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"Clear and Simple": SEC Proposes Say-on-Golden Parachute and Enhanced Disclosure Rules

By Kyoko Takahashi Lin and Gillian Emmett Moldowan of Davis Polk & Wardwell LLP[1]

On October 18th, the SEC proposed rules to implement Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (codified as new Section 14A of the Securities Exchange Act of 1934).[2] There rules require U.S. public companies to conduct separate shareholder advisory votes on:

- executive pay (commonly known as "say-on-pay");
- the frequency of the say-on-pay vote; and
- executive payments in connection with M&A transactions that are presented for shareholder approval (commonly known as "say-on-golden parachutes").[3]

The proposed rules relating to say-on-golden parachutes have two components: voting and disclosure. Neither requirement is triggered until the SEC's final rules become effective, unlike the say-on-pay and frequency on say-on-pay votes, which must be included in any proxy statement for an annual meeting taking place on or after January 21, 2011, regardless of the filing date of the proxy statement and regardless of whether the SEC's final rules have become effective by that date. Once final rules are effective, new Section 14A(b)(1) of the Exchange Act will require the say-on-golden parachute vote to be included in any proxy statement or consent solicitation for meetings taking place on or after January 21, 2011 where a company is soliciting shareholders to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all assets of the company. In addition, once final rules are effective, disclosure of golden parachute arrangements in both tabular and narrative form will be required

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[2] Public Law 111-203 (July 21, 2010) (amending the Securities Exchange Act of 1934 (the "Exchange Act") by adding new Section 14A). The proposed rules do not apply to companies that are not subject to the SEC's proxy rules, and thus generally do not apply to foreign private issuers. Smaller reporting companies are not exempt under the proposed rules; however, among other rule modifications provided in the proposed rules, they do not need to prepare a CD&A in order to comply. The SEC has requested public comment on the proposed say-on-golden parachute rules. Comments are due to the SEC by November 18, 2010.

[3] Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Proposed Rule, 75 Fed. Reg. 66590–66619 (October 28, 2010) (to be codified at 17 C.F.R. pts. 229, 240, and 249). In a companion release issued the same day, the SEC also proposed rules implementing the Dodd-Frank Act provision requiring institutional investment managers to disclose how they voted on these three shareholder advisory votes. Reporting of Proxy Votes on Executive Compensation and Other Matters, Proposed Rule, 75 Fed. Reg. 66622–66642 (October 28, 2010) (to be codified at 17 C.F.R. pts. 240, 249, and 270 *et al.*).

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in SEC filings made in connection with any M&A transaction, not only those where shareholder approval is required, including tender offers and going-private transactions.

In the proposed rules, the SEC declined to mandate any specific language or form of resolution for the say-on-golden parachute votes. However, a company must disclose in its proxy statement the general effect of the shareholder vote, including its non-binding nature.

What Is a Golden Parachute?

Under Section 14A of the Exchange Act, "golden parachutes" are defined as any agreements or understandings concerning any type of compensation, whether present, deferred, or contingent, that a soliciting person has with any named executive officers[4] of the company whose shareholders are being solicited and that are based on or otherwise relate to the proposed M&A transaction.[5] Golden parachutes also include agreements or understandings that the soliciting person has with any named executive officers of the acquirer, if the shareholders being solicited are not the shareholders of the acquirer. Classic examples of golden parachute arrangements include retention bonuses, severance and accelerated vesting of equity on a change in control.

For the purposes of the new *disclosure* requirements, the SEC has expanded the definition of golden parachutes to include all agreements and understandings, whether written or unwritten, between the target or the acquirer and the named executive officers of the target or the acquirer.[6] In the proposed rule release, the SEC explained that this expansion is being proposed in order that disclosure cover the full scope of golden parachute compensation applicable to a transaction.[7] However, for purposes of the new say-on-golden parachute *vote* requirement, the SEC remained closer to the statutory language.[8] For example, if, as is often the case, the target company is the soliciting person, then agreements or understandings between the acquirer and the named executive officers of the target, while required to be disclosed, are not subject to the say-on-golden parachute vote.

Golden parachutes do not include compensation unrelated to an M&A transaction. In the proposed rule release, the SEC sets forth examples of such unrelated compensation including previously vested equity awards and compensation from *bona fide* post-transaction employment agreements.[9] The SEC states that because previously vested equity awards are vested without regard to the transaction at hand, it does not view them as compensation based on or otherwise relating to such transaction. The SEC goes on to say in the proposed rule release that *bona fide* post-transaction employment agreements are not included because it does not view future employment arrangements as compensation that is based on or otherwise related to the proposed transaction.

By introducing the phrase "*bona fide* post-transaction employment agreements," the SEC seems to indicate that certain future employment agreements would not be respected as unrelated to a proposed M&A transaction. Without clarification that post-employment arrangements other those structured solely as a post-transaction payment with the intent to avoid disclosure will qualify as *bona fide* post-transaction employment agreements, circumstances may arise where it is difficult to determine whether a post-employment agreement should be considered part of the golden parachute arrangements.

The proposed rules do not require disclosure of, or a say-on-golden parachute vote on, agreements and understandings with management of foreign private issuers where the target or acquirer is a foreign private issuer.[10]

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[4] Named executive officers of a company include (i) the principal executive officer; (ii) the principal financial officer; (iii) the three most highly compensated executive officers other than the principal executive officer and the principal financial officer who were serving as executive officers at the end of the last completed fiscal year; and (iv) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. However, the proposed rules do not require disclosure with respect to individuals who are named executive officers due to prong (iv) above.

[5] Section 14A(b)(1) of the Exchange Act.

[6] 75 Fed. Reg. 66615 (proposed § 229.402(t)(1)(ii) (Item 402(t)(1)(ii) of Regulation S-K)).

[7] See 75 Fed. Reg. 66599.

[8] 75 Fed. Reg. 66618 (proposed § 240.14a-21(c)).

[9] 75 Fed. Reg. 66601.

[10] 75 Fed. Reg. 66617 (proposed Instruction 2 to § 229.402(t) (Item 402(t))).

When Is Golden Parachute Disclosure v. Say-on-Golden Parachute Vote Required

Under Section 14A of the Exchange Act, the say-on-golden parachute *vote* is required to be included in any proxy statement or consent solicitation for meetings taking place on or after January 21, 2011 where shareholders are being asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all assets of the company, subject to the effectiveness of the rules.[11]

Consistent with this provision, the proposed rules require that a say-on-golden parachute vote be included in proxy statements or consent solicitations where shareholder approval for an M&A transaction is being solicited.[12] If disclosure satisfying the enhanced requirements under Item 402(t) of Regulation S-K, as described below, is provided in an annual meeting proxy statement and that proxy statement includes a say-on-pay vote, a proxy statement used in connection with a subsequent M&A transaction need not include the say-on-golden parachute vote so long as no changes or modifications have been made to the golden parachute arrangements.[13] If changes have been made, the company is required to include a separate table showing the modifications and a separate say-on-golden parachute vote limited to just the changes, although the full golden parachute disclosure must be provided.

The proposed rules go beyond the statutory requirements and amend the SEC's forms used in connection with other M&A transactions similar to those where shareholder approval is being solicited to require golden parachutes *disclosure*.[14] The proposed amendments would require golden parachute disclosure to be included in the following forms:

- information statements filed pursuant to Regulation 14C;
- proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A;
- registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and similar transactions;
- going private transactions on Schedule 13E-3; and
- third-party tender offers on Schedule TO and Schedule 14D-9 solicitation/ recommendation statements.[15]

In addition, the proposed rules amend Item 1011(b) of Regulation M-A to require the bidder in a third-party tender offer to provide information in its Schedule TO about a target's golden parachute arrangements. However, in recognition that a bidder may not have such information (such as when the bidder is hostile), the disclosure is only required to the extent that the bidder has made a reasonable inquiry about the golden parachute arrangements and has knowledge of such arrangements.[16]

In the proposed rule release, the SEC indicated that it was expanding the filings that would require the golden parachute disclosure beyond that required by statute because it seeks to prevent issuers structuring M&A transactions in order to avoid such disclosure.[17] Further, it believes that shareholders may find the golden parachute disclosure informative to their decisions regarding the transaction itself.[18]

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[11] Section 14A(b)(1) of the Exchange Act.

[12] 75 Fed. Reg. 66618 (proposed § 240.14a-21(c)).

[13] 75 Fed. Reg. 66618 (proposed Instruction 2 to § 240.14a-21).

[14] *See* 75 Fed. Reg. 66599.

[15] 75 Fed. Reg. 66602.

[16] 75 Fed. Reg. 66602–3; 66617 (proposed Instructions 1 and 2 to § 229.1011(b) (Item 1011(b))). This proposed amendment to Item 1011(b) includes an exception for both bidders and targets in third-party tender offers and filing persons in Rule 13e-3 going-private transactions where the target or subject company is a foreign private issuer.

[17] 75 Fed. Reg. 66602.

[18] 75 Fed. Reg. 66603.

A New Item 402 Table

Section 14A of the Exchange Act requires that golden parachutes be disclosed in a "clear and simple form in accordance with regulations to be promulgated by the Commission" and include the aggregate total of all golden parachute payments and the conditions upon which it may be paid or become payable.[19] The proposed rules implement Section 14A through the introduction of a new Item 402 table:[20]

GOLDEN PARACHUTE COMPENSATION

Name (a)	Cash ($) (b)	Equity ($) (c)	Pension/ NQDC ($) (d)	Perquisites/ benefits ($) (e)	Tax reimbursement ($) (f)	Other ($) (g)	Total ($) (h)
PEO							
PFO							
A							
B							
C							

The Golden Parachute Compensation table is intended to be all-inclusive and requires specific disclosure of, and a total aggregate dollar amount for:

- any cash severance payments (including base salary, bonus, and pro-rated non-equity incentive compensation plan payments);
- the value of stock awards for which vesting is accelerated, in-the-money option awards for which vesting would be accelerated, and payments in cancellation of stock and option awards;
- pension and non-qualified deferred compensation benefit enhancements;
- perquisites and other personal benefits and health and welfare benefits;
- tax reimbursements (*i.e.*, tax gross-ups); and
- "other" elements of golden parachute arrangements not properly disclosed in another column of the table.

Where disclosure is included in a form related to an M&A transaction, such amounts would be calculated based on the closing market price per share of the issuer's securities as of the latest practicable date. Where disclosure is included in an annual meeting proxy statement, such amounts would be calculated based on the closing market price per share of the issuer's securities on the last business day of the issuer's last completed fiscal year.[21]

The Golden Parachute Compensation table does not require separate disclosure or quantification with respect to compensation disclosed in the Pension Benefits table (Item 402(h)) and the Nonqualified Deferred Compensation table (Item 402(i)).[22] It also does not require disclosure with respect to individuals who are named executive officers because they would have been among the most highly compensated executive officers but for the fact that they were not serving as an executive officer at the end of the last completed fiscal year.[23] However, there is no exclusion for principal executive officers and principal financial officers who are no longer serving in those capacities at the end of the last completed fiscal year.

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[19] Section 14A(b)(1) of the Exchange Act.

[20] 75 Fed. Reg. 66616 (proposed § 229.402(t)(1) (Item 402(t)(1))).

[21] 75 Fed. Reg. 66616 (proposed Instructions 1 and 2 to § 229.402(t)(2) (Item 402(t)(2))).

[22] 75 Fed. Reg. 66601.

[23] 75 Fed. Reg. 66617 (proposed Instruction 1 to § 229.402(t) (Item 402(t))).

For each column of the Golden Parachute Compensation table, a footnote is required that would identify each separate payment or benefit reported and quantify the amounts attributable to "double-trigger" and "single-trigger" arrangements.[24]

In addition to the Golden Parachute Compensation table and its footnotes, Item 402(t) requires companies to provide a narrative description of any material factors necessary to an understanding of each arrangement and associated payments or benefits quantified in the tabular disclosure.[25] Examples of material factors provided in the proposed rule include: (i) the specific circumstances that would trigger golden parachute compensation; (ii) the form (*e.g.*, lump sum), timing (*e.g.*, annual) and obligor of the such compensation; and (iii) any material conditions or obligations applicable to the receipt of such compensation, including restrictive covenants and their terms.

Disclosure More Expansive Than Existing Requirements

Golden parachute disclosure under Item 402(t) is more regimented and more extensive than current disclosure requirements regarding golden parachutes. Under existing SEC requirements, certain payments and benefits provided to executive officers in connection with M&A transactions are required to be disclosed under Item 402(j) of Regulation S-K and the "Interest of Certain Persons" disclosure required by Item 5 of Schedule 14A.[26] In the proposed rule release, the SEC acknowledges that existing disclosure rules already mandate that companies provide much of the information required under Item 402(t); however, the SEC indicates that the existing rules do not meet the requirements of Section 14A(b)(1) of the Exchange Act because they do not include detailed requirements for disclosures that are applicable to proxy or consent solicitations to approve a transaction.[27] Further, the SEC notes that the specificity and narrative and tabular format required by Item 402(t) allows for a clearer presentation of the full scope of golden parachute information.[28]

Not only does Item 402(t) arguably require companies to present information on golden parachute arrangements in a clearer format, it also requires that more information on golden parachutes be presented. Unlike Item 402(t), Item 402(j) provides a *de minimis* exception for perquisites and does not require disclosure of arrangements that do not discriminate in scope, terms or operation in favor of executive officers.[29] Further, Item 402(j) does not require presentation of an aggregate total of all compensation that is based on or otherwise relates to a transaction. Item 402(t) also goes beyond the current disclosure requirements of Item 5 of Schedule 14A. Unlike Item 5, which currently requires companies to disclose substantial interests of executive officers in connection with a transaction, Item 402(t) requires that every payment or benefit that is a golden parachute arrangement, no matter how insubstantial to the recipient, be disclosed. However, it should be noted that Item 5 may require disclosure of golden parachute arrangements of persons who are not covered by Item 402(t) (*i.e.*, executive officers who are not named executive officers and directors).

Planning for the 2011 Proxy Season: Should Companies Include the Item 402(t) Table?

As described above, a say-on-golden parachute vote is not required to be included in proxy statements or consent solicitations where shareholder approval for an M&A transaction is being solicited if the applicable golden parachute arrangements were disclosed in an annual meeting proxy statement in compliance with

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[24] 75 Fed. Reg. 66616 (proposed Instructions 4 and 5 to § 229.402(t)(2) (Item 402(t)(2))). A "double-trigger" arrangement is one where compensation is triggered by a change in control but is conditioned upon the executive officer's termination without cause or resignation for good reason within a limited time period following the change in control. A "single-trigger" arrangement is one where compensation is triggered by a change in control for which payment is not conditioned upon such a termination or resignation of the executive officer.

[25] 75 Fed. Reg. 66617 (proposed § 229.402(t)(3) (Item 402(t)(3))).

[26] Under Item 402(j) of Regulation S-K, companies are required to include in annual reports or annual meeting proxy statements detailed information about payments that may be made to named executive officers upon termination of employment or in connection with a change in control. Under Item 5, a company soliciting shareholder approval of an M&A transaction is required to describe any substantial interest, direct or indirect, by security holdings or otherwise, of any person who has been an executive officer since the beginning of the last fiscal year.

[27] 75 Fed. Reg. 66599.

[28] 75 Fed. Reg. 66600.

[29] 75 Fed. Reg. 66615 (proposed § 229.402(a)(6)(ii) (Item 402(a)(6)(ii))) ("Except with respect to the disclosure required by [402(t)], registrants may omit information regarding group life, health, hospitalization, or medical reimbursement plans that do not discriminate in scope, terms or operation, in favor of executive officers or directors of the registrant and that are available generally to all salaried employees.").

Item 402(t) and that proxy statement included a say-on-pay vote.[30] This raises the question as to whether companies should include Item 402(t) disclosure in their annual meeting proxy statements. In the proposed rule release, the SEC stated that it expects some issuers may voluntarily include Item 402(t) disclosure in annual meeting proxy statements with say-on-pay votes so that the say-on-golden parachute vote exception would be available to the issuer for a potential subsequent M&A transaction.[31] After evaluating the consequences of including the Item 402(t) disclosure in an annual meeting proxy statement, such as those discussed below, we think few, if any, companies will choose to make this voluntary disclosure.

Including the Item 402(t) disclosure may have a negative effect on a company's say-on-pay vote. The past year has shown that shareholders generally have approved say-on-pay votes when presented by management. Between October 2009 and October 2010, 144 Russell 3000 companies included a say-on-pay vote in their proxy statements and only three of these votes failed to receive shareholder approval.[32] Further, support was generally high with approximately 85% of these say-on-pay votes receiving over 80% approval. However, the stark numbers that may be disclosed in, and the "Golden Parachute Compensation" title of, a 402(t) table could bring an unwanted spotlight to a company's golden parachute arrangements. This may be the case even if these same numbers essentially have been disclosed in annual meeting proxy statements as part of the company's 402(j) disclosure. The additional table and required narrative disclosure will also elongate a company's compensation disclosure at a time when companies are focusing on tightening their compensation disclosure story in the face of say-on-pay.

A say-on-golden parachute vote is only excludable from proxy statements and consent solicitations where shareholders are being asked to approve an M&A transaction to the extent the same golden parachute arrangements previously subject to a say-on-pay vote remain in effect, and the terms of those arrangements have not been modified. If any aspect of the golden parachute arrangements changes between the time of the say-on-pay vote and the meeting to approve the M&A transaction, a company must include in the proxy statement related to the M&A transaction both an Item 402(t) table showing all golden parachute arrangements, including those covered by a previous say-on-pay vote, and a second Item 402(t) table disclosing any changes subject to a vote and soliciting a say-on-golden parachute vote on such changes.[33]

This disclosure structure may highlight so-called "sweetheart deals" entered into in the heat of a transaction. Further, creation of the two tables will increase the work required for everyone. Because golden parachute arrangements include arrangements between the target's named executive officers and the acquirer, which would have been unknown at the time of disclosure in an annual proxy statement, it may be the more common fact pattern that golden parachute arrangements have changed between the time of a say-on-pay vote and the meeting to approve an M&A transaction.

Regardless of whether a say-on-golden parachute vote is required in a proxy statement for an M&A transaction, the full golden parachute disclosure must be provided. Even if a company undertakes to include the Item 402(t) disclosure in its annual proxy statement and in fact no changes have been made to golden parachute arrangements since they were approved in connection with a say-on-pay vote, the full 402(t) disclosure will need to be included in the SEC's forms used in connection with all M&A transactions.

Because of the significant effort and possible negative consequences of including Item 402(t) disclosure in annual meeting proxy statements, it may be that companies only include this disclosure where they anticipate an M&A transaction is on the horizon. If this practice develops, inclusion of Item 402(t) disclosure by a company in an annual meeting proxy statement may signal to the market that a significant corporate transaction is imminent as to the company. Even if this practice does not develop, the presence of the Item 402(t) disclosure may confuse shareholders as to the likelihood of a future change in control at the company.

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[30] 75 Fed. Reg. 66618 (proposed Instruction 2 to § 240.14a-21).

[31] 75 Fed. Reg. 66604.

[32] ISS Corporate Services Governance Analytics database.

[33] 75 Fed. Reg. 66604; 75 Fed. Reg. 66616 (proposed Instruction 6 to § 229.402(t)(2) (Item 402(t)(2))).

Delaware Supreme Court Upholds Net Operating Loss Poison Pill

By Bill Kucera, Michael Torres and Scott Davis, Mayer Brown LLP

In *Versata Enterprises Inc. v. Selectica, Inc.*, No. 193, 2010 (Del. 10/ 4/10), the Delaware Supreme Court addressed the validity of a shareholder rights plan, or "poison pill," for the first time in a number of years. The court upheld the adoption of a poison pill with a 4.99 percent trigger designed to protect a company's net operating losses (NOLs) and the subsequent adoption of a "reloaded" poison pill to protect against future threats to those net operating losses.

Background of the Case

Selectica, a micro-cap software company that had experienced losses each year following its initial public offering, had generated approximately $160 million in unused NOLs. NOLs are tax losses that are essentially a contingent asset that can be used to offset future income from taxation under certain circumstances. Section 382 of the Internal Revenue Code of 1986 provides an annual limitation on the ability of a company to use NOLs that arose before an "ownership change" to offset income that arises after such ownership change. For purposes of Section 382, one way that an "ownership change" may occur is when the percentage of stock beneficially owned by one or more of a company's large shareholders (defined for these purposes as shareholders who own 5 percent or more of such corporation's shares) increases by more than 50 percentage points at any point over a three-year rolling testing period. An NOL poison pill is designed to discourage persons from becoming 5 percent shareholders and to discourage existing 5 percent shareholders from acquiring additional stock, in an effort to prevent the company from experiencing a Section 382 ownership change that would impair the value of its NOLs.

One of Selectica's largest shareholders was Trilogy, Inc., which, together with its affiliate Versata, had acquired 6.7 percent of Selectica's shares. Trilogy was a competitor of Selectica that had expressed interest in acquiring Selectica as early as January 2005. Trilogy had also twice sued Selectica for patent infringement, and Selectica owed Trilogy millions of dollars as a result of a judgment and a settlement related to those matters. Trilogy pursued the acquisition of Selectica off-and-on through 2008, but was continuously rebuffed. The record showed that Trilogy, although aware of the NOLs, was not particularly motivated by them, and eventually decided that the threatened impairment of Selectica's NOLs might be a useful means of coercing the company into a transaction benefiting Trilogy.

Trilogy began buying Selectica stock in early November 2008. Trilogy had acquired over 5 percent by November 10, filed a Schedule 13D on November 13, and acquired an additional 1 percent in the days thereafter. At the time of these purchases by Trilogy, Selectica had in place a traditional poison pill with a 15 percent trigger. In the wake of mounting losses, the discovery that prior ownership changes had resulted in an impairment of approximately $24.6 million in unused NOLs and Trilogy's increasing ownership stake, Selectica's board reviewed with its advisors Trilogy's actions, Section 382 calculations and Selectica's recent stock price activity and strategic alternatives. The board decided to amend its rights plan to reduce the triggering threshold from 15 percent to 4.99 percent to prevent additional 5-percent owners from emerging. The amended rights plan also allowed existing 5-percent shareholders, including Trilogy, to purchase an additional 0.5 percent without triggering the rights.

In the face of the reduced triggering threshold of Selectica's poison pill to 4.99 percent, Trilogy made an informed decision to increase its ownership stake in Selectica and trigger the pill, thereby forcing Selectica's board to decide how to respond. Trilogy informed Selectica that it had bought through the pill and proposed that Selectica repurchase Trilogy's shares, accelerate the payment of debt, terminate its license with a client and make an additional $5 million cash payment to Trilogy to settle outstanding issues between the companies. Selectica's board reacted by attempting to negotiate a standstill agreement with Trilogy to allow for further negotiations between the parties in exchange for the board declaring Trilogy an "Exempt" person under the terms of the pill, which would have prevented the dilution of Trilogy.

After Trilogy rejected Selectica's standstill proposals, and based on the advice and analyses conducted by the board's legal and financial experts, the directors of Selectica concluded that the poison pill should be applied to Trilogy because the NOLs were "an important corporate asset that could significantly enhance stockholder value" and Trilogy's actions could materially impair the value of Selectica's NOL assets. A

special committee of the board, to whom the relevant authority was delegated, implemented the poison pill's exchange feature, doubling the number of outstanding shares held by other Selectica shareholders and thereby diluting Trilogy's beneficial holdings from 6.7 percent to 3.3 percent. The special committee also adopted a "reloaded" NOL rights plan, which was a new poison pill with substantially the same terms. Selectica then sought a declaratory judgment in the Delaware Chancery Court that the actions of Selectica's directors were valid and proper.

The Chancery Court applied the familiar test formulated in *Unocal Corp. v. Mesa Petroleum Corp.,* 493 A.2d 946, 955 (Del. 1985): that adoption of defensive measures are protected by the business judgment rule so long as (i) the board had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (ii) the defensive response was reasonable in relation to the threat posed. The Chancery Court found that the directors of Selectica met their burden of proof under each prong of this test, and upheld the directors' action.

Analyzing the Delaware Supreme Court Opinion

The Supreme Court began its analysis by affirming the Chancery Court's finding that "the protection of company NOLs may be an appropriate corporate policy that merits a defensive response" when threatened. The court noted that Delaware courts have approved the use of poison pills as an anti-takeover device and have applied the Unocal test to analyze a board's response to an actual or potential hostile takeover threat. While the court noted that an NOL poison pill was not principally intended to prevent a hostile takeover, it held that "any Shareholder Rights Plan, by its nature, operates as an anti-takeover device," and "notwithstanding its primary purpose, a NOL poison pill must also be analyzed under Unocal because of its effect and its direct implications for hostile takeovers."

Turning to the first prong of the Unocal test, the court noted that the record showed that the Selectica board had repeatedly analyzed its NOLs and received a variety of expert advice on their value. Given these facts, the court found that the record supported the lower court's finding that the board acted in good faith reliance on the advice of experts in concluding that the NOLs were an asset worth protecting and that their preservation was an important corporate objective.

The court also found that the record supported the reasonableness of the board's decision to quickly reduce the trigger of Selectica's existing poison pill from 15 percent to 4.99 percent because (i) the company's accountant informed the board on November 16 that the change-of-ownership calculation under Section 382 already stood at 40 percent, (ii) the board reasonably believed Trilogy intended to continue buying more stock and (iii) nothing prevented others from acquiring stock in amounts up to the existing 15 percent trigger. Such additional acquisitions could push the 40 percent Section 382 calculation to above 50 percent, at which point the value of the NOLs would be permanently impaired.

Turning to the second prong of the Unocal test, the court stated that Unocal requires an initial evaluation of whether a board's defensive response to the threat was either preclusive or coercive and, if neither, whether the response was reasonable in relation to the threat identified. Taking the opportunity to clarify the test for preclusivity under Delaware law, the court held that a defensive measure is preclusive when it makes a bidder's ability to wage a successful proxy contest and gain control "realistically unattainable."

Trilogy claimed that Selectica's NOL poison pill, with a 4.99 percent trigger, prevented a shareholder from signaling its financial commitment so as to establish sufficient credibility to win the necessary supporters in a proxy fight. The court noted that the 5 percent trigger necessary for an NOL poison pill to serve its objective is indeed lower than the poison pill thresholds traditionally upheld as acceptable takeover defenses by Delaware courts, but concluded that the NOL pill and the reloaded NOL pill would not render a successful proxy contest realistically unattainable given the specific factual context.

Trilogy also argued that, even if a 4.99 percent shareholder could realistically win a proxy contest, the preclusiveness question should focus on whether a challenger could realistically attain sufficient board control to remove the pill. Trilogy asserted that because Selectica also had a staggered board of directors, Trilogy would have to win two consecutive proxy contests in order to control enough board seats to remove the pill, making the combination of the staggered board and the NOL pill preclusive. The court rejected this reasoning, noting that classified boards are permitted by the Delaware statute, and operate

as a defensive mechanism by delaying but not preventing a hostile acquiror from obtaining control of the board.

The court also rejected Trilogy's claim that the response of Selectica's board was not reasonable. The court found that, under the circumstances, both the original and the reloaded pill were necessary to overcome the threat that Trilogy's purchases would prevent Selectica from using its net operating losses.

The court made clear that its holding should be narrowly construed, stating that "the fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99 percent trigger in the Rights Plan of a corporation with or without NOLs." The court noted that although the Selectica board carried its burden of proof under the two part test of Unocal, the adoption of a poison pill is not absolute, and under Delaware law, "the ultimate response to an actual takeover bid must be judged by the Directors at that time."

Takeaways from Versata and Other Recent Poison Pill Cases

1. Versata, the first poison pill case decided by the Delaware Supreme Court in a number of years, indicates that, despite the decreasing use of poison pills by public companies, the pill remains a sustainable defense tactic when the courts are convinced that the pill genuinely (i) protects a legitimate corporate interest, (ii) represents a disinterested business judgment, (iii) is made after a careful process is followed and (iv) does not make a successful proxy contest realistically unattainable.
2. The Delaware courts have indicated a willingness to uphold a poison pill in new contexts and with various features (including a relatively low 4.99 percent trigger (Versata) or an exempted 30 percent shareholder (*Yucaipa American Alliance Fund II, L.P. v. Riggio, C.A.* No. 5465-VCS (Del. Ch.; 8/12/10))[1] when the requirements set forth in point 1 above are satisfied.
3. Delaware courts are likely to decide the validity of poison pills on a case-by-case basis, considering the specific features and purpose of the pill and the specific facts and circumstances of the case. Thorough deliberation by a board in adopting a poison pill, aided by assistance from competent advisors, is important to establish a record that the directors acted on a careful and informed basis.
4. The Delaware courts may not uphold a poison pill if it doesn't satisfy the tests laid out above or is being used for punitive purposes, like the pill at issue in *eBay Domestic Holdings, Inc. v. Newmark*, C.A. No. 3705-CC (Del. Ch.; 9/9/10).[2]
5. The Delaware courts have indicated that the proper test for determining the validity of a poison pill is the Unocal standard, even where the primary objective of the pill is not to prevent a hostile takeover, such as in Versata, or where a hostile takeover is a factual impossibility, as in eBay.
6. The validity of the "just say no" defense—the biggest poison pill issue of all—remains unresolved.

[1] For more information about the Yucaipa decision, see our September 21, 2010, Legal Update "Delaware Courts Decide the Validity of Two Poison Pills," available at http://www.mayerbrown.com/publications/article.asp?id=9676&nid=6.

[2] For more information about the eBay decision, see our September 21, 2010, Legal Update "Delaware Courts Decide the Validity of Two Poison Pills," available at http://www.mayerbrown.com/publications/article.asp?id=9676&nid=6.

Top-Up Options: Looking Better and Better

by George Bason, Justine Lee and Scott Luftglass, Davis Polk & Wardwell LLP

As the percentage of tender offers in friendly transactions has risen in recent years, so too has use of so-called "top-up options." Yet, despite their prevalence, the validity of top-up options has not been addressed squarely by the Delaware courts and continues to be challenged by the plaintiffs' bar. However, two separate rulings from the Delaware Court of Chancery this week suggest that the use of top-up options is likely to present little litigation risk.

A top-up option gives the acquiror the right, upon successful completion of a tender offer at or above the minimum condition level (usually 50%), to purchase newly issued shares of the target so as to increase its ownership in the target to greater than 90%. Under Delaware law, once an acquiror crosses the 90% ownership threshold, it may complete the back-end squeeze out through a simple short-form merger. The purpose of the top-up option is to expedite the closing of the merger (and thus the receipt of the consideration by the target's stockholders) once a majority (but less than 90%) of the target's stockholders have endorsed the transaction by tendering their shares.

In *In re Cogent, Inc. S'holders Litig.* (Consol. C.A. No. 5780-VCP), Vice Chancellor Parsons denied a motion to preliminarily enjoin the proposed friendly two-step acquisition of Cogent by 3M. Certain Cogent stockholders challenged, among other things, the companies' inclusion of a top-up option in the 3M/Cogent merger agreement. In denying the motion for preliminary injunction, Vice Chancellor Parsons found that the plaintiffs did not establish a likelihood of success on their challenge to the top-up option:

1. Theoretical Disenfranchisement of Minority Stockholders Too Speculative

Plaintiffs argued that because 3M, with the consent of the Cogent,could waive the minimum tender condition, 3M was theoretically able to exercise the option even if a majority of shares is not tendered. Vice Chancellor Parsons concluded that although "it technically might be possible for 3M to acquire the Company through the Top-Up Option without acquiring a majority of the shares in the tender offer, this argument depends on the occurrence of more than one highly unlikely event (*i.e.,* that 3M would waive the minimum tender) and is far too speculative to warrant injunctive relief."

2. Top-Up Option is Not a "Sham" Transaction or Illusory Promise

Vice Chancellor Parsons likewise found that plaintiffs were not likely to succeed in their contention that, because the top-up option allowed 3M to pay for the top-up shares with a promissory note payable in a year (by which time it presumably would own Cogent), it was an illusory promise to pay itself. Noting that DGCL Section 157 leaves the judgment as to the sufficiency of consideration received for stock to the conclusive judgment of the directors absent fraud, Vice Chancellor Parsons reasoned that the Board had received due consideration for entering into the merger agreement and that the promissory note, at the time issued, would be a legally enforceable obligation owed by 3M to Cogent.

3. Parties May Provide for Exclusion of Top-Up Option from Consideration in Fair Value Appraisal

Plaintiffs argued that the value of existing Cogent shares would be reduced as a result of (i) the dilutive effect of a substantial increase in shares outstanding if the top-up option were exercised and (ii) the "questionable value" of the promissory note given as consideration for them. They contended that the fair value of the appraisal shares in a subsequent appraisal proceeding following the execution of the top-up option would also be decreased.

Cogent and 3M, anticipating this issue, had followed the increasingly common practice of providing in the merger agreement that "the fair value of the Appraisal Shares shall be determined in accordance with DGCL § 262 without regard to the Top-Up Option, the Top-Up Option Shares or any promissory note delivered by the Merger Sub." Noting that there is a strong argument in favor of permitting merger parties

"to stipulate to certain conditions under which an appraisal will be conducted—certainly to the extent that it would benefit dissenting shareholders and not be inconsistent with the purpose of the statute," Vice Chancellor Parsons concluded that, in this case, the merger agreement provision was sufficient to overcome plaintiffs' professed concerns about the potential dilutive effects of the top-up option.

Similarly, in *In re Protection One, Inc. S'holders Litig.* (Consol. C.A. No. 5468-VCS), Vice Chancellor Strine entered an order approving a settlement of stockholder litigation which included, among other things, a stipulation by the parties that any top-up shares would not be included for purposes of adjudicating fair value in an appraisal action. Indeed, Vice Chancellor Strine seemed skeptical of any of the professed concerns about top-up options, declaring that he hadn't "caught the top-up wave." Emphasizing that the top-up option is "part and parcel of the transaction that gave rise to appraisal in the first instance," he questioned why there was even an issue as to whether top-up shares would be included as part of the going concern value of the company.

These recent rulings provide certain comfort to parties that seek to benefit from the flexibility of the top-up option feature. Despite the Court's recent and justifiable skepticism as to the theoretical necessity of the provision excluding the top-up option from appraisal value consideration, we continue to believe in the advisability of such a provision to further reduce litigation risk relating to its purported dilutive effect.

M&A Due Dilgence: The Effect of Restatements

By Jason Lavender, Michelle Gourley and Archana Acharya**

The restatement of a public company's financial statements can result in wide-ranging economic and legal consequences. From capital losses such as increased accounting and legal bills, monetary disgorgement (both individual and corporate), negative market reactions and stock price dips and drops, to loan covenant defaults, shareholder litigation and Securities and Exchange Commission civil action, among others. Restatements not only affect the restating company and its executives, but understanding the nature and scope of a restatement is crucial for any company that is contemplating, or in the process of, merging or acquiring a company that is restating, or has restated, its financial statements. This article provides an overview of the effect of a public company's restatement of its financial statements on an acquiror's due diligence efforts and it provides practical insight for the acquiror with the goal of avoiding—or minimizing—any unexpected surprises resulting from such restatement during the course of or following the acquisition.

1. Overview of Restatements

Financial statements filed with the SEC must be prepared in accordance with accounting principles generally accepted in the United States, otherwise, such financial statements "will be presumed misleading or inaccurate."[1] If financial statements contain a material "error"[2] or an "accounting irregularity,"[3] such financial statements must be restated.[4] The most common errors or irregularities resulting in the restatement of financial statements generally arise from issues associated with (i) the recording of equity or debt accounts, (ii) expense recognition, (iii) accounts/loans receivable, investments and cash, (iv) deferred, stock-based or other executive compensation, (v) liabilities, accounts payable, reserves and accrual estimates, and (vi) revenue recognition.[5]

2. Recent Trends

An acquiror pursuing a merger and/or acquisition transaction should not automatically avoid a target that has restated its financials. It is important to note that, despite the struggles of public companies that restated their financial statements in the initial turbulent days and years surrounding Enron and Worldcom and the adoption of the Sarbanes-Oxley Act of 2002, recent trends suggest that the restatement of financial statements does not always lead to ruin. In fact, both the overall financial impact of restatements on a public company and their respective impact on the stock prices of a public company—determined by looking at stock prices immediately before the announcement of a restatement and stock prices immediately after the announcement of a restatement—has continued to decrease since the early 2000s.[6]

Perhaps this is a reflection of the seismic failures witnessed by the investing public in the early years following the beginning of the 21st century, but it also may be a reflection of a more ho-hum reaction to the increasingly more frequent announcements associated with restatements of financial statements, as well as the seemingly better understanding of the term "material" in the context of whether an error is deemed material such that it would require a restatement. It should not be overlooked, however, that restatements involving irregularities and financial reporting fraud generally led to greater market losses than restatements for other reasons.[7]

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[1] 17 C.F.R. §210.4-01(a)(1).

[2] An "error" is defined as an unintentional misstatement or omission of amounts or disclosures in financial statements.

[3] An "accounting irregularity" is an "intentional misstatement or omission of amounts or disclosures in financial statements." Irregularities include fraudulent financial reporting undertaken to render financial statements misleading.

[4] See American Institute of Certified Public Accountants, "The Auditor's Responsibility to Detect and Report Errors and Irregularities," Statement on Auditing Standards No. 53; see also American Institute of Certified Public Accountants, "Consideration of Fraud in a Financial Statement Audit," Statement on Auditing Standards No. 82.

[5] Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (February 2010), at 21. Restatements also arise from mistakes in gathering or processing accounting data from which the financial statements are prepared, incorrect accounting estimates arising from misinterpretation or oversight of facts, and mistakes in application of accounting principles relating to amount, classification, manner of presentation or disclosure.

[6] See the U.S. Government Accountability Office Report on Financial Restatements: Update of Public Company Trends, Market Impacts and Regulatory Enforcement Activities at 5 (July 2006; Updated March 2007), available at www.gao.gov/new.items/d03138.pdf. See also Audit Analytics, 2009 Financial Restatements: A Nine Year Comparison (February 2010), at 1.

[7] Id.

In the initial four years after the adoption of Sarbanes-Oxley, the U.S. Government Accountability Office, acting at the request of Senator Paul Sarbanes, found that while the number of public companies announcing financial restatements from 2002 through September 2005 rose from 3.7 percent to 6.8 percent, the total number of restatement announcements identified soared 67 percent over that period.[8] By 2006, the number of restatements had reached its zenith, both in number of restatements and aggregate negative dollar value.[9] Since that time, however, both the number of restatements and the amount of total dollar loss have decreased dramatically.[10]

Another trend of note that will impact M&A due diligence relates to the finding—not surprisingly—that public companies that engaged in "stealth restatements" were less likely to suffer as dramatic decreases in stock prices in comparison with those public companies that disclosed restatements on Form 8-K.[11] From the perspective of the public company that is restating its financials, it is easy to see that the less visible the restatement, the less likely it is that the market will react negatively to that restatement.

A "stealth restatement" is made when the company restates its financial statements in a regularly scheduled filing (i) without filing an amended quarterly or annual report for the affected quarter or year, (ii) without first announcing the restatement in a press release filed on Form 8-K, Item 4.02 or (iii) if the regularly scheduled filing is filed late, without citing the restatement as the reason for a late quarterly or annual report in a Form 12b-25 (Notification of Late Filing).[12] Due to the various issues a company must consider in disclosing a restatement of its financial statements to the public, many companies opt to engage in filing "stealth restatements" even in light of the filing requirements for Form 8-K.[13] This includes situations where financials are intentionally misstated in order to make a company seem a more attractive target. Accordingly, an acquiror conducting M&A diligence must be persistent in ensuring that a potential duty to restate was never ignored, so that it is not walking into the potential liability that would be attached.

3. How to Identify a Restatement

A key element of conducting M&A diligence is determining whether the target has restated its financial statements. An acquiror may make that determination by reviewing (i) Item 4.02 of a target's Form 8-Ks, (ii) searching for stealth restatements, (iii) reviewing audit reports made pursuant to Section 10A of the Securities Exchange Act of 1934, and (iv) analyzing stock price patterns in the target's public stock for significant drops in stock price or reviewing credit ratings drops as a means to probe market reactions to the target's financial performance. Of course, no M&A due diligence checklist would be complete without including a few well-worded inquiries regarding the target's financial statements and whether any restatements of those financial statements have occurred or are expected to occur.[14]

Form 8-Ks

Aside from specific inquiries of the target regarding restatements of its financial statements, the foremost method of identifying a restatement is to review the target's Form 8-K filings, in particular Item 4.02. Item 4.02 of Form 8-K ("Non-Reliance on Previously Issued Financial Statements or Related Audit Report or Completed Interim Review") requires that a company file a Current Report on Form 8-K within four days of one of the following two occurrences: (i) when its board of directors concludes that any of the company's previously issued financial statements "no longer should be relied upon because of an error in such financial statements;" and (ii) when its independent accountant advises the company that "disclosure

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[8] See the U.S. Government Accountability Office Report on Financial Restatements: Update of Public Company Trends, Market Impacts and Regulatory Enforcement Activities at 5 (July 2006; Updated March 2007), available at www.gao.gov/new.items/d03138.pdf.

[9] Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (February 2010), at 11, 14.

[10] There are a number of reasons for this decrease, including regulatory changes. For more information, see Gourley and Lavender, *Restatements of Financial Statements*, Corporate Governance Advisor (July/August 2010).

[11] Myers, et al., *Restating Under the Radar? Determinants of Restatement Disclosure Choices and the Related Market Reactions*, at 6 (April 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1309786.

[12] Id.; Myers, Linda A. et al., *Restating Under the Radar? Determinants of Restatement Disclosure Choices and the Related Market Reactions* (April 2010).

[13] Id.

[14] See section entitled "*—Due Diligence Request Checklist*" below.

should be made or actions should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements."[15]

The prevailing opinion in legal circles is that a company must issue a public statement on Form 8-K disclosing the determination that investors cannot rely on previously issued financial statements if the restatement of the financial statements is due to a material error.[16] However, shortly after the issuance of the new Form 8-K requirements, the SEC Regulations Committee of the American Institute of CPAs asked the SEC if all restatements needed to be reported on Form 8-K. The SEC responded by stating that a Form 8-K filing pursuant to Item 4.02 is not required for every restatement and that the discretion of the filing companies should be used in determining the necessity of the filing.[17] Therefore, although a review of the company's Form 8-K is important, it alone may not be sufficient in identifying a restatement.

Stealth Restatements

The impact of stealth restatements should not be underestimated. If a company chooses to pursue a stealth restatement strategy, the financial restatement may be accomplished without filing an amended quarterly or annual report for the affected quarter or year, or without first announcing the restatement on Form 8-K under Item 4.02. In conducting M&A diligence, an acquiror must be aware of this type of restatement strategy and should actively search for occurrences of "stealth restatements" by the target. For example, a target may have:

- Restated its financial statements in a regularly scheduled 10-K or 10-Q without amending the affected 10-K or 10-Q;
- Restated its financial statements in a regularly scheduled 10-K or 10-Q without otherwise disclosing the restatement in a Form 8-K, Item 4.02 filing; or
- Filed a regularly scheduled 10-K or 10-Q late without citing the restatement as a reason for the delay and then restating its financial statements in a later 10-K or 10-Q filing.

An acquiror should note that although studies show that the number of companies restating their financial statements has decreased since 2006, the number of stealth restatements remains a large percentage of the restatements filed.[18] In particular, a recent study shows that the number of stealth restatements filed in 2008 and 2009 were 435 and 310, respectively, which represent approximately 52% and 49%, respectively, of the total restatements filed in each of those years.[19] Thus, even though the total number of restatements and stealth restatements has dropped over the past few years, the rate of stealth restatements out of the total number of restatements filed has remained steady (*i.e.,* roughly 50%).

Audit Report Pursuant to Section 10A of the Securities Exchange Act of 1934

Another indicator of a financial restatement is to review the audit reports of a target. Section 10A of the Securities Exchange Act of 1934 imposes a duty on auditors to report uncorrected illegal acts to a company's board of directors and, if certain actions are not taken by the company, ultimately to the SEC. If, during an audit, the independent accountant detects or becomes aware of information that an illegal act has or may have occurred, the accountant must (i) determine whether it is likely that an illegal act has occurred and (ii) if so, determine and consider the possible effect of the illegal act on the company's financial statements. The accountant must inform the appropriate level of management as soon as practicable and ensure that the audit committee is adequately informed, unless the illegal act is inconsequential. Consequently, if M&A diligence leads to the discovery of an audit report indicating that an illegal act has occurred, the acquiror should be prepared to find a financial restatement as well.

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[15] *See* Securities and Exchange Commission, Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, available at http://www.sec.gov/rules/final/33-8400.htm.

[16] *See* Division of Corporation Finance, Current Report on Form 8-K, Frequently Asked Questions, November 23, 2004, available at http://www.sec.gov/divisions/corpfin/form8kfaq.htm.

[17] Turner, Lynn E. and Thomas R. Weirich, *A Closer Look at Financial Restatements: Analyzing the Reasons Behind the Trend* (December 2006), available at http://www.nysscpa.org/cpajournal/2006/1206/infocus/p12.htm.

[18] Whitehouse, Tammy, *Financial Statements Drop Again in 2009; Will It Last?*, Compliance Week (March 16, 2010), available at http://www.complianceweek.com/article/5847?printable=1.

[19] Id.

Significant Drops in Stock Price or Credit Rating

A final method that should be used in conducting M&A diligence is to analyze the potential effects that a restatement may cause. The most immediate result of a restatement is the negative market reaction, such as a significant drop in the company's stock price, which, in some instances, can average ten percent during the three days surrounding the restatement.[20] To the acquiror, a drop in stock price may be evidence of several factors, including that a financial restatement has taken place, that the company is not properly conducting its business or that its management does not have adequate control over internal procedures. In any case, the financial statements of a target that has experienced a significant drop in stock price should be reviewed for the period(s) relating to such drop and an assessment should be made as to whether a stealth restatement, or other type of restatement, has occurred.

Additionally, a restatement of financial statements may be the cause of a default under representations and warranties or covenants in debt instruments or indentures, or a negative impact on the company's credit rating. The failure to provide financials in a timely fashion, such as when there is a delay in filing due to a restatement, could itself constitute a default or acceleration of payments under existing debt instruments. The restatement may also cause the decreased ability of the company to negotiate financial covenants or pursue certain transactions. All of these types of results can signal that a restatement has occurred and those conducting M&A diligence on behalf of an acquiror should be aware of these warning signs.

Due Diligence Request Checklist

In addition to conducting its own independent diligence about a target's financial statements, an acquiror should also be certain to include in its diligence checklist a request relating to restatements. For example, the acquiror's checklist should include a request substantially similar to the following: "*Provide a description of any revisions or restatements of financial statements, any accounting irregularities or any of the target's accounting principles that do not comply with accounting principles generally accepted in the United States*." The acquiror may also want to include a request for a qualitative description of the restatement or irregularity and the reasons therefor.

Upon receipt of an affirmative response to a restatement diligence request, an acquiror should not only have its counsel review the materials, but should also have its accountants' review the materials. When reviewing the materials, the accountants should ensure that the target's accounting practices comply with GAAP and that they are consistent with the acquiror's own accounting policies. To the extent the target's accounting practices differ from the acquiror's practices, the acquiror's accountants will need to identify the differences and provide a roadmap for the future assimilation of their respective accounting practices. It will also be instructive for the acquiror's accountants to identify how differences in accounting principles can impact the target's financial statements and affect the purchase price discussions.

4. The Effect of an SEC Investigation of a Target

It is often the case that once a target has discovered a material error in its financial statements, it will conduct an internal investigation to assess the depth of the problem and then it will disclose the issue both to the public and to the SEC (as well as to the stock exchange on which it is listed, if applicable). If the target discloses certain remedial measures and effectively implements such measures, it is possible that a substantial SEC investigation may be avoided.

However, if the SEC decides to investigate the matter, it may request access to the documents related to the target's internal investigation and may require that the target waive its attorney-client privilege in connection with the internal investigation. The most important consequence of the waiver, for both the target and acquiror, is that any information provided to the SEC could be discoverable in the future by shareholder plaintiffs in an action against the target. To avoid this dangerous possibility, it is common practice that a target should request to substitute the documents for an oral report to the SEC, detailing the results of the internal investigation, and thus preserving the privacy of such documents.

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[20] Bischoff, Jane et al, *Financial Statement Restatements: Causes and Effects, Tennessee CPA Journal* (April 2008), available at www.tscpa.com/Journal/articles/fin_statmt_restatmt.pdf.

An acquiror must also be aware of the SEC's recent decision to strengthen its investigative efforts.[21] In March 2010, the SEC and the U.S. Department of Justice announced new incentives to encourage companies and individuals to aid in the investigation of financial fraud. In addition to offering deferred prosecution agreements and non-prosecution agreements, the SEC and DOJ may allow cooperating individuals or companies to receive credit for assisting in investigations, as long as the assistance is substantial and truthful.[22] Because of these incentives, whistleblowers may defeat a target or acquiror's efforts to conduct a stealth restatement and may create media attention that could lead to a significant drop in stock price and/or an expensive settlement agreement.[23]

Other sections of this article support the proposition that an acquiror should not automatically terminate deal discussions simply because the target has restated its financial statements (or has reason to restate its financials statements in the future). However, this section underscores the need to pursue a cautionary approach if the acquiror discovers a target is under investigation by the SEC or DOJ.

5. Evaluating Controls and Procedures Versus the Personnel of a Target

When conducting diligence on a target that has been through a restatement, it is worth looking at the impetus for the restatement because it can be an indicator of the future success of the target following the acquisition. When looking at the causes of restatements, generally, a couple of interesting trends stand out.

First, the most common reasons for restatements have not been consistent. In the GAO's initial report on restatements issued in 2002, revenue recognition issues were the leading causes of restatements, generating nearly 38% of all restatements.[24] However, in its report issued in 2006, the leading causes of restatements were for expense recognition reasons—especially lease-accounting expenses, which spawned over 35% of all restatements—and deferred compensation-related issues, which accounted for over 14% of all restatements.[25] By 2009, the leading causes of restatements were the improper recording of equity or debt accounts—nearly 18% of all restatements—and expense recognition errors—over 14% of all restatements.[26]

Second, the changing nature of the most common causes of restatements suggests that the trend will continue with a healthy dose of influence by regulatory proclamations and rulings invariably leading to a new batch of types of restatements.[27] By focusing on the cause of a restatement, three things become easier to understand: (i) why a target was subject to a restatement, (ii) whether the restatement can be attributed to the actions of certain personnel—personnel that the acquiror may not want to retain following the closing of the acquisition, and (iii) whether the restatement that occurred was necessary for more benign reasons, such as the impact of regulatory changes and rulings (*e.g.*, the proliferation of restatements owing to lease-accounting expense recognition).

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[21] Darmer, Roman, *SEC and DOJ Announce Changes to Enhance Investigation and Prosecution of Financial Fraud*, The Defender, (Spring 2010) available at http://thedefender.howrey.com/sec-and-doj-announce-changes-to-enhance-investigation-and-prosecution-of-financial-fraud-03-30-2010/.

[22] Id.

[23] For example, after the SEC investigation following its own internal investigation and restatement of its financial statements, AIG agreed to pay more than $1.6 billion in a global settlement agreement related to the SEC's claim of securities fraud. *See* Securities and Exchange Commission, Press Release 2006-19, *AIG to Pay $800 Million to Settle Securities Fraud Charges by SEC*, available at http://www.sec.gov/news/press/2006-19.htm.

[24] *See* the U.S. Government Accountability Office Report on Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges at 5.

[25] Id. at 17. A leading factor in the increase of expense recognition restatements was the SEC's chief accountant's February 7, 2005 letter regarding the treatment of certain lease and leasehold improvements and a leading factor in the increase of equity-related restatements likely was the revisions to Financial Accounting Standards No. 123 in the wake of the option back-dating scandals discovered in 2004 and 2005. *See* http://www.sec.gov/info/accountants/staffletters/cpcaf020705.htm.

[26] Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (February 2010), at 22, 23.

[27] There can be no doubt that just as Enron and Sarbanes-Oxley provided ample work for lawyers, their economic impact on the accounting industry (the spawn of the PCAOB and the reduction of competition among the Big 4 accounting firms through the implosion of Arthur Anderson demonstrates their impact) cannot be underestimated.

6. Litigation and Investigations

Another major concern when doing diligence on a company that has announced a financial restatement, especially recently, is the effect that its interaction with the government may have, potentially many years into the future. A public company that has announced a financial statement restatement may well expect both litigation and an investigation by the SEC, usually beginning at the company level, but which, depending on the reasons for the restatement, may ultimately mature into an executive-level investigation and/or litigation. Of course, a company's executives and counsel should anticipate these types of investigations and litigation before a press release is issued, so as to ensure the accuracy of the information contained in the press release and to make sure that the nature of the restatement is conveyed in such a way as to discourage litigation (while still maintaining the truthfulness of the disclosure).

Yet another factor that influences both the likelihood of SEC involvement and the aggression of their enforcement relates to the manner of restatement. Research shows that before Sarbanes-Oxley, a transparent disclosure tended to make a company more likely to face SEC enforcement.[28] However, in the recent years after Sarbanes-Oxley, that trend has reversed and companies that are transparent with their disclosure not only face a reduced likelihood of government enforcement, but also smaller penalties when they are sanctioned.[29] This is likely a result of the SEC's desire to discourage stealth restatements, while also encouraging companies to be candid and thorough when deciding a restatement strategy. Any decision to disclose must be analyzed carefully though because transparency does not come without another risk. While the SEC may be more forgiving in light of increased public disclosure, shareholders are not likely to be similarly inclined. As disclosure becomes more public, the chances that more shareholders will both see it and act on it also increase.

7. Conclusion

One of the acquiror's essential processes when pursuing an M&A transaction is conducting its due diligence on the target, and two of the key components of that diligence are evaluating the financial health of the target and understanding the reliability of its financial statements and practices. To that end, determining if a target has or should have undertaken, or if it will need to undertake, a restatement of its financial statements, is a critical part of the diligence analysis.

The goals of this article have been to provide an understanding of why these parts of the diligence process are necessary and to explore the best methods of discovering and evaluating a financial statement restatement. Absent outright fraud, the discovery of a recent restatement should not cause an acquiror to automatically abandon the M&A transaction. Rather, a restatement will be just another risk that the acquiror should consider when determining when to go forward with the transaction and whether the substantive terms of the transaction (*i.e.*, price, escrow provisions, survival of representations and warranties, and indemnity coverage) should be revised in light of the restatement.

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[28] Files, Rebecca L, *Do More Transparent Corporate Actions Following a Restatement Influence the SEC's Decision to Issue an Enforcement Action?* (February 2009), available at acctwkshop.cox.smu.edu/acctwkshop/Rebecca%20Files%20road%20paper%20Feb%2009.doc.

[29] Id.

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