

Deal Making A Practice Focus

Let the Buyer Beware

Investigating Sarbanes-Oxley compliance is key to due diligence.



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Since the passage of the Sarbanes-Oxley Act, acquisition diligence has become very important for public company acquirers. Because a public company's post-acquisition business must comply with Sarbanes-Oxley—and must comply immediately upon closing—the act's requirements should be taken into account in assessing both public and private targets. As a result, acquisition diligence now frequently emphasizes a number of Sarbanes-Oxley topics in addition to routine areas of diligence inquiry.

In particular, buyers are increasingly focused on the impact of acquisitions on Sarbanes-Oxley certifications and on requirements relating to financial reporting and disclosure controls and procedures.

More intensive diligence is required to ensure that integrating the new business will not create lapses in Sarbanes-Oxley compliance and that appropriate procedures and internal controls relating to the acquired business will be in place at closing or shortly thereafter.

Due diligence on these topics that reveals concerns could have significant implications for an acquisition. As a threshold matter, Sarbanes-Oxley issues could reduce the valuation of a target business. Additional protections in the agreement—such as broader termination rights, price adjustments, tailored representations and warranties, or specific indemnification rights—may be called for. Closing may be delayed so that corrective actions can be taken.

Post-closing integration of the two businesses may require special efforts. The more thorough and meaningful the diligence endeavor and related analysis, the better the odds for a successful transaction.

CONTROLS AND PROCEDURES

Chief executive and financial officers of public companies must make quarterly disclosure about the effectiveness of their companies' disclosure controls and procedures, and they must include related certifications under Section 302 of Sarbanes-Oxley. In addition, Sarbanes-Oxley imposes requirements under Section 404 relating to internal control over financial reporting.

The starting point for examining a public target's controls and procedures is a review of its Securities and Exchange Commission filings about such disclosure controls and procedures and internal control over financial reporting. These are required by Regulation S-K and appear in Part I, Item 4, of quarterly reports on Form 10-Q and in Item 9A in annual reports on Form 10-K.

Management's view of disclosure controls and procedures will be reflected in the filings, and any material changes to internal control over financial reporting will likely be discussed. In addition, the annual report filing may include management's report on internal control and the related auditor attestation required under Section 404 of Sarbanes-Oxley.

The diligence examination should include review of a public target's disclosure committee charter and related procedures, along with disclosure committee minutes. Discussions with the disclosure committee members will provide insight regarding compliance with applicable procedures and might elicit information about disclosure concerns. Because the outside auditor often participates in disclosure committee meetings, the auditor also might be interviewed.

Looking at the correspondence between management, the independent auditor, and/or the audit committee can assist greatly in understanding the company's internal control over financial reporting and any related deficiencies. Recent earnings releases also may include updates on the target's internal control regime.

If the diligence review reveals that the target or its auditor have identified material weaknesses or significant deficiencies, the underlying issues should be analyzed. Not all material weaknesses merit the same level of concern. Outside auditors for the target and the acquirer can help gauge their significance.

If material weaknesses or significant deficiencies are identified in the diligence process, appropriate acquirer personnel must promptly determine implications for negotiations and integration planning. They also should consider the potential impact on management's next Sarbanes-Oxley 302 certifications.

An acquirer also must consider the implications of the tar-

get's deficiencies or material weaknesses on the acquirer's Sarbanes-Oxley compliance and public reports. For example, a material weakness that requires substantial post-deal integration efforts might trigger disclosure of a material change to the acquirer's internal controls in the next periodic report. Acquirers should note that in material business combinations, the SEC will allow the acquired company's internal control system to be excluded from the evaluation undertaken by management in connection with its first Section 404 report filed after the acquisition.

Private company targets present separate internal control diligence considerations. As a result of Sarbanes-Oxley (and the Public Company Accounting Oversight Board's related Auditing Standard No. 2), many private companies that are service providers already have had internal control audits performed (so-called SAS 70 Type II audits) because their public company clients will have required these audits to complete their own internal control evaluations and audits.

For these companies, diligence should consist of reviewing the SAS 70 Type II audits and requesting access to the outside auditor. For other private targets that have not conducted internal control audits, a common starting point is a discussion of the target's internal control system and processes with the outside auditor and the target's CEO and CFO.

COMPLAINTS, WAIVERS, AND MORE

A number of other Sarbanes-Oxley diligence topics warrant review. In particular:

- *Complaint procedures.* For public company targets, one important diligence exercise is reviewing complaints received by the audit committee. Section 301 of Sarbanes-Oxley mandates that public company audit committees establish procedures for the submission of complaints relating to accounting and auditing matters. Complaints submitted under these procedures could readily identify potential risks.

In addition to requesting such complaints, materials related to any audit committee investigation initiated in response to a complaint should be requested. Private companies may have similar procedures.

- *Personal loans to company insiders.* Although related-party transactions always have been an important diligence inquiry, Section 402 of Sarbanes-Oxley specifically prohibits personal loans to corporate insiders. If target personnel will become directors or executive officers of the acquirer, the acquirer needs to know whether personal loans were extended, maintained, or arranged by the target and if so, when. If personal loans for these persons originated after July 30, 2002, (the enactment date of Sarbanes-Oxley) and remain outstanding, then the loan likely will need to be paid off before closing the transaction.

Sources of information regarding personal loans include board minutes, audit and compensation committee minutes, management interviews, and related-party documentation.

- *Corporate governance.* For public companies, board-of-director additions in connection with acquisitions will require an evaluation of the independence qualifications of prospective nominees from the target. As with personal loans, this aspect of diligence in the post-Sarbanes-Oxley environment underscores the importance of knowing the acquirer's post-acquisition plans for the target's senior officers.

- *Code of ethics.* Another diligence tip is to review whether the target has granted any waivers to its code of ethics. Careful review of

board and committee minutes as well as management interviews should help identify such waivers.

Repeated waivers for directors or officers should trigger further inquiry. Evidence that the code of ethics is not being enforced—such as an inability to locate the code or lack of awareness regarding oversight responsibilities for the code—also could be cause for concern.

- *Off-balance-sheet arrangements.* Think Enron. Section 401 of Sarbanes-Oxley requires public companies to disclose in their periodic reports all material off-balance-sheet transactions, arrangements, obligations, and relationships.

If the target is a public company, review these disclosures and then drill down: Understand the nature of the relationships and request access to relevant documentation. Inquire of management whether there are other significant, but perhaps not material, off-balance-sheet arrangements.

If the target is a private company, inquire about off-balance-sheet arrangements and related documentation as part of the diligence request list and follow up on this topic during the management interviews.

- *Auditor independence.* As a result of Sarbanes-Oxley, the SEC amended its auditor independence rules. Acquirers should attempt to identify any auditor independence irregularities under these rules at a public target. If the target company's financial statements (either those that have been previously filed or those that may be later incorporated by reference) were audited by an auditor that was not independent during the engagement period, difficult liability issues, as well as re-auditing issues, may need to be considered.

In addition to management and outside auditor discussions, diligence review should include audit committee minutes; copies of ISB 1 letters (in which the auditor affirms its independence to the audit committee); and copies of the audit committee's preapproval policies and procedures, if any.

GENERAL DILIGENCE

Besides diligence related to specific Sarbanes-Oxley provisions, the SEC's implementation of the Sarbanes-Oxley requirements has placed a premium on accounting-related diligence as a general matter.

As a result, while any diligence endeavor necessarily will be tailored to the target, traditional diligence techniques remain valuable in the post-Sarbanes-Oxley environment.

For example, in addition to the points noted above regarding SEC filings, the target's filings, exhibits to the filings, and certifications should be reviewed. Particularly in view of the Section 302 and Section 906 certification requirements, diligence efforts should focus on materials and documents supporting public disclosures, including documentation of compliance checks, director and officer questionnaires, comfort letters, and diligence files relating to registration statements.

Several provisions of Sarbanes-Oxley are designed to place accountability for compliance lapses squarely at the feet of management. Given these legal developments and related liability concerns, acquisition diligence efforts should be taken to the next level by focusing on the degree of Sarbanes-Oxley compliance in addition to routine diligence inquiries.

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