

THE IMPACT OF SARBANES-OXLEY ON MERGER & ACQUISITION PRACTICES¹

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A review of the flood of secondary sources on the Sarbanes-Oxley Act of 2002 ("SOX") reveals a natural focus on corporate governance and disclosure issues and relatively little consideration of the impact of this seminal act on merger and acquisition transactions.² This article asserts that SOX and the recent corporate governance proposals of the New York Stock Exchange, American Stock Exchange and NASDAQ will 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.³

In a public company acquisition of another public company, some comfort may be drawn from the fact that the target has been subject to SOX prior to closing. Nonetheless, the assumption of SOX compliance should be rigorously tested and

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² A review of the mountain of law firm client alerts regarding SOX reveals at least one thoughtful piece on this subject, *Sarbanes-Oxley Act Changes Best Practices for Public and Private Companies Engaged in Acquisitions* by Katten Muchin Zavis Roseman dated February 2003.

³ The authors assume a basic familiarity with SOX; it is not a goal of this article to set forth SOX's substantive requirements, the SEC rules and releases relating thereto, or the stock exchange or NASDAQ rules that will be adopted as a result of SOX.

documented. Further, the combined entity's compliance with SOX after the acquisition is consummated must be planned from a substantive and timing standpoint.

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 will have no history of SOX observance and may have less robust reporting and internal controls. In this situation, the pro forma compliance issues must be orchestrated carefully. The recent enactment of SOX, combined with the flood of SEC pronouncements and the uncertain status of the stock exchange and NASDAQ rules, make this process more challenging than it likely will become when best practices are clearly established.

Moreover, SOX 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.⁴ 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 SOX a few months after the closing upon the filing of the registration statement for the A/B exchange offer.⁵

Set forth below are recommendations regarding appropriate supplements to the due diligence process following SOX'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

⁴ However, the authors' experience is that private equity buyers are rarely willing to effect acquisitions in a manner that excludes the possibility of an initial public offering if market conditions become unexpectedly favorable in the near-term.

⁵ SOX § 2(a)(7). The increased burden of "issuer" status under SOX may lead companies that become subject to SOX solely because of a high-yield debt issue to resist their investment banker's request for an indenture covenant that requires continued filing of reports with the Securities and Exchange Commission after such filing ceases to be required by Section 15(d) of the Securities Exchange Act of 1934 (generally after the filing of the Annual Report on Form 10-K for the fiscal year in which the A/B exchange offer occurs).

in which the target shareholders obtain equity in the acquiror). The article concludes with thoughts on SOX's impact on the fundamental structure of M&A transactions.

DUE DILIGENCE UNDER SOX

Financial Condition

SOX and the SEC rulemaking in its aftermath clearly have signaled the necessity of transparent financial reporting for public companies. Thus, financial due diligence must be expanded to include not only the consistency of financial reporting under 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.⁶ The acquiring company must thoroughly understand the target's critical accounting policies, with an emphasis on significant accounting estimates. 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 workpapers⁷ 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.⁸

⁶ Under SOX, the SEC is required to issue regulations mandating that annual and quarterly reports filed with the SEC 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." *Id.* § 401(a).

⁷ A process that inevitably results in a negotiation with the target's auditors.

⁸ The SEC's Final Rule on Conditions for Use of Non-GAAP Financial Measures, which will become effective on March 28, 2003, provides that new Regulation G will 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 will 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 No. 33-8176 (January 22, 2003)(available at <http://www.sec.gov/rules/final/33-8176.htm>) ("Non-GAAP Financial Measures Release").

The forfeiture provisions contained in Section 304 of SOX and the certification requirements of Sections 302 and 906 of SOX 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 of the document containing the non-compliant report. Although this area 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.

This new emphasis on financial statement diligence is reinforced by SOX's certification requirements, which are designed to force senior management to obtain sufficient information to form a basis for the certification. 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 must 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 SOX 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. 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 controls and procedures. These disclosure obligations, as well as SOX's mandate that the SEC promulgate rules for "real time disclosure" on a "rapid and current basis," may affect directly public companies engaged in acquisitions by, for example, requiring disclosure of the execution of non-binding letters of intent. These immediate reporting requirements should be followed closely by M&A practitioners.

Disclosure controls and procedures also are required to be covered in the Section 302 certification, discussed below. At a minimum, during the due diligence process, the acquiring company should inquire whether the target has a disclosure controls and procedures committee, whether this committee has governing principles or a charter to guide its operations and whether there are minutes or memoranda of committee meetings. If the target's disclosure controls and procedures are deficient, the acquiror should calculate the human and financial costs of establishing the appropriate level of controls and procedures by the next quarterly certification date.

Loans to Executives and Directors

Acquiring companies should expand the due diligence process to discover any loans or other extensions of credit to the target's executive officers and directors that were made or continued in effect since SOX's passage. This inquiry has two objectives: to confirm that the target company has complied with Section 402(a) of SOX, which generally prohibits loans to executive officers and directors of "issuers," and, with respect to those individuals who will become executive officers and directors of the acquiring company following the acquisition, to ensure that the acquiring company does not inadvertently violate Section 402(a) of SOX by continuing such a loan in effect. Acquisitions of private companies may present the greatest concern, since a loan made after July 30, 2002 (and thus proper until the closing of the acquisition) will become unlawful if it remains in effect when the borrower becomes an executive officer or director of the public acquiring company.⁹

There is no official interpretive guidance with respect to Section 402(a) of SOX, which requires each "issuer" to make difficult judgments concerning a variety of issues arising under the statute.¹⁰ An acquiring company should review the judgments made by a target to confirm that they comply with its own standards.

Certification Issues

Critical components of SOX are the CEO and CFO certifications of periodic reports required by Sections 302 and 906. The Section 302 statement allows the certifying executive to rely on a knowledge qualification, and criminal exposure under Section 906 is limited to knowing or willful violations. While these standards give some comfort to the public company CEO or CFO, a certification made without a reasonable

⁹ A private equity buyer must be careful to take § 402(a) of SOX into account in structuring loans to facilitate equity investments by target company management if there is a high-yield debt component in the acquisition financing. *See supra* text accompanying notes 4 and 5.

¹⁰ *See Sarbanes-Oxley Act Interpretive Issues Under Section 402—Prohibition of Certain Insider Loans*, THE SECURITIES REPORTER, Fall 2002, at 3.

factual basis is problematic and careful due diligence of the matters subject to certification is therefore warranted. In particular, financial due diligence supporting that the reports of the target present fairly its financial condition and results of operations (without a GAAP limitation) is recommended.

The SEC rules confirm that Section 302 certification requirements do not apply to the target company financial statements filed with a Form 8-K in connection with the acquisition. This confirmation should not provide significant comfort to the public acquiring company since the target's financial information will be a component of the financial statements included in periodic reports covering periods after the acquisition, and thus the certification will be expanded at that time to include the acquired entity's financial information.¹¹ It cannot be overemphasized that shortly after the consummation of the acquisition, the SOX certifications will force the acquiring company's CEO and CFO to take a degree of responsibility for financial statements that include the target's financial condition and results of operations. To the extent that there is any flexibility in connection with scheduling the closing, an acquiror may wish to consider closing immediately after, rather than prior to, the next due date of a periodic report, to allow the CEO and CFO a longer period of time within which to assimilate the target's financial condition before the required report is due.

Further, scrutiny of the target's disclosure controls and procedures and the internal controls are mandated so that the executives will be in a position to make the Section 302 certification on these issues. The certification covering these issues may be particularly problematic, because the officers must certify that they have designed the required disclosure controls and procedures to ensure that material information is made known to them. The CEO and CFO should understand the disclosure controls in place at the target so that changes can be made to integrate the predecessor system with that of the acquiror's, facilitating the CEO's and CFO's ability to make the required certification.

¹¹ From this perspective, certifying officers should appreciate the elimination of pooling-of-interests accounting, which required inclusion of historical balance sheet data and restatement of pre-acquisition period results to reflect the combined operations of both companies.

The private target will have to create these processes and procedures so that integration into the public company's disclosure controls and procedures is seamless. Similarly, due diligence of the target's internal controls, and their compatibility with the acquiror's controls should be undertaken. Procedures in this regard should be updated as the mandates under Section 404 of SOX are finalized.

Corporate Governance Documentation

It is perhaps a gross understatement to note that a fundamental reaction to the significant corporate collapses of the last year has been an increased emphasis on the corporate governance of public corporations. Thus SOX and the related SEC rules, along with the proposed stock exchange listing standards, have emphasized the importance of the independence of directors, the appropriate roles for and composition of various committees of the board of directors and other related topics. A thorough post-SOX due diligence investigation will attempt to assess the strength of the corporate governance policies in effect at the target corporation, and whether the corporation is actually following the policies and procedures that it has put into place. This analysis may assist the acquiring company in its determination of whether the target will assimilate easily into the acquiror's corporate governance environment.

At a minimum, the acquiring company should ask for copies of the following documents from the target that relate to its corporate governance:

- Principles of corporate governance;
- Charters and minutes of audit, compensation and nominating/corporate governance committees; and
- Codes of compliance or conduct.

These documents should be reviewed because (i) they will reflect the quality and seriousness of the corporate governance structure at the organization and (ii) they may reveal problems that require further investigation.

Director Independence

If persons affiliated with the target are expected to assume roles as directors of the acquiring company, the acquiring company must analyze their independence under SOX and the proposed listing standards. While the independence requirements of the NYSE and NASDAQ are not yet finalized, as proposed they vary from the independence mandates of SOX and the SEC's proposed rules. Under SOX, the audit committee must consist of independent directors only, which may not include "an affiliated person" of the issuer, a concept that the SEC has proposed to define very broadly.¹² Ownership of a significant percentage (the SEC has proposed 10%) of the acquiring company's stock alone may cause a director not to be independent under SOX. Under the proposed NYSE and NASDAQ rules, affiliates may be considered to be independent, but there are other prohibited relationships that must be considered. All relationships between each person who will become an acquiror director and the acquiring company (including current and historical business, charitable, familial and personal relationships) should be explored to determine whether such person will pass muster as an independent director of the acquiror. In certain circumstances it may be necessary to explore relationships between independent directors of the acquiring company and the target to determine if the acquisition might change the independence status of such directors.

Compliance and Ethics Culture

An overarching goal that should permeate the due diligence process is gaining an understanding of the fundamental culture of the target and its senior executives. If the target's executives have set a tone of questionable integrity, corner-cutting, revenue manipulation, earnings management, sloppy controls or any one of a number of other major or even minor improprieties at the top, this mindset may well characterize the entire corporate environment. Any disrespect for the financial and legal processes that now are considered best practices should be flagged in the due diligence process. A

¹² It is important to recognize that the SOX independence standard applies only to audit committees.

corporate culture lacking the desired compliance attributes may not be the attractive acquisition target that the raw financial projections suggest.

DOCUMENTATION AND NEGOTIATIONS AFTER SOX

Not only will best practices change in the due diligence arena after SOX, it is likely that representations, warranties, covenants and conditions negotiated in acquisition agreements will likewise be altered in this environment.

Financial Statements

A primary contributing factor to the collapse of Enron, WorldCom, Tyco and other companies that led to SOX was the perceived unreliability of the financial statements. To this end, many SOX–inspired acquisition agreement provisions highlight the need for so-called “transparent” financials. A careful contract drafter in the post-SOX environment will augment the standard financial statements representations to address this shift. Prior to SOX, the core of the standard financial statement representation was that the financial statements “fairly present the financial condition and results of operations of the target in accordance with GAAP.”¹³ The certification required by Section 302 of SOX removes the GAAP qualification, so that the CEO and CFO are required to certify that the financial statements fairly present the financial condition and results of operations of the company, without regard to GAAP. Additionally, assurances regarding the lack of off-balance sheet transactions may be appropriate. An example of a representation drafted with these considerations in mind is set forth below. Provisions that are particularly relevant post-SOX are bold faced.

***Financial Statements.** The financial statements of the Company and its subsidiaries included in Company SEC Documents (including the related notes) complied as to form, as of their respective dates of filing with the SEC, in all material respects with applicable accounting*

¹³ Negotiated Acquisitions Committee of the Section of Business Law, American Bar Association, MODEL STOCK PURCHASE AGREEMENT § 3.4 (1995)

requirements and the published rules and regulations of the SEC with respect thereto (including, without limitation, Regulation S-X), have been prepared in accordance with generally accepted accounting principles in the United States ("GAAP") (except, in the case of unaudited statements, to the extent permitted by Regulation S-X for Quarterly Reports on Form 10-Q) applied on a consistent basis during the periods and at the dates involved (except as may be indicated in the notes thereto) and fairly present the consolidated financial condition of the Company and its subsidiaries at the dates thereof and the consolidated results of operations and cash flows for the periods then ended (subject, in the case of unaudited statements, to notes and normal year-end audit adjustments that were not, or with respect to any such financial statements contained in any Company SEC Documents to be filed subsequent to the date hereof are not reasonably expected to be, material in amount or effect). Except (A) as reflected in the Company's unaudited balance sheet at September 28, 2002 or liabilities described in any notes thereto (or liabilities for which neither accrual nor footnote disclosure is required pursuant to GAAP) or (B) for liabilities incurred in the ordinary course of business since September 28, 2002 consistent with past practice or in connection with this Agreement or the transactions contemplated hereby, neither the Company nor any of its subsidiaries has any material liabilities or obligations of any nature. Part __ of the Company Disclosure Statement lists, and the Company has delivered to Parent copies of the documentation creating or governing, all securitization transactions and "off-balance sheet arrangements" (as defined in Item 303(c) of Regulation S-K of the SEC) effected by the Company or its subsidiaries since • •, which has expressed its opinion with respect to the financial statements of the Company and its subsidiaries included in Company SEC Documents (including the related notes), is and has been throughout the periods covered by such financial statements¹⁴ (x) a registered public accounting firm (as defined in Section 2(a)(12) of the Sarbanes-Oxley Act of 2002), (y) "independent" with respect to the Company within the meaning of Regulation S-X and, with respect to the Company, and (z) in compliance with subsections (g)

¹⁴ Modify as necessary for financial statements covering periods before the enactment of SOX or the operation of the Public Company Accounting Oversight Board.

through (l) of Section 10A of the Exchange Act and the related Rules of the SEC and the Public Company Accounting Oversight Board. Part ___ of the Company Disclosure Schedule lists all non-audit services performed by •for the Company and its subsidiaries since •.

Financial Controls

Several public company acquisition documents contain representations that focus specifically on the quality of the target’s internal controls, a previously uncommon practice. Sample language is included below:

Each of the Parent and its subsidiaries maintains accurate books and records reflecting its assets and liabilities and maintains proper and adequate internal accounting controls which provide assurance that (i) transactions are executed with management's authorization; (ii) transactions are recorded as necessary to permit preparation of the consolidated financial statements of the Parent and to maintain accountability for the Parent's consolidated assets; (iii) access to the Parent's assets is permitted only in accordance with management's authorization; (iv) the reporting of the Parent's assets is compared with existing assets at regular intervals; and (v) accounts, notes and other receivables and inventory are recorded accurately, and proper and adequate procedures are implemented to effect the collection thereof on a current and timely basis.¹⁵

SEC Reports

When the target is subject to SOX, the standard representation regarding timely and complete filings with the SEC should be strengthened. This revised representation will highlight the filing or furnishing of certifications under the SEC’s June 27, 2002 order (if this requirement was applicable to the target) and under Section 906 (which certifications are not technically filed documents). This representation will become

¹⁵ Agreement and Plan of Merger among Perry Ellis International, Inc., Connor Acquisition Corp. and Salant Corporation dated February 3, 2003 (“Perry Ellis Merger Agreement”).

increasingly important to establish that the target has properly “furnished” earnings releases that contain non-GAAP financial information.¹⁶ An expansion of the typical "SEC Reports" representation may also be the appropriate place to request accurate and complete descriptions of the disclosure controls and procedures required by Rule 13a-15 or 15d-15 under the Exchange Act. A sample representation to meet these objectives is the following.

***SEC Reports.** The Company has on a timely basis filed all forms, reports and documents required to be filed by it with the SEC since •. Part • of the Company Disclosure Schedule lists, and, except to the extent available in full without redaction on the SEC's web site through the Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") two days prior to the date of this Agreement, the Company has delivered to Parent copies in the form filed with the SEC of (i) the Company's Annual Reports on Form 10-K for each fiscal year of the Company beginning since •, (ii) its Quarterly Reports on Form 10-Q for each of the first three fiscal quarters in each of the fiscal years of the Company referred to in clause • above, (iii) all proxy statements relating to the Company's meetings of stockholders (whether annual or special) held, and all information statements relating to stockholder consents since the beginning of the first fiscal year referred to in clause (i) above, (iv) all certifications and statements required by (x) the SEC's Order dated June 27, 2002 pursuant to Section 21(a)(1) of the Exchange Act (File No. 4-460), (y) Rule 13a-14 or 15d-14 under the Exchange Act or (z) 18 U.S.C. §1350 (Section 906 of the Sarbanes-Oxley Act of 2002) with respect to any report referred to in clause (i) or (iii) above, (y) all other forms, reports, registration statements and other documents (other than preliminary materials if the corresponding definitive materials have been provided to Parent pursuant to this Section • filed by the Company with the SEC since the beginning of the first fiscal year referred to in clause (i) above (the forms, reports, registration statements and other documents referred to in clauses (i), (ii), (iii), (iv) and (v) above are, collectively, the "Company SEC Reports" and, to the extent available in full without redaction on the SEC's web site through EDGAR two days prior to the date of this Agreement, are, collectively, the "Filed Company SEC reports"), and (vi) all comment letters received by the Company from the Staff of the SEC since • and all responses to such comment letters by or on behalf of the Company. The Company SEC*

¹⁶ Non-GAAP Financial Measures Release, *see supra* note 6.

reports (x) were or will be prepared in accordance with the requirements of the Securities Act and the Exchange Act, as the case may be, and the rules and regulations thereunder and (y) did not at the time they were filed with the SEC, or will not at the time they are filed with the SEC, contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. No Subsidiary of the Company is or has been required to file any form, report, registration statement or other document with the SEC. The Company maintains disclosure controls and procedures required by Rule 13a-15 or 15d-15 under the Exchange Act; such controls and procedures are effective to ensure that all material information concerning the Company and its subsidiaries is made known on a timely basis to the individuals responsible for the preparation of the Company's filings with the SEC and other public disclosure documents. Part ___ of the Company Disclosure Schedule lists, and the Company has delivered to Parent copies of, all written descriptions of, and all policies, manuals and other documents promulgating, such disclosure controls and procedures. To the Company's knowledge, each director and executive officer of the Company has filed with the SEC on a timely basis all statements required by Section 16(a) of the Exchange Act and the rules and regulations thereunder since •. As used in this Section •, the term "file" shall be broadly construed to include any manner in which a document or information is furnished, supplied otherwise made available to the SEC.

Certifications

Many acquisition agreements entered into after the effective date of SOX have been more explicit with respect to the certifications required by Section 906 of SOX (presumably because these certifications may not be “filed” with the SEC). For example, a recent common stock purchase agreement contains the following representation under the heading “Reports and Financial Statements:”

The Chief Executive Officer and the Chief Financial Officer of the Company have signed, and the Company has furnished to the SEC, all certifications required by Section 906 of the SOX Act of 2002; such certifications contain no qualifications or exceptions to the

*matters certified therein and have not been modified or withdrawn; and neither the Company nor any of its officers has received notice from any Governmental Entity questioning or challenging the accuracy, completeness, form or manner of filing or submission of such certifications.*¹⁷

Some representations have gone farther, eliciting specific comfort on the public target's compliance with Sections 302 and 906 of SOX, including an affirmation by the target of the contents thereof:

*The Parent heretofore has provided to the Company complete and correct copies of all certifications filed with the SEC pursuant to Sections 302 and 906 of SOXA and hereby reaffirms, represents and warrants to the Company the matters and statements made in such certificates.*¹⁸

Loans to Executives and Directors

It may be prudent to expand the standard acquisition agreement's representations and warranties to provide assurances of a public target's compliance with SOX's provisions prohibiting loans or extensions or arrangements of credit to executive officers and directors. Such a provision might read as follows:

The Acquiror has not, since July 30, 2002, extended or maintained credit, arranged for the extension of credit, or renewed an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the Target. Part • of the Target Disclosure Schedule identifies any loan or extension of credit maintained by the Acquiror to which the second sentence of Section 13(k)(1) of the Exchange Act applies.

If the target is a private company, not subject to SOX, the acquiring company should include a representation that causes the target to list loans to executives and directors.

¹⁷ Common Stock Purchase Agreement between SEEC, Inc. and KPCB Holdings, Inc. dated January 8, 2003.

¹⁸ Agreement and Plan of Merger among Environgen, Inc., Shaw Environmental Company and others dated January 30, 2003.

Such a list will enable the acquiror to assess, at least as to those individuals that will continue as executives or directors of the acquiring company, what loans are outstanding. Under SOX, the acquiring company will not be allowed to permit these loans to remain in effect following the acquisition,¹⁹ a prohibition that should be taken into account when the compensation packages for those individuals joining the acquiror are being negotiated.

Legal Proceedings and Compliance with Laws

The standard representation regarding the absence of unscheduled legal proceedings should be expanded to require disclosure of actions against any director or officer of the target pursuant to Section 8A or 20(b) of the Securities Act or Section 21(d) or 21C of the Exchange Act.

Some recently executed acquisition agreements have contained very specific representations relating to the compliance with SOX (in addition to the more standard representation regarding compliance with laws generally). The following is an example of such an expanded representation (which interestingly, requires compliance with the proposed NYSE standards):

Parent is, or will timely be in all material respects, in compliance with all current and proposed listing and corporate governance requirements of the New York Stock Exchange, and is in compliance in all material respects, and will continue to remain in compliance following the Effective Time, with all rules, regulations, and requirements of the Sarbanes-Oxley Act of 2002 and the Securities and Exchange Commission.²⁰

An even more specific representation eliciting SOX-compliance assurances is found in the following language:

¹⁹ The SOX Section 402(a) “grandfather” provision is limited to loans in effect when SOX became law.

²⁰ Agreement and Plan of Merger and Reorganization among Quiksilver, Inc. and others dated September 17, 2002.

Each of the Company, its directors and its senior financial officers has consulted with the Company's independent auditors and with the Company's outside counsel with respect to, and (to the extent applicable to the Company) is familiar in all material respects with all of the requirements of, SOXA. The Company is in compliance with the provisions of SOXA applicable to it as of the date hereof and has implemented such programs and has taken reasonable steps, upon the advice of the Company's independent auditors and outside counsel, respectively, to ensure the Company's future compliance (not later than the relevant statutory and regulatory deadlines therefore) with all provisions of SOXA which shall become applicable to the Company after the date hereof.²¹

Covenant Regarding Board Representation

To the extent that the target negotiates the right to add representation on the acquiror's Board of Directors, and mandates that the acquiror document this arrangement as a covenant, the acquiror may wish to require that the nominees be independent under both SOX and the applicable stock exchange or NASDAQ rules. In response, the target may wish to negotiate for the right to include a non-"independent" director on the Board.

Covenant Regarding Indemnification

Most acquisition agreements contain a covenant requiring that the acquiror indemnify the target's officers and directors after the consummation of the acquisition under certain circumstances. SOX's prohibitions on loans to officers and directors may affect the ability of the acquiror to comply with the standard indemnification covenant. Although the issue is currently unsettled, some commentators believe that the SOX prohibition on loans may negatively affect the ability of a corporation to advance expenses in the indemnification context. Thus, the following language in the indemnification covenant may be appropriate:

²¹ Perry Ellis Merger Agreement, *supra* note 15.

[The acquiror shall indemnify the officers and directors of the target] to the fullest extent permitted under the Delaware General Corporation Law and [Acquiror's] articles of incorporation and bylaws, including provisions relating to the advancement of expenses in advance of the final disposition of any such Action to the fullest extent permitted under the Delaware General Corporation Law and the Sarbanes-Oxley Act, upon receipt of any undertaking required by the Delaware General Corporation Law.²²

Covenant Regarding Scope of Due Diligence

The expanded breadth of due diligence warranted under SOX may cause the acquiror to negotiate specific due diligence rights, exemplified by those contained in the following sample covenant:

Between the date of this Agreement and the Closing Date, Sellers shall permit Buyer's senior officers to meet with the Assistant Controller of Sprint and officers of the Companies responsible for the Financial Statements, the internal controls of the Companies and the disclosure controls and procedures of the Companies to discuss such matters as Buyer may deem reasonably necessary or appropriate for Buyer to satisfy its obligations under Sections 302 and 906 the Sarbanes-Oxley Act of 2002 and any rules and regulations relating thereto.²³

Closing Conditions

Finally, in documenting post-SOX transactions, the closing conditions should be thoughtfully considered. The closing condition based on accuracy of representations and warranties is typically qualified so that it does not fail unless the inaccuracy is either material or has a material adverse effect. The acquiring company may wish to exclude some of the SOX-inspired representations and warranties from that qualification so that strict accuracy is required. It may also be appropriate to include

²² Agreement and Plan of Merger of IRT Property Company with and into Equity One, Inc. dated October 28, 2002.

²³ Stock Purchase Agreement among Sprint Corporation, Centel Directories LLC and R. R. Donnelley Corporation dated September 21, 2002.

specific conditions relating to (i) the filing of unqualified Sections 302 and 906 certificates during the interim period prior to closing and (ii) the lack of disputes with accountants.

STRUCTURAL CHANGES BROUGHT ABOUT BY SOX

As outlined above, SOX is expected to impact the manner in which acquisitions involving public companies are investigated and documented. Another consequence of SOX, unintended perhaps, is that it has prompted some public companies to go private.²⁴ The sheer legal and accounting complexity of SOX measured both in added expenses and management time (as well as exposure, especially under the Sections 302 and 906 certifications) may be motivating factors in the relatively large number of going private transactions that have been finalized or are under consideration. These SOX-related factors, combined with diminishing public market valuations, especially for small companies, the dissipation of public equity market for raising capital, the increased expense of directors' and officers' insurance, and the corporate governance demands of the stock exchanges and SOX, with their increased emphasis on independent directors and financial experts, have combined to diminish the attractiveness of public company status.

A cash tender offer to effect a management-led going private transaction filed in 2003 contains the following rationale for the transaction:

In late September and early October of 2002, Offerors concluded that these disadvantages were significantly outweighing the advantages of leaving Landair as a publicly-traded company controlled by Mr. Niswonger. A factor contributing to this conclusion by Offerors was the enactment of the Sarbanes-Oxley Act of 2002 and the adoption of related rule proposals by the NASD. As a result of these developments and the current environment relating to the regulation of public companies,

²⁴ See Frank Aquila and Jonathan Gluck, *Sarbanes-Oxley and the "Law of Unintended Consequences": Public Companies Opt to Go Private*, THE M&A LAWYER, October 2002, at 16.

Messrs. Niswonger and Tweed anticipated significant increased costs in operating as a public company. They also believed that such increased regulation would place additional burdens on management that would further distract them from managing the business operations of Landair.²⁵

While beyond the scope of this memorandum, interesting developments under Delaware fiduciary law have suggested an available process that avoids the exacting "entire fairness" standard of review of the board's consideration of the going private transaction.²⁶ This legal development may also serve to popularize going private transactions.

As an expansion of the same analysis, the expense and exposure of the going public process and the complexity of maintenance in the public environment may affect private equity decision matrices. SOX makes the classic LBO exit strategy of a public offering more problematic. Loss of what has historically been one keystone of the LBO economic model may depress the private equity market.²⁷

CONCLUSION

It should be clear from this article that SOX should not be considered as merely a housekeeping detail to be dealt with after closing. The development of new M&A practices in response to SOX will be an evolving process. Practices among the M&A bar will become more refined as we have the opportunity to digest the SEC and the stock exchange pronouncements that become the aftermath of SOX. Vigilance and creativity are urged during this transition period.

²⁵ Offer to Purchase for Cash all Outstanding Shares of Common Stock of Landair Corporation dated December 23, 2002.

²⁶ *In re Pure Resources, Inc. Shareholders Litigation* (Del.Ch. October 1, 2002).

²⁷ See Charles M. Nathan, *The SOX Affect*, CAPITAL EYES, January 2003 (available at <http://www.fleetcapital.com/resources/capeyes/a01-03-139.html>).