



FOLEY & LARDNER LLP

SOX Impact on M&A/ Financing Transactions

FOLEY & LARDNER'S 2005 NATIONAL DIRECTORS INSTITUTE

Corporate Governance Reform:

What's Next?

SOX IMPACT ON M&A/FINANCING TRANSACTIONS

Overview

At the fourth annual Foley & Lardner LLP National Directors Institute (NDI) held March 10, 2005 in Chicago, a panel entitled “SOX Impact on M&A/Financing Transactions” featured discussion by prominent corporate leaders and merger and acquisition (M&A) professionals on the effect the Sarbanes-Oxley Act of 2002 (SOX) is having on M&A transactions.

SOX is having an important impact on the way corporate transactions are conducted, despite the fact that mergers, acquisitions, and financings are not mentioned specifically anywhere in the legislation.

The most significant impact arises out of the various certifications mandated for public companies and public company CEOs and CFOs — specifically those required under SOX §§ 302, 404, and 906. SOX § 404 is generally considered the most burdensome and the one having the greatest impact on M&A transactions. The SOX § 404 certification requires the public company’s annual report on Form 10-K to include a statement:

- Stating the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting
- Containing an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting for the past fiscal year

In addition, with respect to each internal control assessment, the company’s public accounting firm must attest to, and report on, management’s assessment of internal control of financial reporting (ICFR).

It is widely recognized by industry participants that a SOX § 404 certification can only be responsibly made after a time-consuming and costly endeavor to design, implement, and test control systems of the company and its subsidiaries.

Accelerated filers — generally, U.S. companies that have a public equity market capitalization of \$75 million or greater and have previously filed an annual report with the U.S. Securities and Exchange Commission (SEC) — were required to make a SOX § 404 certification in annual reports on Form 10-K for fiscal years ending on or after November 15, 2004. Non-accelerated filers and foreign filers need to certify their ICFR procedures in their annual reports for fiscal years ending July 15, 2006 and thereafter. The filing deadline for these filers has been extended twice in

recognition of the particularly difficult challenges small companies and foreign filers face in trying to reach SOX § 404 compliance.

SOX §§ 302 and 906 also are significant undertakings. SOX § 302 requires both the CEO and the CFO to certify in the company's quarterly reports on Form 10-Q and in its annual report on Form 10-K that they are responsible for disclosure controls and procedures and have evaluated and reported on such controls and procedures. SOX § 906 requires the CEO and CFO to state in the quarterly and annual reports that the financial statements comply with applicable securities laws and fairly present the financial condition and results of operations of the company. Executives who are found to have intentionally made false SOX § 906 certifications are subject to criminal fines up to \$5 million and up to 20 years in prison. This personal liability significantly raises the stakes to executives and will no doubt result in added care, attention, and expense in the way M&A transactions are conducted.

SOX Impact on M&A Transactions

Enhanced Due Diligence Procedures

General Considerations

Companies must re-think their due diligence process to include SOX due diligence. The goal is to confirm that a potential acquisition target's ICFR procedures are adequate and are compatible — or at least can readily become compatible — with your company's ICFR procedures. There are various reasons why a potential target may not be SOX § 404 compliant. For example, the target may be a non-accelerated filer. In that case, the acquiring company must ensure that it can impose adequate ICFR procedures in the permitted timeframe. It is necessary to understand how an acquisition will affect the ability to certify to the combined company's ICFR. The failure to effectively understand, consider, and investigate SOX issues in the transaction process could lead to embarrassing and costly surprises; reduced credibility and an adverse impact on stock prices and/or deal valuation; and possible personal liability for executive officers.

The work required to make the annual SOX § 404 certification requires a very significant investment in time, money, and personnel. Given the magnitude of the task, SOX compliance must be a due diligence consideration from the outset of the transaction.

Transaction Considerations

The characteristics of the acquiring and target entities play a significant role in the due diligence considerations. Assume the acquiring entity is an accelerated filer, and thus already required to

make SOX § 404 certifications. Whether the potential target is another accelerated filer, a non-accelerated filer, or a private company affects the target's likely state of SOX preparedness. Another accelerated filer should already be compliant. A non-accelerated filer may have made some strides towards SOX compliance, but probably has not completed the process. A private company may not have even considered SOX yet. Each scenario presents unique challenges. In addition to the integration issues present in each M&A transaction, the acquiring entity needs to understand the scope of post-closing SOX § 404 compliance efforts regarding the budget, and then work aggressively to ensure implementation of those compliance efforts after the close. No matter what state of preparedness the target has attained, SOX § 404 due diligence must begin early and be an integral part of the due diligence process.

There are several other factors to consider in assessing the ability of a target's business to achieve SOX § 404 compliance within the required timeframe. Some of the most important factors include complexity of the business; management structure and philosophy; and both the acquirer's and target's experience and knowledge of internal control concepts.

The timing and costs of achieving SOX § 404 compliance must be factored into the transaction model and overall investment decision. Companies that view themselves as potential targets should bear this in mind and consider whether some voluntary SOX preparation may improve their attractiveness. Some firms that are not required to comply with SOX may nevertheless seek to adopt a policy of "SOX-lite," which can mean a range of compliance postures short of full SOX § 404 compliance.

Audit Committee

The buyer's audit committee should be involved in transaction due diligence as early as the pre-letter of intent stage. An active role for the audit committee is crucial because properly reported financial statements are more important than ever before. The audit committee should work with the buyer's M&A team to ensure appropriate due diligence and post-closing integration and compliance efforts are put in place, with a special focus on the target's financial statements and internal controls.

Drafting Considerations

A thorough due diligence effort is the best way to ensure SOX problems do not arise post-closing. There are, however, some drafting considerations that may offer additional protection. Generally, these will be in the form of additional representations and warranties that specifically reference SOX-related issues.

Areas that may deserve a specific representation or warranty include:

- Financial statements
- Quality of target's internal controls
- Timeliness and completeness of SEC filings with regard to SOX certifications, including SOX § 302 and SOX § 906 certifications
- Loans to executive officers and directors (SOX § 402)

Timing Logistics

SOX § 404 One-Year Grace Period

The SEC has acknowledged that a company may not have sufficient time to properly assess a target's ICFR procedures between the closing of a material acquisition and the date for the filing of the registrant's first annual report. Thus, when there is a material business combination, management may exclude the acquired business from the SOX § 404 controls assessment for a period of up to one year from the date of acquisition, and from one annual report. In order to take advantage of this exception, the registrant must disclose the business unit that is omitted and discuss the significance of that unit to the overall company.

Using the SOX § 404 one-year exception creates certain operational logistics issues. In order to take advantage, the acquired entity must be "carved-out" to allow for omission of the acquired business from required assessments. Depending on the nature and speed of post-closing integration efforts, this may or may not be possible.

SOX § 302 Certifications Are Required in the First Quarterly Report

Note that SOX §§ 302 and 906 certifications are due in the first quarterly report after the transaction closes; there is no grace period. This may cause some strategic timing of deal closings. Ideally, a transaction will close soon after a quarter-end to maximize the amount of time the acquired business will be in the registrant's control before SOX §§ 302 and 906 certifications are due.

Post-Closing

Once the deal closes, all of the ICFR issues become responsibilities solely for the buyer. Properly timing the transaction or tight drafting are important, but alone, they are not sufficient. Nothing will substitute for complete, thorough, and thoughtful due diligence.

For More Information

For more information on the session “SOX Impact on M&A/Financing Transactions,” feel free to contact the speakers directly.

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