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Client Advisory

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Sarbanes-Oxley Act Changes Best Practices for Public and Private Companies Engaged in Acquisitions

The Sarbanes-Oxley Act, which attempts to address issues raised by the collapse of Enron, WorldCom and other companies, and related SEC, stock exchange and Nasdaq rules will have a significant impact on companies engaged in acquisitions and may require development of a new set of best practices. Specifically, companies will need to update their due diligence procedures to avoid potential violations of these new rules as a result of acquisitions and to reduce the risks associated with CEO and CFO certifications of periodic reports.

This Client Advisory addresses some of the areas of concern and actions that might be taken by companies considering acquisitions as they relate to:

- application of the Sarbanes-Oxley Act
- certification issues
- forfeiture risks
- internal controls
- personal loans
- target's personnel
- non-audit services
- auditor independence
- director independence
- non-GAAP financial measures
- enhanced disclosure
- evolution of GAAP

Application of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act applies, generally, to all companies required to file reports under the Securities Exchange Act of 1934. A public company engaged in an acquisition of another public company might be tempted to assume that the target company's pre-closing compliance with the Sarbanes-Oxley Act will allow the business combination to be completed with relatively little concern for the Sarbanes-Oxley Act's requirements. In an acquisition of a private company, a public company might also assume that the target can be integrated into the acquiring company relatively easily because the target was never subject to the requirements of the Sarbanes-Oxley Act. A company that completes an acquisition under these assumptions may encounter post-closing difficulties with the application of the Sarbanes-Oxley Act to the acquiring company and its new subsidiary.

In acquisitions of public companies, buyers sometimes rely heavily on analysis of investment bankers and SEC filings and other publicly available information concerning the target company, rather than a comprehensive due diligence investigation of the target company. This practice is necessarily the rule in

hostile takeovers. The requirements of the Sarbanes-Oxley Act will force acquiring companies to engage in additional due diligence investigations to verify not only the target's pre-closing compliance with the Sarbanes-Oxley Act but also the post-closing "pro-forma" compliance with the Sarbanes-Oxley Act by the acquiring company and the target on a combined basis. The Sarbanes-Oxley Act is also likely to bring about greater participation of boards of directors and audit committees in acquisition evaluation and integration.

The Sarbanes-Oxley Act holds some potential surprises for privately held companies considering acquisitions. The Sarbanes-Oxley Act also applies to any company that has filed a registration statement under the Securities Act of 1933 that has not yet become effective and has not been withdrawn. Privately held companies engaged in acquisitions sometimes find a need for registration of securities under the Securities Act, either as a result of the placement of debt securities, the issuance or exchange of equity securities without an exemption from registration, or the granting of registration rights in private placements. These Securities Act filings could result in a privately-held company subjecting itself to the requirements of the Sarbanes-Oxley Act without a registration under the Exchange Act, even if the deal never closes. As a result, attention needs to be given to deal structure and how that may affect a private company's status under the Sarbanes-Oxley Act.

For public companies, the costs of compliance with the Sarbanes-Oxley Act, and the risks of failure to comply, will increase the costs of being a public company and will alter the calculation of that business justification for going private. For private equity investors, these increased costs and risks create new obstacles to reliance on an initial public offering as an exit strategy.

Certification Issues

Section 302 of the Sarbanes-Oxley Act and new SEC rules set forth requirements for certification of periodic financial reports by the principal executive officer and principal financial officer. Section 906 of the Sarbanes-Oxley Act imposes criminal liability for CEOs and CFOs who knowingly or willfully furnish inaccurate certifications relating to periodic reports. These certification requirements apply only to "periodic" reports, and the SEC rules confirm that the Section 302 certification requirements do not apply to target company financial statements filed with a Form 8-K in connection with an acquisition. However, as a practical matter, an officer's confidence in the pre-closing financial reports of an acquired business will be tested in connection with the officer's post-acquisition certifications accompanying a quarterly or annual report that includes consolidated statements based, in part, upon financial information (for example, accounts receivable, inventory, and accounts payable) from the target company.

Certification under Section 302 and the new SEC rules relating to the accuracy of financial statements is based on the knowledge of the certifying officers. Criminal liability under Section 906 depends on a knowing or willfully inaccurate certification. This knowledge qualification might alleviate some concerns about certifying the accuracy of an acquiring company's annual and quarterly reports that reflect a target company's historic financial information. However, other aspects of the required certification could be expected to raise larger concerns for an acquiring company's CEO and CFO. For example, as far as an acquired business is concerned, the CEO and CFO of the acquiring company may be uncomfortable certifying, as required by the SEC rules, that they have designed the required "disclosure controls and procedures to ensure that material information is made known to them . . . , particularly during the period in which the periodic reports are being prepared." The CEO and CFO are also required to certify that the report presents their conclusions about the effectiveness of the disclosure controls and procedures. This will very likely require more immediate attention to the process of acquisition integration in the area of disclosure controls and procedures.

The certification requirements and the criminal penalties may also necessitate greater emphasis on financial due diligence to confirm the accuracy of the target company's financial information and the sufficiency of the target's disclosure controls and procedures and internal controls. The acquiring company's own internal controls and disclosure controls and procedures should be designed to include controls and due diligence procedures sufficient to confirm the integrity of the target's financial information and disclosures. Note, also that the required certifications under the Sarbanes-Oxley Act are that the financial statements and other financial information "fairly present in all material respects" the financial condition and results of operations of the company, without regard to generally accepted accounting principles. Although a target company's warranties probably do little to reduce certification risks for officers of the acquiring company, a company engaged in an acquisition should consider whether the usual representations and warranties covering a target's historic financial reports are adequate in light of the certification requirements of the Sarbanes-Oxley Act. The typical financial statement warranty that the target's financial statements "fairly present the financial condition and results of operations of the target in accordance with GAAP" falls short of the certification requirements under Sections 302 and 906, although other warranties may close that gap.

Forfeiture Risks

The importance of financial due diligence underlying the certification required by the Sarbanes-Oxley Act is underscored by the forfeiture provisions of the Sarbanes-Oxley Act. These provisions raise concerns for forfeiture of bonuses and incentive compensation of the CEO and CFO of an acquiring company and "profits realized" by them on stock trades if the acquiring company is required to restate its financial statements because an acquired business, as a result of misconduct, misstated its pre-closing financial results.

Unlike the criminal sanctions associated with the required certification, the forfeiture provisions of the Sarbanes-Oxley Act do not depend upon a CEO or CFO having knowledge of the misconduct or the error that leads to the restatement of financial results; nor does it appear that forfeiture necessarily depends on misconduct on the part of the CEO or CFO or anyone else within the acquiring company. It is possible that the SEC will use its exemptive power in this part of the Sarbanes-Oxley Act to reduce the potential for unfair forfeiture results. Thorough financial due diligence by the acquiring company may help reduce the risk of forfeiture for a restatement attributable to pre-acquisition misconduct within the target company and may help support a request for the SEC to use its exemptive powers.

Internal Controls

The Sarbanes-Oxley Act calls for the SEC to establish rules requiring each annual report to include a report on the effectiveness of the issuer's internal controls and procedures related to financial reporting. The Sarbanes-Oxley Act requires the issuer's outside auditor to attest to the report as a part of the normal audit engagement. The SEC's proposed rules for this report added a requirement for quarterly review of internal controls. As proposed, those rules would apply to annual reports for fiscal years ending on or after September 13, 2003.

The proposed rules are subject to change as part of the rule-making process. For public companies considering acquisitions, this required report would necessitate early attention to the target's internal controls. In addition, an acquiring company would want to include some discussion in the report about its own internal controls (for example, due diligence procedures) designed to assure the accuracy of the financial reports that reflect financial information of acquired businesses. The resulting report to be included in the annual report might also need to include a discussion of changes made to due diligence procedures of the acquiring company and internal controls of acquired businesses.

Personal Loans

The Sarbanes-Oxley Act prohibits personal loans to directors and executive officers of issuers, with some exceptions, including an exception for loans made before July 30, 2002. This exception for pre-existing loans should continue to exempt loans made by a public or private target company before July 30, 2002, even after an acquisition by another company. However, it also seems clear that personal loans made to directors and executive officers of a private company after July 30, 2002, would need to be paid off prior to the acquisition of the target by a public company if the recipient of the loan will become a director or executive officer of the buyer after the closing of the acquisition. Due diligence investigation typically calls for some disclosure of these loans, but companies will need to review due diligence procedures to be sure that disclosure is adequate and steps are taken to have any prohibited loans paid off before the closing. Attention should also be directed to benefit plans and arrangements of the acquired business that could result in the creation of new loans to a director or executive officer after the closing date.

Fitness of Target Company Personnel

The Sarbanes-Oxley Act gives the SEC the power to bar persons from serving as officers and directors of a public company if they committed a securities law violation and their conduct demonstrated unfitness to serve as an officer or director. The Sarbanes-Oxley Act also lowers the standard for the SEC to impose the bar to mere "unfitness", compared with the previous requirement for "substantial unfitness" before a federal court could issue an order prohibiting a person from service as a director or officer of a public company. This may necessitate background checks for any principal of a privately-held target company who is slated for service as a director or officer of the acquiring company.

The Sarbanes-Oxley Act gives the Public Company Accounting Oversight Board (the "Oversight Board") responsibility for setting rules and procedures for the investigation and disciplining of registered public accounting firms ("RPAFs") and associated persons of RPAFs. The Oversight Board has the power to take disciplinary action and impose sanctions against RPAFs and persons associated with RPAFs. Sanctions include, among other things, temporary or permanent bar of a person from association with an RPAF, and any other appropriate sanction provided for in rules of the Oversight Board. Apparently the Oversight Board, as part of its sanctions, could also suspend or bar a person from being associated with a company in an accounting or a financial management capacity. It would be prudent for a buyer, in the course of acquisition due diligence, to verify that the target company does not employ in an accounting or financial management capacity any person who has been suspended or barred from being associated with a RPAF or a company subject to the Sarbanes-Oxley Act.

Non-Audit Services

The Sarbanes-Oxley Act prohibits RPAFs from performing specified non-audit services and requires prior audit committee approval of non-audit services that are not prohibited. In many cases, the acquiring company's auditor will take over the audit work for the target company after the acquisition is completed. In that case, the acquiring company's audit committee need not concern itself with approval of non-audit services performed by an accounting firm (the target's former auditor) that is not the post-closing auditor for the acquiring company and its new subsidiary. However, it would be good practice for the acquiring company's audit committee to review non-audit services of the target company as part of the normal acquisition integration process.

In some cases, the target and the acquiring company will have the same auditor. The Sarbanes-Oxley Act requires the audit committee of the acquiring company to approve in advance any non-audit services that the acquiring company's audit firm may continue for the target after the acquisition. For this reason the acquiring company's audit committee should review and approve in advance any post-closing non-audit services performed for the target by the acquiring company's auditor. Note the possibility, also, that non-audit services being performed for a private company could include some of the prohibited

non-audit services, such as bookkeeping services. Those services would have to terminate after the target is acquired by a public company, unless they are performed by a firm other than the acquiring company's auditor. The prudent public company should, during the course of due diligence and acquisition integration, identify and evaluate all non-audit services being performed by the target's auditors.

Auditor Independence

The Sarbanes-Oxley Act prohibits a RPAF from performing audit services for a public company if a chief executive officer, chief financial officer, controller, chief accounting officer or any person serving in an equivalent position for the company was employed by the auditor and participated in any capacity in the audit of the company during the one-year period preceding the date of the audit. It seems unlikely that this prohibition would present any problem in connection with an acquisition. However, it is possible that a target company employee could serve in a senior finance or accounting position with the acquiring company (or a subsidiary) after the acquisition, in which case inquiry should be made about that person's prior association with the acquiring company's auditor in order to avoid a violation of this prohibition.

Director Independence

The Sarbanes-Oxley Act sets forth requirements for independence of members of a listed public company's audit committee. One of the independence requirements is that members of the audit committee may not be "an affiliated person of the issuer or any subsidiary" of the issuer. An "affiliated person" of an issuer is not defined in the Sarbanes-Oxley Act but it is defined in the Exchange Act by reference to Section 2(3) of the Investment Company Act of 1940. It is possible, therefore, that "affiliated person" has the meaning given in the Investment Company Act, which includes any five percent stockholder or any officer, director, partner, copartner, or employee of the company, in addition to the common definition of an "affiliate".

The more relevant consideration for most companies will be rules of the stock exchanges and Nasdaq. For example, the NYSE and Nasdaq have proposed independence requirements for directors and audit committees that are more restrictive than the Sarbanes-Oxley Act's new requirement. Under the proposed rules of the stock exchanges and Nasdaq, it is possible that a director who is independent could lose his or her independence as a result of an existing or previous relationship to a company acquired by the listed company or a person employed by that company. It is also possible that target company directors or officers who expect to have a seat on the acquiring company's board may not meet the requisite independence requirements for the position. Prior to completing an acquisition, the acquiring company should inquire into affiliations between members of its board and the target company (including its employees) in order to avoid questions about director or audit committee independence after the acquisition.

Non-GAAP Financial Measures

The Sarbanes-Oxley Act also directs the SEC to adopt rules regarding public disclosure of so-called "pro forma" financial measures by a reporting company. The SEC adopted new Regulation G and amendments to Item 10 of Regulation S-K and Regulation S-B on this subject in January 2003, referring to "pro forma" financial measures as "non-GAAP financial measures". The new rules do not alter the presentation of pro forma financial information of the type required by Article 11 of Regulation S-X (for example, the pro forma financial presentations commonly included in SEC filings relating to business combinations), but they do prohibit the presentation of any non-GAAP financial measures on the face of any pro forma financial information required by Article 11 of Regulation S-X.

In the SEC's new rules, a "non-GAAP financial measure" is a numerical measure of a company's historic or future financial performance, financial position or cash flows that, because of exclusions (or inclusions) or adjustments, differs from a comparable measure calculated and presented in accordance with GAAP in the financial reports. Under the new rules, public disclosure of material information that includes a

non-GAAP financial measure must be accompanied by a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP and a reconciliation of the differences between the non-GAAP financial measure and the GAAP financial measure. An example of a non-GAAP financial measure would be EBITDA, which may derive from GAAP elements but is not presented in accordance with GAAP.

Regulation G and Item 10 do not apply to disclosures of non-GAAP financial measures included in disclosures related to a proposed business combination transaction, the entity resulting therefrom, or an entity that is a party thereto, if the disclosures are contained in a communication subject to specified SEC rules applicable to business combinations. The business combination disclosures that are exempted from Regulation G and Item 10 are Rule 425 under the Securities Act, Rule 14a-12 and 14d-2(b)(2) under the Exchange Act, and Item 1015 of Regulation MA. Public disclosures of non-GAAP financial measures that are not made pursuant to those requirements would be subject to Regulation G and Item 10. As a result, companies engaged in acquisitions will need to be careful about the use of non-GAAP financial measures in public statements about business combinations.

Enhanced Disclosure

The Sarbanes-Oxley Act calls for the SEC to issue regulations for annual and quarterly reports required to be filed with the SEC to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operation, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses." The rules adopted by the SEC in January 2003 limited this otherwise broad disclosure requirement and eliminated concerns that could have been relevant in the context of mergers and acquisitions.

The Sarbanes-Oxley Act also calls for new SEC rules for "real time disclosure" on a "rapid and current basis" of information concerning material changes in the financial condition or operations of the company. In addition to the questions this provision raises for every public company, there are additional questions for a company engaged in acquisition negotiations. These requirements may eventually take shape in a form similar to the SEC's rule-making initiative introduced in June 2002. Under that proposal, U.S. public companies would be required to file a Form 8-K within two business days after the occurrence of an event falling within any one of several categories, including the execution of a letter of intent, whether or not binding or subject to conditions. A requirement for immediate reporting of letters of intent will offer another reason for public companies to avoid use of letters of intent.

Evolution of GAAP

The Public Company Accounting Oversight Board will have the power to establish professional auditing standards. However, the Board will not have the power to establish accounting principles. Historically, the SEC has recognized as generally accepted those accounting principles established by the Financial Accounting Standards Board as generally accepted accounting principles. The Sarbanes-Oxley Act appears to formalize the SEC's recognition of FASB as the body that sets GAAP.

The Sarbanes-Oxley Act provides that the body that sets GAAP must have in place procedures to ensure prompt consideration of changes in accounting principles necessary to reflect emerging accounting issues and changing business practices. The Sarbanes-Oxley Act also requires the SEC to study the use of principles-based accounting and financial reporting rather than the existing rules-based system, and FASB has already asked for public comment on adopting a principles-based approach. Although the Sarbanes-Oxley Act made many changes to the status quo, the most significant changes may be yet to come in the form of changes in GAAP.

Representations and warranties in acquisition agreements typically cover the target company's financial statements and often include a warranty to the effect that the statements have been prepared in accordance with generally accepted accounting principles. In addition, post-closing purchase price adjustments usually require closing date determinations to be made in accordance with GAAP. Earn-out arrangements sometimes calculate the payment with reference to determinations made in accordance with GAAP. Over the years, mergers and acquisitions practitioners have developed different definitions of (and ways of referring to) GAAP. During the next few years, what is considered GAAP is likely to change, and that is likely to change the way mergers and acquisitions practitioners define and refer to GAAP.

Conclusions

Several generalizations can be drawn for companies engaged in acquisitions:

- As to the accuracy of the target's financial information, greater reliance should be placed on meaningful financial due diligence and, in appropriate circumstances, closing date audits. Attention should also be directed to the target's internal controls and disclosure controls and procedures to ensure the adequacy and accuracy of disclosures relating to the target in the acquiring company's post-closing quarterly and annual reports. This inquiry should be directed to the required certification for the next quarterly or annual report including the target's operations.
- Design due diligence and integration plans to produce the disclosures required in the acquiring company's post-closing quarterly and annual reports, including the required reports on disclosure controls and procedures and internal controls. Due diligence should include meetings with the target company's internal audit team and those target company employees who are part of the target's disclosure controls committee.
- Perform a "pro forma" corporate governance audit to verify compliance with the Sarbanes-Oxley Act and relevant listing standards by the acquiring company after giving effect to the acquisition. Evaluate accounting and finance personnel and the independence and fitness of directors and proposed directors, including possible relationships directors of the acquiring company may have had in the past with the target company or may currently have with employees of the target company or persons doing business with the target company or the auditor for the target company.
- In making public disclosures about proposed business combinations, be aware of the requirements of the SEC's rules regarding use of non-GAAP financial measures.
- If the target uses the same auditor as the acquiring company, the acquiring company and its audit committee should approve in advance any non-audit services that will be performed by the auditor after the closing date. Any non-audit services that are not approved, and any non-audit services that are prohibited, should be terminated at or before the closing and substitute services should be arranged through other service providers.
- An acquiring company should consider whether any employee of the target company will become a director or executive officer of the acquiring company after the closing. If so, the acquiring company will need to evaluate loans to that person, including benefit plans and other arrangements that might result in the extension of credit to that person at a later date.
- In negotiating and drafting acquisition agreements, pay attention to references to GAAP and consider the effect of any future developments that would alter what accounting principles are considered generally accepted at any subsequent point in time.

We Can Help

The Sarbanes-Oxley Act and related SEC, stock exchange and Nasdaq rules will require companies to update their due diligence procedures to avoid potential violations of these new rules as a result of acquisitions. Legal counsel can provide valuable guidance to help companies meet these demands. Please direct questions regarding the issues discussed in this Client Advisory to the Co-Chairs of Katten Muchin Zavis Rosenman's Mergers and Acquisitions Practice:

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KMZ Rosenman has previously published a number of Client Advisories on additional ways that the Sarbanes-Oxley Act affects public companies. For a copy of these Advisories, visit our Web site at http://www.kmzr.com/resource/resource.asp or contact any of the attorneys listed above.

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