IS CONTAINED IN A COMMUNICATION THAT IS SUBJECT TO THE COMMUNICATION RULES APPLICABLE TO BUSINESS COMBINATION TRANSACTIONS. THEREAFTER, THE NEW NON-GAAP FINANCIAL MEASURE PROHIBITIONS APPLY TO PUBLIC DISCLOSURES OF NON-GAAP FINANCIAL MEASURES RELATING TO THE TARGET OR THE COMBINED ENTITY. SEE FINAL RULE: CONDITIONS FOR USE OF NON-GAAP FINANCIAL MEASURES, RELEASE NOS. 33-8176, 34-47226, FR-65 (JANUARY 22, 2003) ("NON-GAAP FINANCIAL MEASURES RELEASE") AVAILABLE AT WWW.SEC.GOV/RULES/FINAL/33-8176.HTM.

FORFEITURE RISK

THE FORFEITURE PROVISIONS CONTAINED IN SECTION 304—AND THE CERTIFICATION REQUIREMENTS OF SECTIONS 302 AND 906—OF SARBANES-OXLEY UNDERSCORE THE NEED FOR THOROUGH FINANCIAL DUE DILIGENCE. THE FORFEITURE PROVISIONS MANDATE THAT IF MISCONDUCT (BY WHOM IS UNCLEAR) RESULTS IN MATERIAL NON-COMPLIANCE WITH SEC FINANCIAL REPORTING, AND AS A RESULT OF THIS NON-COMPLIANCE A PUBLIC COMPANY IS REQUIRED TO RESTATE ITS FINANCIALS, THE CEO AND CFO MUST DISGORGE ALL PERFORMANCE-BASED COMPENSATION AND ALL PROFITS REALIZED FROM THE SALE OF THE ISSUER'S SECURITIES DURING THE 12 MONTHS FOLLOWING THE FIRST PUBLIC ISSUANCE OR FILING WITH THE SEC OF THE DOCUMENT CONTAINING THE NON-COMPLIANT REPORT. ALTHOUGH THE APPLICATION OF THIS NEW LAW IS NOT YET CLEAR, IT IS REASONABLE TO EXPECT THAT THE ACQUIRING COMPANY'S CEO AND CFO WILL NOT WISH TO EXPOSE THEMSELVES TO POTENTIALLY

SIGNIFICANT PERSONAL LIABILITY BASED ON TARGET MISCONDUCT THAT AFFECTS THE COMBINED FINANCIAL STATEMENTS.

CONSIDER A PRE-CLOSING AUDIT

THIS NEW EMPHASIS ON FINANCIAL STATEMENT DILIGENCE IS REINFORCED BY SARBANES-OXLEY'S CERTIFICATION REQUIREMENTS, WHICH ARE DESIGNED TO FORCE SENIOR MANAGEMENT TO OBTAIN SUFFICIENT INFORMATION TO FORM A BASIS FOR THE CERTIFICATION AS TO ADEQUACY OF DISCLOSURES. IN THOSE SITUATIONS IN WHICH THE ACQUIRING COMPANY IS UNABLE TO GET COMFORTABLE WITH THE FINANCIAL CONDITION OF THE TARGET TO THE EXTENT NECESSARY TO ALLOW THE CEO AND CFO TO INCLUDE THESE RESULTS IN THEIR CERTIFICATIONS, CONSIDERATION SHOULD BE GIVEN TO A PRE-CLOSING CLOSING AUDIT TO PROVIDE THE NECESSARY COMFORT.

INTERNAL CONTROLS

WHILE HISTORICALLY CRITICAL, THE NEW REGULATORY PARADIGM EMPHASIZES THAT THE TARGET'S INTERNAL CONTROLS MUST BE ASSESSED CAREFULLY TO DETECT ANY SIGNIFICANT DEFICIENCIES OR MATERIAL WEAKNESSES. SECTION 404 OF SARBANES-OXLEY, 15 U.S.C. §7262, REQUIRES DISCLOSURE IN ANNUAL REPORTS FILED UNDER THE EXCHANGE ACT OF MANAGEMENT'S RESPONSIBILITY FOR ESTABLISHING AND MAINTAINING INTERNAL CONTROLS AND ITS CONCLUSIONS ABOUT THE EFFECTIVENESS OF THE INTERNAL CONTROLS, INCLUDING ANY CHANGES AND CORRECTIVE ACTIONS. FURTHER, THE PUBLIC COMPANY'S OUTSIDE AUDITOR WILL BE REQUIRED TO ATTEST TO, AND REPORT ON, THE ASSESSMENT OF THESE MATTERS BY THE CEO AND CFO. OBVIOUSLY, THE ACQUISITION DILIGENCE PROCESS MUST BE SUFFICIENT TO PROVIDE A BASIS FOR THESE DISCLOSURES AND THE ACQUISITION OF AN ENTITY WITH WEAK OR NON-EXISTENT INTERNAL CONTROLS MUST BE CAREFULLY ANALYZED IN LIGHT OF THESE NEW REQUIREMENTS.

DISCLOSURE CONTROLS AND PROCEDURES

THE DUE DILIGENCE PROCESS SHOULD ASSESS THE EXTENT TO WHICH THE TARGET HAS IN PLACE DISCLOSURE CONTROLS AND PROCEDURES THAT CAPTURE ALL INFORMATION REQUIRED TO BE DISCLOSED UNDER THE EXCHANGE ACT. THE IMPORTANCE OF THE ABILITY OF THESE CONTROLS AND PROCEDURES TO PROVIDE DATA UPSTREAM IN A PROMPT AND RELIABLE FASHION WILL ACCELERATE AS THE TIME PERIODS FOR FILING FORM 10-K IS REDUCED TO 60 DAYS AND FOR FORM 10-Q TO 35 DAYS FOR MOST FILERS.

THE EXPANSION OF 8-KS

EVEN MORE IMPORTANTLY, THE PROPOSALS THAT WOULD REQUIRE FORM 8-K FILINGS ON A WIDE RANGE OF NEW TOPICS (INCLUDING ENTRY INTO OR TERMINATION OF MATERIAL CONTRACTS OTHER THAN IN THE ORDINARY COURSE OF BUSINESS, TERMINATION OR REDUCTION OF BUSINESS RELATIONSHIPS WITH SIGNIFICANT CUSTOMERS, CREATING OR TRIGGERING MATERIAL DIRECT OR CONTINGENT FINANCIAL OBLIGATIONS AND MATERIAL IMPAIRMENTS) AND MANDATE THOSE FILINGS TO BE MADE WITHIN TWO BUSINESS DAYS AFTER THE EVENT TO BE REPORTED, WILL REQUIRE SOPHISTICATED, EFFECTIVE DISCLOSURE