

COLUMBUS BUSINESS FIRST®

VOL. 21, NO. 53

THE CENTRAL OHIO BUSINESS AUTHORITY

AUGUST 26, 2005

LITIGATION & CORPORATE LAW

Sarbanes-Oxley sure to affect variety of transactions

The impact of the Sarbanes-Oxley Act on public companies has been well-documented since its enactment four years ago. The spillover effect Sarbanes is having on other areas of the economy is less understood.

One area that has been significantly affected is the mergers and acquisitions market. This market involves public and private companies (since most acquisition targets of public companies are private companies) and has been forever altered by Sarbanes.

It is helpful to remember how the components of Sarbanes were put together in order to gain a deeper understanding of how it has affected mergers and acquisitions. To begin with, most of the important components of Sarbanes existed well before its enactment.

Congress was caught as off-guard about the problems with Enron, Global Crossing, Adelphia and others as was the general public. When the call went out at the end of 2000 and the beginning of 2001 to do something, Congress did not craft Sarbanes out of the mist like Brigadoon. Lawmakers went on a corporate governance shopping spree, lifting principles and best practices from state law, noteworthy cases, academic writing and other sources.

What was unique about Sarbanes was the amalgamation of these various principles and practices into a central body of law. It is not an exaggeration to say that Sarbanes was the most significant revision to the federal securities laws since the 1930s. The effect that these principles and practices would have on the mergers and acquisitions market when combined together and enforced by the SEC and U.S. Department of Justice never entered anyone's mind.



DUE DILIGENCE
ROBERT OUELLETTE

Sarbanes controls how public companies operate. The bedrock principle is transparency - making the inner workings of the company more visible to shareholders. The business of mergers and acquisitions is a major avenue through which companies grow. Deals are cloaked in secrecy and confidentiality. In many instances there is no way to satisfactorily reconcile the principles of Sarbanes and these traditional M&A market practices.

Due diligence

Prior to Sarbanes, due diligence was sometimes dismissed as an investment of time and resources that had a very low return. Those days are over. Companies will now exhaustively review the financial records of a potential target company, regardless of whether that company is publicly or privately held. There is so much pressure placed on chief executive officers and chief financial officers to stand behind public company financial statements that many deals are not completed because of the hesitancy to be accountable for financial records of acquired companies.

It has taken public companies several years and many dollars to become compliant with Sarbanes' provisions. After a deal closes, the public company must be able to stand behind the acquired company's financial controls to the same extent as the public company. If the acquired company happens to be a private company, there is little doubt its financial controls and processes will need substantial improvement before becoming compliant with Sarbanes.

Another area of growing importance is a company's relationship with its key customers, vendors and creditors. With Sarbanes' emphasis on corporate accountability,

executives of companies looking to make acquisitions are particularly concerned with understanding the projected revenue and cost structure of an acquisition target. Companies looking to be acquired are understandably nervous about a potential buyer speaking directly with key customers and vendors prior to closing.

Higher transaction costs

Another tangible effect that can immediately be seen as a result of this interplay between Sarbanes and the mergers and acquisitions market is the increase in transaction costs. These costs may be philosophically acceptable based on the presumption that Sarbanes was enacted to benefit shareholders of public companies.

In other words, public shareholders chose higher transaction costs as a necessary price to pay in order to gain the protections of Sarbanes. From the perspective of the private company involved in mergers and acquisitions transactions, there is nothing acceptable about higher transaction costs. The higher costs act as a disincentive to pursue a deal and reduce the return the private company's owners receive as a result of a deal.

Sarbanes has changed the way due diligence is conducted, financial terms are negotiated and transactions are pursued. The affected constituencies are broad, including suppliers, customers, banks, employees and unsecured creditors. In short, the manner in which mergers and acquisitions deals take place, and the associated growth in companies, has been significantly altered from the standard of even just a few years ago.

ROBERT R. OUELLETTE is partner and chair of the corporate practice group at Schottenstein Zox & Dunn Co. LPA. Reach him at 614-462-2242 or rouellette@szd.com.