
Chief Executive Legal Guide

Marshall Cooper: Chief Executive Officer

Wayne Cooper: Chairman

David Beck: Senior Vice President

Michael Bamberger: Vice President of Research

Chris Horner: Editor

Elayne Demby: Editor

Paula Santonocito: Editor

Monique Nijhout: Desktop Editor

© 2012 Chief Executive Group. No part of this publication may be reproduced, stored in a retrieval system or transmitted by any means, electronic or mechanical, without prior written permission of the Chief Executive Group, Greenwich, CT USA.

CHAPTER 6

CORPORATE LAW

Gibson, Dunn & Crutcher LLP

Corporate Governance

Steven P. Buffone, Partner

Katherine A. McCord, Associate

Mergers and Acquisitions

Scott J. Calfas, Partner

Personal Liability

Mark S. Lahive, Partner

Securities Law

Peter J. Hanlon, Partner

Peter W. Wardle, Partner

Michael H. Davis, Associate

PART I. PERSONAL LIABILITY OF OFFICERS AND DIRECTORS

WHAT IS AT STAKE

Although corporations are recognized as distinct legal entities, officers and directors should realize that stockholders, law enforcement, the media, and the general public all share the view that corporations don't break laws, people do.

Recent history, starting with WorldCom and Enron and continuing through more recent turmoil within financial institutions, has seen officers and directors judged harshly and found personally liable for misdeeds that involved not only violations of law and fraud, but also breaches of fiduciary duties. While such behavior is not, hopefully, a likelihood for most corporate officers and directors, the current climate requires officers and directors, whether serving a corporation with thousands of shareholders or just a few, to be particularly vigilant with respect to their duties and obligations.

This section explores some of the circumstances in which the actions or inactions of corporate officers and directors may create personal liability and suggests ways to mitigate or eliminate such liability. Due to the large number of corporations incorporated in Delaware and its well-developed case law, this section focuses primarily on officer and director liability under Delaware law, as well as certain elements of federal securities law.

Directors' Fiduciary Duties

In general, directors are required to discharge duties of care and loyalty. Failure to effectively discharge fiduciary duties can result in personal liability to the director. The duty of care requires that directors adequately inform themselves in preparation for a decision.

What constitutes adequate diligence in a particular case depends on the relevant facts and circumstances, but it is generally agreed that directors do not need to be informed of every fact. Directors are responsible for considering the material facts that are reasonably available, but not facts that are immaterial or out of their reach.

The duty of loyalty requires directors to be loyal to the interests of the corporation's shareholders and to avoid conflicts of interest. Clearly, if directors act to benefit their personal interest at the expense of stockholder interests, such action is improper. The duty of loyalty forbids directors to "stand on both sides" of a transaction and prohibits them from deriving "any

personal benefit through self-dealing.” Also imbedded within the duty of loyalty is a duty of oversight—an obligation to take reasonable steps to identify and prevent violations of law. Years ago, directors were only expected to react to “red flags;” today, ignorance is not bliss for fiduciaries.

General Protections of the Business Judgment Rule

Delaware and most other states recognize the concept of the “business judgment rule,” which is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.

A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be attributed to any rational business purpose. For the business judgment rule to apply, however, three pre-conditions must be met: care, loyalty, and independence. If these elements are found, the substantive decision, whether in hindsight good or bad, will be sustained if it can be attributed to a rational business purpose.

Liability for Breaches

Delaware law, consistent with the rationale of the business judgment rule, provides directors with wide latitude when it comes to the duty of care. Absent gross negligence, courts generally have not second-guessed directors in this area. Directors do not, however, enjoy similar deference when it comes to the alleged breaches of the duty of loyalty since the nature of the claim suggests that the director received some benefit to the detriment of the corporation or its shareholders.

When a director has a personal interest in a transaction, the interested director will only be relieved of liability if:

- The transaction is approved by a majority of the independent directors or the corporation’s stockholders, in each case, after full disclosure of the material facts; or
- interested director can establish the “entire fairness” of the transaction by showing that the transaction’s price and process for approval were fair to shareholders.

Indemnification and Insurance

Most corporations have provisions in their organizational documents that require the corporation to indemnify directors and officers for claims against them arising out of their service and advance them expenses for defending such claims. Similarly, most corporations carry D&O insurance that provides for both direct payment to directors and officers in situations where the corporation is unable to indemnify (Side A coverage) and reimbursement to the corporation for amounts paid to indemnify officers and directors (Side B coverage). Furthermore, the Delaware corporate code (Section 102(b)(7)) permits corporations to adopt a charter

provision that expressly exculpates directors from monetary liability for a breach of the duty of care.

Practical Advice

It goes without saying that the best way for directors to protect themselves is to effectively discharge their fiduciary duties. To that end, directors should:

- Confirm that the corporation has adequate internal controls and reporting systems that will enable directors and officers to monitor the corporation's compliance with laws;
- Ensure that they have all the information reasonably available and necessary to make informed decisions on proposed actions; and
- Consider whether they have, or could be alleged to have, a personal interest in each proposed action and, if so, fully disclose that interest to the board and abstain from participating in the decision process.

In addition, to ensure that directors will have the fullest protection possible if a breach is asserted, directors should:

- Determine whether the corporation's organizational documents provide for comprehensive indemnification protections—the language can vary and may include unwelcome exceptions;
- For a Delaware corporation, identify whether the corporation's charter includes the express exculpation for breaches of the duty of care; and
- Check the corporation's D&O policy to determine if the policy limit is appropriate for the size of the company, and to make sure the policy includes Side A coverage—which is particularly relevant to directors when the corporation is highly leveraged or distressed.

Officers' Fiduciary Duties

The Delaware Supreme Court's 2009 decision in *Gantler v. Stephens* confirmed that corporate officers owe fiduciary duties to the corporation and its shareholders that are identical to those owed by directors. Unfortunately, unlike the well-developed area of directors' duties, there is little case law explicitly addressing the nature and scope of officers' fiduciary duties. This lack of guidance leaves questions as to how officers' fiduciary duties will be interpreted and what will be required to discharge these duties.

In addition, while officers are entitled to indemnification and coverage under D&O insurance, Delaware law does not provide an avenue to expressly exculpate officers for breaches of the duty of care. The resulting ambiguity and decreased level of protection dictates that officers pay close attention to the discharge of their fiduciary duties.

Open Questions

Delaware courts have not addressed whether the business judgment rule should apply as broadly, or at all, to officers. In fact, many commentators have suggested that because officers possess more and better information than directors, they may be subjected to a higher level of scrutiny when it comes to the duty of care.

In addition, Section 8.42 of the Model Business Corporation Act, which helps further refine officers' duties, recommends burdening officers with the additional obligations to inform a superior officer or the board of directors of:

- (i) material information regarding the affairs of the corporation; and
- (ii) any actual or probable material breach of duty by another officer.

In other words, officers, to a greater degree than directors, may be under an obligation to “speak up” — either to make sure a superior officer or the board has all relevant information regarding a proposed action or to call attention to possible breaches of fiduciary duties. The potential scope of these duties remains uncertain, but officers should be cognizant of their possible application.

Officers may also be subjected to heightened scrutiny with respect to their duty of loyalty. While Delaware courts generally reject claims that a director has a conflict of interest solely because the result of the corporate action allowed him or her to remain on the board, the *Gantler* court reviewed a company treasurer's actions through the heightened “entire fairness” standard because he could be deemed to have a conflict of interest in acting to “retain his job and the benefits it generated.” The court inferred that the treasurer breached his duty of loyalty by helping the CEO sabotage an auction process, because the treasurer was beholden to the CEO for job security.

This presents unique conflicts for officers vis-à-vis job security and the fulfilling of their fiduciary duties. Officers may be presented with difficult questions when instructed by the board or a superior officer to engage in conduct that may be later alleged to be against the corporation's best interests.

If they follow such orders, are their actions likely to be reviewed under the entire fairness standard, exposing them to increased risk of fending off a breach of loyalty claim? Or if they refuse to follow such orders, are they exposing themselves to employment risk?

And if Delaware courts determine that officers are burdened with the additional obligations to inform a superior officer or the board, additional questions arise as to whether an officer would need to vocally object or attempt to prevent a corporate action that the officer believes is not in the corporation's best interests.

At some level, it seems officers, more so than directors, must have a clear understanding of the corporation's best interests — and the motivations of their superior officers and their boards — in order to both fulfill their fiduciary duties and keep their jobs. This seems appropriate, given officers' greater intimacy with the corporation's operations and circumstances. However, it

suggests that officers may have a more difficult time discharging their fiduciary duties than directors do.

Practical Advice

With this backdrop, officers should:

- When taking actions that do not require board approval, consider whether they have all information reasonably available and necessary to evaluate that action;
- When dealing with the board or a superior officer, consider whether the board or such officer has all requisite information to evaluate a decision;
- Be mindful of a potential duty to “speak up” regarding the existence of material information or potential breaches of fiduciary duties by other officers; and
- Evaluate whether their actions are being dictated by self-interest (e.g., job retention).

Liability for Unlawful Distributions

Virtually every state makes it unlawful for a corporation to pay a dividend, redeem stock or otherwise make a cash distribution to shareholders if the transaction would impair the corporation’s capital. The methods for determining when a corporation’s capital is impaired vary across states and can be fairly complex. Although Delaware and other states allow directors to rely on the books and records of the corporation as well as the valuation of an expert, directors are held jointly and severally liable to the corporation or if the corporation is insolvent, to its creditors for the full amount of the payment.

Practical Advice

When contemplating a potential dividend or other distribution, directors should:

- Understand the relevant statutory test for capital impairment and walk through its application with the corporation’s chief financial officer and outside accountants, as well as internal and external legal counsel; and
- Take advantage of directors’ right to rely on expert advice and engage a reputable valuation expert to report to the board, if state law permits directors to “revalue” the corporation’s assets and liabilities.

Transactions in Public Company Stock and Section 16 of the Securities Exchange Act of 1934

Reporting Requirements under Section 16(a)

Officers and directors of public companies are required by Section 16(a) of the 1934 Act to report to the SEC his or her transactions in the company’s publicly traded stock, as well as derivative securities such as options, warrants, and other rights relating to such stock.

Under the rules, each officer and director is required to file a Form 3 within 10 calendar days after the event that causes such person to become an officer or director (e.g., the person's election or appointment as an officer or director). Generally, subsequent changes in an officer's or director's beneficial ownership of company securities must be reported on Form 4, which is due on the second business day after the sale or purchase transaction is executed.

Typically, public companies handle the Form 3 and 4 filings for their officers and directors, but individual officers and directors are ultimately responsible for the filings. Public companies are required to disclose, either in their proxy statement or Form 10-K each year, the names of the officers, directors, and other insiders who failed to timely file all required forms for the fiscal year. Such public disclosure could prove embarrassing to the officer or director, as well as the company.

Furthermore, failure to file reports on a timely basis may subject officer or director to a possible SEC enforcement action and monetary fines and will toll the running of the statute of limitations for an action to recover "short-swing" profits under Section 16(b) of the 1934 Act, discussed below.

Liability for Short-Swing Profits under Section 16(b)

Section 16(b): Section 16(b) is designed to prevent the unfair use of inside information that may be available to officers, director and other insiders. Specifically, Section 16(b) provides that any profit realized by an officer or director from the purchase and sale, or sale and purchase, of company securities within any six-month period ("short-swing" profits) is recoverable by the company. Such recovery can occur due to the company's action or derivative action brought by shareholders on behalf of the company.

Good Faith Not a Defense: Section 16(b) imposes strict liability for purchases and sales made within a six-month period, regardless of the intent of the officer or director or the actual possession of, or access to, inside information. Liability is absolute. Therefore, a violation of Section 16(b) does not depend on whether the officer or director actually relied on inside information. Good faith, inadvertence, or misunderstanding of the law is not relevant.

Sequence of Transactions Not Relevant: Section 16(b) applies even when a sale of shares precedes a later purchase within a six-month period. For example, if an officer sells 500 shares that he or she has owned for five years for \$15 per share on August 1, 2011, and on December 1, 2011, buys 500 shares at \$10 per share, a sale and purchase will have occurred within a six-month period requiring the officer to remit the short-swing profit on the transaction to the company. All stock of the same class (including options and other derivative securities relating to securities of that class) are fungible under Section 16(b) and, therefore, an officer may not avoid Section 16(b) liability by selling securities held more than six months if there has been a purchase of securities of the same class within six months.

Computation of Short-Swing Profits: In computing the short-swing profit recoverable by a company under Section 16(b), the courts have held that recovery will not be limited to the actual

profit made on a sale. Rather, profit will be calculated in a manner to obtain the largest possible recovery for the company, based on the cost of securities bought and the price obtained for securities sold during the applicable six-month period. Thus, in the case of 500 shares sold for \$15 per share on August 1, 2011 and 500 shares purchased for \$10 per share on December 1, 2011, profit recoverable would not be computed on the basis of the actual profit, if any, realized on the shares sold on August 1, but rather on the difference between the \$7,500 sales price and the \$5,000 purchase price, even though the shares sold might have cost more than \$7,500 and been sold at an actual loss.

Tolling of Statute of Limitations: Section 16(b) provides a two-year statute of limitations on a company's (or its shareholders') right to bring an action against an officer or director for short-swing profits with respect to a particular transaction. However, if the officer has not timely filed a Section 16 report with respect to a transaction, the statute of limitations with respect to that transaction is suspended or tolled until the officer or director makes the requisite disclosure.

Practical Advice

In order to avoid Section 16 problems, officers and directors should:

- Confirm that the corporation has appropriate protocols in place to ensure that the corporation is made aware of his or her transactions in the corporation's securities and receives all necessary information and the corporation is timely filing the requisite reports.
- Work with the corporation and their own financial advisors to establish a system that will determine, before the transaction is made, whether a sale or purchase will be subject to the short-swing profit rule of Section 16(b).

ADDITIONAL RESOURCES

- Gibson Dunn Client Alert, *SEC Targets Directors Who Ignore Red Flags*, available at: www.gibsondunn.com/publications/Pages/SECTargetsDirectorsWhoIgnoreRedFlags.aspx
- The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at: <http://blogs.law.harvard.edu/corpgov/>
A blog providing news and commentary related to corporate governance, D&O insurance and financial regulation.
- The text of Section 16 of the Exchange Act and related rules and regulations are available at: <http://sec.gov/about/laws.shtml>
- The text of Delaware laws relating to unlawful distributions (including Sections 154, 170 and 244) are available at: <http://delcode.delaware.gov/title8/c001/sc05/index.shtml>

- *Reality Check on Officer Liability*, Lyman Johnson and Robert Ricca, in *The Business Lawyer*, a publication by the American Bar Association, available at:
www.americanbar.org/tools/digitalassetabstract.SIGNIN.html/content/dam/aba/publications/business_lawyer/2011_67_1/tbl_2011_v67_n1_03_a_johnson_ricca.pdf

PART II. SECURITIES LAWS BASICS FOR PUBLIC AND PRIVATE COMPANIES

WHAT IS AT STAKE

For both private and public companies, federal and state securities laws require compliance with a wide array of laws and regulations that cover a broad range of issues. While it would be impossible to cover all areas of the federal securities laws in summary fashion, what follows are brief discussions of some important compliance issues that companies commonly face.

This section highlights some of the issues a CEO should be generally aware of in order to direct a company toward full compliance with applicable securities laws. Because many important regulations only apply to publicly listed companies, some of the topics below will not be of interest to a private company CEO unless his or company is considering or effecting an initial public offering.

The first topic—private placements of securities—covers the procedures and issues a company must consider in an offering of securities that is exempt from registration under the U.S. Securities Act of 1933, as amended (the Act).

For publicly listed companies, a discussion of the reporting requirements under the U.S. Securities Exchange Act of 1934, as amended (the Exchange Act), follows, including the important topic of CEO and CFO certifications.

Finally, there are brief discussions of sales of public securities by directors and officers under Rule 144 of the Act and insider trading regulations.

Private Placements

Private offerings of securities that are exempt from registration require compliance with a number of securities laws and regulations, including state “Blue Sky” laws that vary by jurisdiction. Because the failure to comply with these regulations can result in a right of rescission for investors and direct claims against a company, some basic recommendations regarding the private sale of securities and related topics to assist companies in completing a compliant private placement are set forth below.

By closely following the requirements for the private offering safe harbors under the Act, a company can ensure a successful private offering.

Exemption from Registration Requirements for Private Placements

Section 5 of the Act sets the framework for securities offerings, and provides that all offers and sales of securities in the United States must be registered with the U.S. Securities and Exchange Commission (SEC), unless otherwise exempt under the Act. In most cases, a private placement

will be governed by the exemption in Section 4(2) of the Act, which exempts transactions “not involving any public offering.”

To assist companies in complying with this private offering exemption, the SEC has created a “safe harbor” under the Act called Regulation D. The Act does not specifically set forth the requirements necessary to satisfy Section 4(2), so companies will typically structure an offering to rely on this safe harbor, most often under Rule 506 of Regulation D (Rule 506). Rule 506 and other rules under Regulation D lay out the specific steps that a company must follow in order to conduct a private offering that is exempt from registration under Section 4(2) using the safe harbor.

Below are some of the specific attributes of a private offering under Regulation D:

- A company may offer and sell its securities to an unlimited number of “accredited investors,” and up to 35 non-accredited investors. “Accredited Investor” is defined to include individuals and entities with a specific level of income and/or net worth. Regardless of whether or not investors are accredited, all investors, either alone or through a representative, must be sophisticated. This means that every investor that is offered securities must have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the investment.
- If securities are offered to any non-accredited investors, the company must provide investors with disclosure materials that are similar in scope to what would be required in a registered offering, usually by way of an offering memorandum. Many companies only offer securities to accredited investors in order to have much more flexibility in what information is disclosed (although it is still recommended that companies provide ample disclosure to all investors). In all cases, any disclosure will be subject to the antifraud prohibitions of the federal securities laws discussed below. The company must also be available to answer questions by prospective purchasers.
- In any private placement, investors will receive “restricted” securities that cannot be re-sold unless registered under the Act or pursuant to an available exemption (such as Rule 144 under the Act as discussed below).
- A company cannot use general solicitation or advertising to market or offer the securities or otherwise attract investors. This includes advertisements, articles, notices, or other communications published in any newspaper, magazine, or similar media or broadcasts over television, the Internet, or radio.
- A key factor in determining whether a solicitation or advertisement is general or limited is whether there is a preexisting substantive relationship between the potential investor and the company. A relationship is “preexisting” if there is sufficient time between when the relationship started and when the communication about the offering is made. A relationship is considered to be “substantive” if the company knows enough about

the financial circumstances of the investor that it has a reasonable basis to believe that the proposed investor is sophisticated (as described above) and also has a history of purchasing securities like the securities being offered by the company.

- A Federal Form D must normally be filed electronically with the SEC within 15 days after the first sale of securities. State Blue Sky notices generally may need to be filed after each sale of securities as well.

Practical Advice

In order to ensure compliance with these requirements, CEOs and their companies should:

- Limit offers and sales of securities to a small number of accredited investors;
- Only engage in discussions with potential investors if the company knows they are sophisticated and knows their financial circumstances enable them to participate in a private placement;
- Require potential investors to complete a suitability questionnaire before providing any information regarding the offering;
- Ensure that all appropriate investors who express an interest in the offering receive an offering memorandum—each copy of the offering memorandum delivered should be numbered and specifically addressed to the potential investor;
- Ensure that any materials used with prospective investors (including the offering memorandum) satisfy applicable anti-fraud standards by having counsel review materials before they are distributed;
- Make sure that there is a reasonable period of time for investors to have the company answer all questions and perform their diligence prior to closing the offering;
- Keep careful comprehensive records of all proposed investors, including record of any intermediaries—especially lists of the names and addresses of recipients of the offering memorandum and any other written offering materials; and
- Include appropriate representations and warranties from the investor regarding their status in subscription documents for the offering.

In certain offerings, communications with the media and internet usage can raise difficult issues when trying to comply with Regulation D. In order to avoid a prohibited general solicitation, the company should consider the recommendations below:

- The general solicitation ban includes any news articles (whether in the mainstream press or in trade periodicals) about the company. All discussions with the media relating to the company should be kept to a minimum during the offering and, if possible, press interviews should be declined.

- If a member of the media asks the company about the status of any offering, the appropriate officer should indicate that, on the advice of counsel, the company is prohibited from commenting on that subject.
- In order to avoid conflicting treatment or statements that don't properly reflect company views, the company should designate a single senior officer to be responsible for clearing and coordinating all statements to the press during the offering process.
- All employees and other agents and representatives should be made aware of communications restrictions and directed toward the designated senior officer.
- Communications restrictions also apply to any publicly accessible websites maintained by the company. The company and its counsel should review any websites of the company.
- Any offering materials distributed by e-mail should include an appropriate disclaimer in the cover email regarding the confidentiality of the private offering and requiring recipients to acknowledge that they will not share the materials.

It is important to note that federal and state antifraud rules will always apply to private offerings. Section 12(a) of the Act provides that any person who offers or sells a security that includes a materially untrue statement, or omits to state a material fact necessary in order to make the statements made not misleading, can be liable to the investor. In addition, Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act generally make it unlawful for any person, directly or indirectly, to use any scheme to defraud, or to make any untrue statement of a material fact or omit to state a material fact in connection with the purchase or sale of any security. It is therefore important that all offering materials are also reviewed carefully from the antifraud perspective.

Public Company Reporting and Certifications

Public companies must develop effective procedures for ensuring the timely reporting of all information required under the Exchange Act, including certifications that are now required from the CEO and CFO of each reporting company.

Reporting Requirements for Public Companies

The Exchange Act and the rules of the SEC under the Exchange Act contain reporting requirements designed to keep shareholders and potential investors informed about significant information regarding a publicly listed company. A public company must file certain periodic and current reports with the SEC under these requirements, and almost all filings with the SEC must be made electronically through EDGAR, the SEC's proprietary system for electronic filings.

If a company is not timely in filing required SEC reports, it could lose its ability to rely on certain abbreviated disclosure requirements in the future, incur penalties, and prevent insiders from selling shares of the company.

The major periodic and current reports that a publicly held company must file are as follows:

- **Form 10-K.** Form 10-K is a detailed annual report that must contain disclosure regarding the company's business, property, pending legal proceedings, and financial condition, among other things. Form 10-K also requires material contracts and other exhibits relevant to the fiscal year for which the report is made. Note that the SEC has procedures to request confidential treatment of certain competitively sensitive information contained in exhibit filings. For public companies, a Form 10-K is due annually, with the exact timing depending on the status of the applicable company. A Form 10-K must also include fully audited financial statements for the applicable year. Form 10-K requires the manual signature of the principal executive officer, the principal financial officer, the principal accounting officer, and a majority of the directors of the company. These signatures must be kept on file for five years. This requirement, in addition to the certifications discussed below, indicates an SEC intention to hold signing directors and officers to a high standard regarding the accuracy and completeness of such reports.
- **Form 10-Q.** Form 10-Q is a quarterly report requiring unaudited financial information and a description of significant non-recurring events during the quarter, such as material defaults on debt or the commencement of significant legal proceedings. Like Form 10-K, Form 10-Q also must include material contracts and other exhibits relevant to the quarterly period for which the report was made. A Form 10-Q is required to be filed with the SEC within a specified period of time after the end of each of the first three fiscal quarters of each fiscal year since no Form 10-Q is required for the fourth quarter of a company's fiscal year. The Form 10-Q must be manually signed by a duly authorized officer of the company and the company's principal financial or chief accounting officer.
- **Form 8-K.** A company also must disclose on an ongoing basis on Form 8-K the occurrence of significant corporate events, including, among other things:
 - entry into or termination of a material definitive agreement or termination of such an agreement;
 - bankruptcy proceedings;
 - acquisitions or dispositions of a significant amount of assets;
 - earnings releases;
 - creation of a material, direct financial obligation;
 - material impairments and financial restatements;
 - change in control transactions;
 - changes in director and officer positions and significant executive compensation-related events; and

- amendments to or waivers of the company's code of ethics for the CEO and senior financial officers if not posted on the company's website.

In addition, a company may voluntarily disclose on Form 8-K other events that a company deems to be of importance to its shareholders. Form 8-K must generally be filed with the SEC within four business days after the occurrence of a reportable event.

Certifications by CEOs and CFOs

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), enacted in part to provide more stringent financial reporting standards, requires CEOs and CFOs to provide two certifications to be filed with certain SEC filings: one certification pursuant to SEC rules adopted under Section 302 of Sarbanes-Oxley and one certification pursuant to Section 906. These certification requirements apply to each annual or quarterly report filed under either Section 13(a) or 15(d) of the Exchange Act (such as Forms 10-K and 10-Q). To the extent that information required in a Form 10-K is provided in another document, such as a proxy statement, each certification covers such information. Current reports on Forms 8-K are not subject to the certification requirements.

These rules highlight an increased focus on CEO and CFO involvement with, and accountability for, a company's public disclosures. Following corporate scandals in which senior officers testified that they delegated all responsibility for financial and other disclosures to others in management, Congress and the SEC made it clear that they view such abdication to be inappropriate.

While CEOs and CFOs are able to involve and rely on others involved in the disclosure process, in order to make the mandated certifications, CEOs and CFOs will need to be directly involved each quarter in reviewing SEC filings and in monitoring the processes that generate the information required to be disclosed in those filings.

The certification requirements in Rules 13a-14 and 15d-14 under the Exchange Act, which implement Section 302 of Sarbanes-Oxley, require that the CEO and CFO certify, with respect to each covered report, that:

- each of them has reviewed the report;
- to each person's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- to each person's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;
- each is responsible for establishing and maintaining "disclosure controls and procedures," and "internal control over financial reporting"; and

- each has disclosed to the outside auditor and the audit committee all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the issuer's ability to record, process, summarize, and report financial information, and any fraud involving employees with a significant role in internal control over financial reporting.

The certification provision in Section 906 of Sarbanes-Oxley requires periodic reports (including Forms 10-K and 10-Q) to be accompanied by a certification from the CEO and CFO stating that the report fully complies with Exchange Act reporting requirements, and that the information in the report fairly presents, in all material respects, the issuer's financial condition, and results of operations.

Section 906 imposes criminal penalties if the CEO or CFO makes the certification "knowing" that the periodic report does not comply with the requirements set forth in the certification, and imposes greater penalties if the conduct is also "willful."

These penalties include:

- civil money penalties and/or injunctive actions in SEC enforcement actions;
- monetary damages in private actions;
- criminal liability, including fines of up to \$5,000,000 and/or 20 years in prison for CEOs and CFOs who knowingly or willfully falsely certify their company's financial report; and
- clawbacks of incentive-based compensation when an accounting restatement must be issued due to material noncompliance as a result of misconduct, even in cases where the misconduct was committed by a person other than the CEO or CFO.

The SEC has not mandated any specific due diligence procedures for the certification requirement, and CEOs and CFOs are entitled to rely on information as provided by other members of management. However, this certification is intended to be a critical review. CEOs and CFOs should take this obligation seriously, inquiring about disclosures they do not understand and questioning the materiality of specific items. If the CEO or CFO believes that the required statement would not be true, he or she should consult with counsel.

The fact that a CEO or CFO believes he or she is unable to make the certification will likely be viewed as material information, resulting in a company's need to consider whether it should publicly disclose in the periodic report that one or both of its executives are unable to provide the certification, together with the reasons for their inability to provide the certification.

Sales of Public Shares by Directors and Officers

Rule 144 under the Act (Rule 144) provides a safe harbor from the registration requirements of the Act for the resale of securities by parties other than the issuer of the securities. Rule 144

provides a means by which persons who might otherwise be considered “statutory underwriters” (and would therefore be required to register stock under the Act prior to selling) may sell their stock without registration.

Two types of securities are covered by Rule 144:

- (a) securities held by “affiliates” of the Company; and
- (b) securities deemed to be “restricted securities.”

Since directors and CEOs are generally affiliates, below is a brief summary of Rule 144 from the perspective of sales by affiliates.

Definitions of “Affiliate” and “Restricted Securities”

An “affiliate” is defined as a person who directly — or indirectly, through one or more intermediaries — controls, or is controlled by, or is under common control with, the issuer of securities. In general, directors, executive officers and shareholders who have the power to influence or affect corporate affairs are “affiliates.”

The SEC has defined “control” as direct or indirect power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise. “Control” thus is dependent upon the circumstances of each case.

In addition, the SEC has stated that the end of affiliate status is also a facts-and-circumstances determination, and it should not be assumed that affiliate status ends instantly when, for example, a former affiliate resigns from his or her position at the Company.

In general, “restricted securities,” as defined in Rule 144, are securities acquired directly or indirectly from the Company or from an affiliate of the Company in a transaction or chain of transactions not involving any public offering.

Application of Rule 144

Pursuant to Rule 144, the maximum amount of securities of a company that may be sold in any three-month period by an affiliate of that company is the greater of:

- 1 percent of all outstanding shares of the applicable class of securities, and
- the average weekly trading volume for such securities during the four calendar weeks preceding the proposed sale.

The volume limitations on sales of securities by affiliates apply to sales by the person individually plus sales by members of the person’s household and minor children and sales by corporations and other entities in which the person holds a 10 percent or more equity interest.

For restricted securities only (including restricted securities held by an affiliate), there is a six-month holding period before any such securities may be sold. In the case of restricted

securities acquired upon the exercise of stock options, the holding period does not commence until exercise of the option. Restricted securities held by non-affiliates may be sold without any restrictions after the six-month holding period, subject only to the requirement, which applies for an additional six months after conclusion of the holding period, that there be adequate current public information available about the company (meaning that the company has made all required filings with the SEC).

Rule 144 also requires that affiliates of the Company file a Form 144 with the SEC if the securities sold by such affiliate during any three-month period will:

- exceed 5,000 shares or other units, or
- have an aggregate sale price in excess of \$50,000.

In addition, sales of Company Securities by affiliates under Rule 144 must be sold either:

- in unsolicited “brokers’ transactions,”
- directly to a “market maker,” or
- in “riskless principal transactions.”

Practical Advice

Each of the requirements under Rule 144 must be carefully evaluated in the context of the individual situation of a director or officer when considering the use of Rule 144 to provide an exemption to the registration requirements under the Act. Before selling securities, affiliates and those who think they may own restricted securities should discuss the proposed transaction with counsel.

Insider Trading

Nature of Liability

Rule 10b5, the general antifraud rule promulgated under Section 10(b) of the Exchange Act, makes it unlawful for any person, in connection with the purchase or sale of any security, to make any untrue statement of a material fact or omit to state any material fact which would be necessary to make the statement made not misleading. Rule 10b5 is the source of case law that prohibits “insider trading.”

Rule 10b5 also has been interpreted to impose an affirmative duty upon companies to make disclosure in certain situations and upon individuals to refrain from buying or selling securities of a company while in possession of material information about that company which is not yet publicly disseminated (inside information). Inside information generally becomes available to the public when it has been disclosed by the company or third parties in a press release or other public statement, including any filing with the SEC, and after sufficient time has passed for the disclosed information to be disseminated in the market. A person will be deemed to have

traded “on the basis” of material non-public information if the person transacts in securities while “aware” of the information.

Directors, officers and employees of a company, or their “tippees” (people to whom they disclose inside information) should not trade for their own benefit or recommend trading in securities of a company on the basis of inside information. The same guidelines should be observed by the immediate family members and close associates of the directors, officers, and employees of a company. Every company should have an insider trading policy in effect to provide guidance as to when insiders may trade in the company’s securities.

Several important considerations regarding insider trading follow:

- Determining what information is “material” and “inside” at any given time can be difficult. “Material” information is that which would be considered important by reasonable investors in deciding whether to buy or sell the securities in question. The standard for assessing whether information is “inside” or non-public is whether the information is generally available to the investing public.
- Information generally would be considered material if it concerns earnings estimates, significant merger or acquisition proposals or agreements, tender offers, public or private sales of a company’s securities, proposed increases or decreases in dividends, stock splits, significant expansion or termination of operations, extraordinary borrowing, liquidity or litigation problems, important management changes, research developments, pending regulatory action, or any other important developments that may have an impact on the company.
- Information generally should be considered public between one and two full trading days after the information has been publicly disclosed, depending on the size of the company and the extent to which it is followed in the marketplace.
- If doubt exists, information should be presumed to be non-public and material.
- Keep in mind that the insider trading rules apply to sales as well as purchases of a company’s securities, and includes the purchase and sale of puts, calls, other options, and other derivative securities.
- Communications that may subject a company to liability under Rule 10b5 include press releases, speeches by corporate officials, communications with shareholders, discussions with analysts or members of the press, statements made in the context of negotiations with creditors or labor unions, interviews, and any other type of disclosure that reasonably could be expected to reach the general public.
- “Tips” for trading by others should not be conveyed. Both the “tipper” and the “tippee” may be in violation of the federal securities laws in such circumstances.
- Family members and close associates might be presumed to have an insider’s knowledge and/or to have a duty of trust or confidence to the insider/tipper.

- Violation of the insider trading laws could result in criminal penalties, civil damages to class action plaintiffs, injunctions, and consent decrees. Litigation, of course, is also expensive, time-consuming, and potentially embarrassing for a company and the individuals involved.

Insider Trading and Securities Fraud Enforcement Act

Insider trading is a top enforcement priority of the SEC and the United States Department of Justice (the DOJ). Criminal prosecution and the imposition of large fines are commonplace. Under the Insider Trading and Securities Fraud Enforcement Act of 1988 (the ITSFEA), a company and other “controlling persons” (which may be deemed to include directors and officers and that company) who recklessly fail to prevent insider trading violations by employees (“controlled persons”) may be held liable to the SEC and/or the DOJ for civil and/or criminal fines for the profit gained or loss avoided in addition to potential imprisonment.

Both the violating controlled person and controlling persons may be held liable. In addition, the controlling person may be held liable for violations by “tippers.” ITSFEA also provides a private cause of action to contemporaneous traders against the violator as well as his or her controlling persons.

Affirmative Defenses

Rule 10b5-1 provides that a person will be deemed to have traded on the basis of material non-public information if he or she was aware of that information at the time of the trade. If the insider in question planned the transaction prior to the time he or she came into possession of the information, however, Rule 10b5-1 provides an affirmative defense for the purchase or sale of the securities.

Moreover, a person accused of insider trading may claim as an affirmative defense that material non-public information did not affect his or her decision to trade. In addition, a person will not be viewed as having traded “on the basis” of material non-public information if he or she can demonstrate that the transaction was effected pursuant to a contract, instructions, or other written plan that was established before the person became aware of the information, referred to as 10b5-1 Plans.

PART III. CORPORATE GOVERNANCE

WHAT IS AT STAKE

Corporate governance is essentially the day-to-day management of the relationships between a company's management, board, and stakeholders. Corporate governance has garnered much public attention in the wake of the financial crisis as corporate stakeholders and the public have become increasingly concerned about the responsible use of corporate power.

Corporate governance is often considered to be the province of a company's board of directors, whose primary function is to supervise and direct the company using independent and objective judgment. However, with increased attention on corporate actions and the harsher light through which these actions are scrutinized, CEOs and senior management would be remiss to leave corporate governance considerations solely to the board.

This section discusses some of the issues a CEO should keep in mind when navigating the various corporate governance regimes that apply to companies.

Financial Reporting Oversight

Sarbanes-Oxley, discussed in the previous section, is an assortment of reforms aimed to protect investors by imposing, among other corporate governance reforms, more rigorous financial reporting requirements. Generally, Sarbanes-Oxley compliance requires companies to implement policies and certify practices to ensure that the company's financial statements accurately reflect the condition of the business and that the company has an effective system of internal controls to monitor financial reporting.

The financial reporting requirements imposed by Sarbanes-Oxley apply only to public companies, but private companies will be indirectly affected as Sarbanes-Oxley becomes the benchmark for responsible financial reporting and corporate governance practices. Sarbanes-Oxley's requirements may filter through to private companies more directly as lenders, insurers, investors, and auditors begin to evaluate companies' financial reporting controls in light of corporate governance standards modeled on Sarbanes-Oxley provisions, or for private companies considering a sale to a public company.

In such cases, the strength of a private company's internal controls and the effectiveness of its financial reporting oversight may materially impact a public company's decision about a potential acquisition. In addition to the overall enhanced financial reporting and internal control provisions, Sarbanes-Oxley specifically sets two requirements for CEOs:

- personal certification of financial statements (discussed above), and
- an annual report on the company's internal financial controls.

Assessment of Internal Financial Controls

In addition to the certification requirement, management must produce an internal-control report in connection with the company's annual report. This internal-control report must confirm management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The internal-control report must also contain an assessment of the effectiveness of those controls and procedures.

The SEC also issued interpretative guidance for management premised on a "top-down risk assessment," intended to encourage efficiency in the evaluation process by providing direction on these key areas:

- Identifying areas of material risks to the company's financial reporting and the controls to address those risks;
- Evaluating the operation of those controls that present the highest risk to responsible financial reporting;
- Reporting on the results of management's evaluation, including indicators of material weaknesses;
- Evaluating the reasonableness of documentation with respect to those areas of highest risk.

While this SEC guidance is not intended to supplant any internal-control systems already established for compliance with Sarbanes-Oxley, management can incorporate its aspects to make the evaluation and assessment process more efficient.

For private companies considering whether to voluntarily comply with the requirements and proscriptions of Sarbanes-Oxley, these guidelines offer a more straight-forward approach to instituting compliance.

Shareholder Influence and Engagement

Shareholders of both private and public companies are granted certain basic rights and obligations. These rights include the power to appoint directors, make key corporate decisions, and the right to obtain the company's information in order to evaluate management's decisions. As owners of the company, shareholders then have the obligation to consider the information and vote their shares thoughtfully and responsibly.

For public companies, these basic rights have been significantly expanded through the passage of recent legislation. This has created a substantial shift of governance power to the shareholders, who are now empowered to hold boards and management accountable for decisions contrary to the shareholders' or company's interest.

While these new regulations do not apply to private companies, this new emphasis, coupled with regulators' intensified focus on high profile corporate governance wrongdoing, suggests

that all companies, public or private, would be well served to work to improve their approach to shareholder communication and engagement.

These new regulations give shareholders greater influence and a larger number of issues on which to vote, and many shareholders are no longer following the traditional approach of voting with board and management recommendations. Instead they look to broad voting guidelines recommended by independent proxy advisors.

The management and board of directors therefore needs to work together to increase engagement with shareholders, initiating communication and encouraging dialogue to better communicate decision rationales and increase shareholder support.

Shareholder Rights and Responsibilities

In determining the specific rights and responsibilities of a particular company's shareholders, a company should first look to its governing documents: the articles or certificate of incorporation and bylaws. A company's bylaws will often set forth the rules governing shareholder engagement, and may provide guidance on the shareholders' rights regarding:

- calling special meetings;
- voting and proxy representation; and
- acting by written consent.

Public companies will, of course, also need to be familiar and comply with additional federal laws and SEC regulations governing shareholder power and voting, and in particular will want to focus on new and pending regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Of special interest to CEOs will be the regulations governing executive compensation, with the 2011 proxy season being the first year shareholders of most public companies were given the opportunity to vote on their company's executive pay practices.

Additional rules, scheduled to go into effect for the 2013 proxy season, will further require executive management to justify their compensation by requiring disclosure in the company's proxy statement on:

- the relationship between executive compensation and the company's financial performance; and
- the CEO's compensation relative to median employee pay.

Shareholder Communications

CEOs seeking to increase shareholder engagement should begin by identifying the company's key shareholders and the issues about which they are most concerned. In coordination with the

board of directors, CEOs may then want to reassess their approach to shareholder relations, in particular seeking to improve communication on the following issues:

- executive compensation, board composition and leadership and any key governance practices of the company;
- corporate strategy, risk management, and other substantive issues;
- any topics identified as of particular concern to the company's shareholders.

The goal of this focus on shareholder communications should be to:

- encourage the thoughtful evaluation of the decisions of the company's management to promote company-specific decision making and voting; and
- inform management and board decision making in light of shareholder concerns and perceived weaknesses.

By working to more actively engage the company's shareholders, and encouraging shareholders to discharge their role with greater responsibility and attention, CEOs and companies in general can bolster shareholder support by communicating the company-specific conditions that motivate internal decision making. As shareholders begin to take advantage of their increased power, companies that encourage their shareholders to participate in the governance process and engage with management will benefit from the support of shareholders who understand the details of the company, and believe that their concerns are a component of the decision-making process.

Succession Planning

CEOs should also focus their attention on succession planning. With the myriad issues facing boards of directors and management of companies, boards may be reluctant to raise this issue with a well-performing CEO, either because the board may fail to see the necessity if there is already strong management in place or simply because it may be an awkward issue to raise.

However, in addition to the obvious risk-mitigation benefits, succession planning can be a productive issue for any CEO to consider by providing beneficial side effects like:

- Providing a framework to align management development efforts with the strategic needs of the company;
- Encouraging those in executive management positions to analyze their job requirements and adjust their roles depending on the evolving strategic imperatives of the company; and
- Strengthening the relationship between the board and management by communicating the evolving skill set required for senior management positions. By thoughtfully

communicating the most important skills required for certain positions, future candidate searches will be easier and more directed. Further, the board will likely appreciate management's commitment to ensuring that the company continues to function smoothly.

Developing a Plan

While succession planning is primarily the responsibility of the board of the directors, a CEO can play an active role in succession planning by taking the steps described below:

- Assessing the job responsibilities and capabilities required to be successful in the position of CEO. This should be a written evaluation, updated as necessary to take into account changes in strategy and market conditions, and should be given to the board of directors to ensure the board has a complete understanding of the talent, leadership, and skills required for a position when screening potential candidates.
- Developing internal candidates. The current CEO should take a proactive goal in grooming any internal candidates for the position of CEO to ensure that the successor has the necessary training and leadership skills.
- Evaluating the management team to determine the other key positions to which this succession plan should apply, including lower level positions for which an immediate vacancy would significantly disrupt operations.

In short, succession planning is an important topic because it ensures a smooth transition to new leadership and encourages the board of directors and management to think critically about which skill sets need to be further developed for the company to accomplish its strategic goals. Encouraging the creation of a written succession plan and the strategic thinking required for its development will ensure better leadership transitions for the company, and provide assurances to investors and other stakeholders.

Transition Planning

While the board of directors may assume that their work is done once a successor has been chosen, it is also important to develop a succession plan to prepare the successor for his or her new role. Even the best-qualified candidates will need guidance and support once they have been installed in their new role.

Current CEOs can help with this task by developing a corporate culture that encourages feedback both up and down the leadership chain and by building a strong management team with clearly defined roles and responsibilities.

In order to give the new CEO the benefit of a strong foundation, the transition period should involve:

- comprehensively sharing information;

- communicating with and introducing the new CEO to and the company's stakeholders; and
- developing and sharing a detailed timeline for transition.

By making succession planning an ongoing process, companies effect smoother leadership transitions and mitigate the risk of being caught off guard by the loss of a key member of their management team. Further, by pushing senior management to consider the company's strategic employee-development objectives, ongoing succession planning can help foster successful governance and management. This can provide benefits long in advance of any changes to the company's management group.

Compliance Program Effectiveness

Effective compliance programs are becoming increasingly significant in the corporate governance arena. CEOs must ensure that their companies have robust compliance and ethics programs in place. The CEO must also work to promote a corporate culture in which employees report compliance and ethical concerns within the structure of the company's internal mechanisms.

Companies violating anti-corruption and anti-bribery statutes can face serious consequences, including:

- reputational damage;
- criminal prosecution;
- fines and penalties that can run as high as hundreds of millions of dollars;
- shareholder lawsuits; and
- continuing government oversight of the company to ensure future compliance.

The Foreign Corrupt Practices Act (FCPA), the main U.S. anti-corruption statute, is primarily concerned with accounting transparency requirements and the bribery of foreign officials. It applies to any individual or corporation residing or with its principal place of business in the United States. Because the FCPA can hold companies liable for the actions of their agents, joint-venture partners and even an acquired company's violations before acquisition, companies must emphasize compliance so that employees do not unknowingly violate the law's prescriptions.

Public companies should be particularly concerned with FCPA violations, as the risk of these violations being exposed has increased with new SEC whistleblower rules that went into effect in August 2011 and offer enormous incentives to employees and others to report securities laws violations, including FCPA violations. These new rules provide a powerful incentive for employees to report misconduct to the SEC rather than through the company's internal mechanisms. The challenge for companies is to encourage internal reporting without discouraging employees from reporting directly to the SEC, should they choose to do so.

One source of direction for CEOs seeking to establish effective compliance controls is the Federal Sentencing Guidelines, amended in November 2010, and used by federal judges to determine appropriate penalties for companies convicted of wrongdoing. In light of the stated intentions of the Department of Justice and the SEC to pursue companies and individuals where the ethical culture or internal controls of the company failed to prevent FCPA violations, CEOs should carefully consider the compliance programs of their companies in light of the Guidelines, focusing on:

- giving high-level management the authority to implement and manage the company's compliance programs;
- whether management regularly communicates an emphasis on compliance throughout the company;
- gaining clear support from management of the company's compliance programs; and
- whether senior compliance personnel can communicate, directly to the board and senior management, material issues as they arise, and the strength of compliance programs generally.

CEOs, while not responsible for creating the compliance and ethics programs, can play a significant role in their company's compliance by emphasizing the importance of ethical decision making and encouraging a strong culture of compliance.

ADDITIONAL RESOURCES

- PricewaterhouseCooper's Center for Board Governance, available at: www.pwc.com/us/en/corporate-governance/index.jhtml. A website aggregating articles and discussions on important governance issues.
- Holly J. Gregory, Practical Law Company, Twelve Key Corporate Governance Issues for 2012 (Dec. 1, 2011). An article from Ms. Gregory's regular column on corporate governance issues examining 12 important areas requiring attention in 2012.
- Gibson Dunn Client Alert, The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers, available at: www.gibsondunn.com/publications/pages/Dodd-FrankActReinforcesAndExpandsSECEnforcementPowers.aspx. An article discussing the various enforcement provisions established by the Dodd-Frank Act. Additional articles on corporate governance can be located at: [www.gibsondunn.com/Search/Pages/PublicationsSearch.aspx?k=\('Publication%20Practice': 'Corporate Governance'\)](http://www.gibsondunn.com/Search/Pages/PublicationsSearch.aspx?k=('Publication%20Practice': 'Corporate Governance')).
- Elizabeth A. Ising and Amy L. Goodman, Corporate Board Member, Top 11 Legal and Regulatory Tips for Boards of Directors in 2011 (Feb. 8, 2011).

PART IV. MERGERS AND ACQUISITIONS

WHAT IS AT STAKE

Depending on the size and strategic importance of the target business, a CEO may merely oversee an acquisition (or sale) process that is otherwise executed by business development professionals, or act as the lead negotiator and become intimately involved with the daily aspects of the transaction and the myriad legal and strategic decisions.

The CEO's role is also dictated by other factors such as:

- the desired financing structure;
- whether the transaction contemplates the sale of an entire company, as opposed to a division or subsidiary; and
- whether the parties are public companies, private companies, or private equity funds.

While a detailed discussion of all the legal issues that may arise is beyond the scope of this chapter, this section provides a framework for a typical acquisition process and calls out some of the many issues that arise in most transactions.

Marketing and Preliminary Negotiation

Preparation for and Preliminary Marketing of the Target Business

Among the first decisions a seller must make is how to market the target business. If the transaction involves investment bankers conducting an auction, companies will typically provide basic information to the proposed bankers, under cover of a confidentiality agreement. Confidentiality agreements are usually negotiated, but generally follow a somewhat standard form. They help to protect the company's information by restricting how parties may use it.

The issues facing a seller's management team at this stage include:

- **Investment Banker Compensation.** Bankers are usually paid a percentage of the value of the acquisition, which helps align their interests with the seller's. However, most investment banking engagement letters will also provide for a reimbursement of out-of-pocket expenses, whether a transaction is consummated or not.
- **Due Diligence Materials.** The seller will consolidate the due diligence materials relating to the target's business, often in an electronic data room, and provide access to potential bidders. Depending on the internal systems of the seller, this process may be time consuming. Bankers typically control access to the data room and many financial printers and other providers can provide the necessary technology platform. Diligence is often presented to bidders in stages—the further bidders go in the process, the more access they have.

- **Preparing a Confidential Information Memorandum (CIM).** Bankers will assist the company in preparing a CIM, which will lay out basic information about the target business. The CEO or another senior officer should carefully review the proposed CIM for accuracy prior to its distribution to bidders. Potential bidders will be asked to return a Confidentiality Agreement before receiving the CIM.
- **Drafting an Agreement.** In many cases, if an auction is going to be conducted, the seller will work with its legal counsel to prepare a draft acquisition agreement to be reviewed and revised by potential bidders. The officer in charge of the transaction will want to discuss the desired approach with the in-house or external counsel preparing the agreement. For example, this is when sellers often decide how aggressive the first auction draft should be with respect to “seller-friendly” provisions.
- **Conducting Management Meetings.** At some point in the process, the bankers may set up a series of management meetings at which potentially interested parties may discuss the target business with senior management.
- **Evaluating Bids.** Depending on the specific methods chosen, the company will work with the bankers and outside counsel to review the bids and determine which bidders should continue into later rounds of the process. Bids usually take the form of a non-binding letter of intent (LOI) which a bidder will use to make a preliminary bid for the target business. The LOI will include the bidder’s price as well as various conditions, which typically include: the conduct of a due diligence investigation, possibly a financing contingency, and a mark-up of the proposed draft acquisition agreement if one is included.

Letter of Intent

The LOI provides a framework for the basic terms of the acquisition, and usually includes a short summary of key transaction terms: assets of the business or division at issue, price, treatment of employees, conditions to consummation, key third-party or governmental consents or approvals required (for example, key customers or suppliers), due-diligence rights, timing considerations, an exclusive negotiation period (which is virtually always a bidder request), escrow or deposit, the extent and structure of indemnity provisions, termination rights and other “outs” that will be contained in the operative agreement, and other matters.

Exclusivity

For obvious reasons, bidders will usually want to condition their offer on some period of exclusivity so they do not remain in a competitive process. Sellers, of course, may wish to keep multiple bidders engaged and play them against each other. Every transaction is different and exclusivity is usually determined by the relative leverage of the parties. In some cases, sellers may decide to grant a particularly attractive bidder some period of exclusivity to negotiate a purchase agreement—perhaps 30 days. Depending on the transaction, the process of winnowing the bidders down to one or a short list of active participants may take hours, days, or weeks.

Usually, though, the bankers will respond to bidders promptly and ask them to provide their best and final bids and perhaps address other key terms.

LOIs Usually Non-Binding

Most letters of intent are non-binding, meaning that the parties are not obligated to consummate a transaction, but instead agree to negotiate. If the intent is to make the LOI non-binding, clear language to that effect and regarding the circumstances under which the parties may abandon the negotiations (e.g., for any reason or no reason) is important and will help avoid disputes.

Diligence

After one or more LOIs are executed, remaining bidders will continue to conduct a due-diligence review of the target business through review of the data room, in person visits to facilities, and discussions among the management and attorneys for both sides. To avoid monopolizing a CEO's time, typically the bankers, attorneys and lower level managers will address most of the diligence questions.

Diligence related to sensitive business information—proprietary information technology, key customer or supplier relationships, raw material pricing information, and the like is particularly important. Since relationships can be damaged if customers catch wind of a potential transaction which is ultimately not consummated, key third parties are typically not notified until later in the process.

Acquisition Agreement

Structures

The acquisition agreement may take many forms, each presenting different tax and accounting issues. Some of the structures and the relevant issues are as follows:

- An asset purchase agreement will cover only those assets and liabilities that are enumerated in the agreement itself. Buyers may prefer to purchase assets because it is easier to carve out specific liabilities and leave them behind with the seller.
- A stock purchase agreement can be used to purchase the whole enterprise or an entire division (if it resides in a separate subsidiary or subsidiaries). In this form the buyer is purchasing the equity interests of the particular entity that owns and operates the target business rather than specified assets.
- A merger agreement provides for a different mechanism to acquire all of the outstanding equity interests of the target business. Once the merger is approved by both sides, a form is filed with the appropriate state or states and by operation of the law the outstanding stock is, in effect, transferred to the buyer.

- In a public company context, the transaction may take the form of a tender offer for the outstanding shares.
- Additionally there will undoubtedly be a number of schedules, certificates, and ancillary agreements.

While the mechanics of the acquisition will vary based on the structure chosen, there are many provisions common to all types of agreements. An overview of selected key common provisions follows.

Purchase price and form of payment

The agreement will provide the price and the mechanism of payment, which could be cash, debt (e.g., a promissory note), securities of the buyer or an affiliate of the buyer, or a combination. The purchase price may be subject to various adjustments for items such as net working capital or a so-called “earn out” which adjusts the acquisition consideration for the post-closing performance of the business.

Mechanism for closing

Asset purchase agreements will contain a detailed list of assets and liabilities acquired and those that are left behind. A stock purchase agreement will contain provisions for the purchase of stock from the selling stockholders. Merger agreements will contain appropriate mechanics under state law to effect the merger.

If the buyer is a public company and is using securities as consideration, there may be provisions related to the valuation of its securities—the currency which it is using in the transaction. The use of securities as consideration may also lead to various securities law issues.

For privately held targets, these issues include:

- The status of recipients of the securities as “accredited investors” under the securities laws, which in turn impacts the amount of disclosure that the purchaser may need to make about its business; and
- The potential registration of the securities used in connection with the acquisition or later under a registration rights agreement, and the like.

These issues will vary depending on, among other things, whether the purchaser is a public or private company.

Representations and Warranties

While these provisions tend to tire even seasoned deal veterans, they are among the most important parts of the agreement because they comprise what amount to promises by the seller as to the nature and status of the business and assets that are being sold. A breach (or inaccuracy) of the representations (reps) and warranties is the most likely source of an indemnification claim

by the buyer after closing. Perhaps more importantly, a breach of a rep known at the time of closing may allow the non-breaching party to choose not to close the transaction.

The seller's management needs to review these provisions carefully and repeatedly throughout the negotiation process in order to ensure the accuracy of the reps. The companion document to the reps and warranties is a disclosure schedule—an often lengthy attachment to the agreement, or companion document—that lists various exceptions or provides additional specifics to the representations themselves. This too must be reviewed with care.

While a CEO will not likely be in a position to ascertain the accuracy of all the reps himself or herself, it is incumbent on the leader of the selling effort to be sure that the right people review the right provisions. That is, all of the financial representations are reviewed by the CFO, operational reps by the appropriate managers, etc. Some of the representations will be limited to the “knowledge” of the seller, which is often defined to be the knowledge of certain specified individuals. Thus, it is especially important that all officers listed as “knowledge” parties pay particularly close attention to those representations throughout the drafting and negotiation process.

Pre-closing Covenants

The agreement will contain obligations, primarily with respect to the seller, regarding actions that should be taken prior to closing. These generally take two forms—affirmative and negative covenants. Affirmative covenants are actions that the seller is obligated to take prior to closing. Negative covenants are prohibited activities (at least prohibited without the buyer's written consent). So, for example, a seller will be obligated to seek consents required under the agreement and cooperate with the buyer. But a seller will probably be prohibited from operating the business outside of the ordinary course, amending charter documents, or entering into any significant or affiliate transactions without the buyer's consent. The idea, of course, is for the buyer to know what it is buying and to ensure that the agreed-upon purchase price reflects the nature of the business at closing.

Conditions to Closing

Below are some significant closing conditions:

- A “bring down” of the reps and warranties—that is, a statement that they remain true in all material respects at the closing. Senior management will likely be required to sign a certificate to be delivered at closing stating as such, another reason why it is important to stay abreast of the negotiations of the reps and warranties.
- No material adverse change to the business between signing and closing.
- Some transactions will include a “financing out,” meaning a closing condition for the buyer that it has successfully obtained third party financing. This is the type of issue that would be addressed at the LOI stage given its potential impact on a successful closing.

Sellers generally prefer that buyers obtain all necessary commitments prior to signing. Sellers will want to investigate the buyer's creditworthiness and seek appropriate guarantees, as in many cases shell entities are formed for the purpose of the acquisition.

Termination Rights

The termination provision sets forth the circumstances under which either party may terminate the agreement and what consequences flow from such circumstances. Among other provisions, termination rights comprise the provisions below:

- **Drop dead date.** This is a date by which the transaction must close; if it fails to close by the specified date it is terminated.
- **Breach.** These are provisions permitting one party to terminate the transaction if the other party materially breaches a representation. In some cases, the non-breaching party may only terminate after a cure period has elapsed.
- **Limitation of damages.** This section may contain a limitation on damages recoverable by a non-breaching party and a reference to any other remedies—such as specific performance – that the parties may have access to.
- **Break Fees.** These are fees paid by the seller to the buyer in the event of certain specified situations in which the buyer fails to close, such as the board of the seller accepting a third party's higher offer after signing an agreement with a buyer. Breakup fees often range from 1 percent to 3 percent of the deal value.
- **Reverse break fees.** These are fees payable by buyers to sellers when buyers back out of transactions, for example due to the failure to obtain financing or governmental approvals.

Indemnification and Survival of reps and warranties

Probably the second-most important provision beyond the price in an acquisition agreement is the indemnification section. Indemnification provides a basis of recovery for a party to be reimbursed for damages sustained as a result of, among other things, breaches of representations, warranties, or covenants in an agreement. It is, in effect, a refund of some of the purchase price. Because the likelihood of a claim is larger, indemnification is typically more important for a buyer than a seller, and much of the time spent negotiating agreements surrounds the limitations and exceptions for indemnification.

A CEO is unlikely to be immersed in the minutia of these provisions, but will likely be involved in the larger issues: an overall cap for indemnification recovery (often a percentage of the purchase price in a transaction), a deductible (basket) amount that the damaged party must absorb before claiming indemnification, as well as the survival period. Additionally, parties often negotiate whether the buyer receives only the amount by which a claim exceeds the basket amount or the basket amount as well. For example, if the basket amount is \$1 million

and the buyer suffers \$1.2 million of damage due to a breach by seller, may the buyer recover the entire \$1.2 million or only the additional \$200,000? Certain representations and warranties will “survive” longer than others, meaning that the damaged party has a longer opportunity to make claims.

General representations often survive for a year or more and certain representations (taxes, environmental issues, ownership of assets and/or securities) may survive much longer. At a minimum, buyers typically want to make it through at least one full audit cycle post-closing before the reps and warranties lapse. However, in acquisitions of public companies the reps and warranties “die” at closing—that is, claims for breaches may not be made post-closing. Buyers generally rely on the target’s substantial public disclosure as the basis of evaluation. As a result, the reps and warranties are frequently more limited in public transactions.

Escrow or Holdback

Buyers will often ask for some of the purchase price to be held back or set aside in a separate escrow account with an independent third party to provide some assurance that a source of funds is available for the indemnity obligations. Additionally, the buyer may request set-off rights to the extent that it has ongoing payment obligations post-closing.

Post-Signing Period Through Closing

During the period between signing and closing, third parties consents will be sought and the parties will prepare for closing. Buyers may be working with lenders to solidify funding if the agreement provides for it. During this time, in addition to attending to the closing mechanics, management will need to remain focused on adherence to the covenants in the agreement, and promptly advise the other parties as may be required to avoid an inadvertent breach of a representation or covenant.

While both the buyer and the seller are typically looking ahead to the transfer and integration of the business with the buyer, anti-trust counsel should be consulted to ensure that the parties do not overstep legal guidelines by integrating the businesses prior to closing. During this time, management will need to review the closing certificates referenced above. Additionally, if the law firms are providing legal opinions as part of the transaction, management will often be asked to provide a factual back-up certificate to the firm.

Attorney-Client Privilege in Transaction Context

Generally speaking, transaction professionals (lawyers, bankers, and accountants) are typically more focused on negotiating successful deals and tend to think of attorney-client privilege as a “litigation” issue. If an acquisition (or failed acquisition) gives rise to litigation, questions will arise regarding which communications between and among company personnel, investment bankers, accountants, and lawyers are protected by the attorney-client privilege. Careful planning can greatly enhance the protection for appropriate communications.

CEOs should obtain advice on how this topic relates to materials prepared for internal evaluation, board room discussions, and discussions among business people, bankers, and lawyers.

There are a number of common misconceptions about the privilege. Among them is the idea that the mere presence of an attorney at a meeting or as a “cc:” on an e-mail or letter cloaks all the information discussed therein with the privilege. This is not the case.

The exact nature of the attorney-client privilege varies under state and federal law, but below are several general considerations that should be kept in mind:

- Generally, the privilege extends to (i) communications, (ii) made between an attorney and a client or related persons, (iii) in confidence, (iv) for the purpose of seeking, obtaining, or providing legal advice.
- The law is not settled on whether negotiation advice is privileged, so to be safe assume that it is not.
- Generally the privilege does not extend to business advice.
- In a transactional context the “client” that holds the privilege is the corporation, generally not individual officers or directors absent a separate agreement. This becomes especially important in change of control transactions.
- Draft transaction documents (that were not circulated to the other side) may or may not be privileged. Some courts protect draft documents to the extent they reflect client confidences and legal advice; others have held that drafts that were prepared with the intention of circulation are not privileged.
- In California, writings prepared by an attorney while acting in a non-litigation legal capacity (i.e., negotiating a business deal) are protected, but in other states (e.g., Delaware and Nevada), materials must have been prepared in anticipation of litigation to be covered.
- The role of in-house counsel and the interaction with affiliated entities (such as subsidiaries) can be complex in a privilege analysis because, among other things, in-house counsel often serve in a hybrid business and legal capacity so this should be addressed.

Practical Advice

- The CEO or officer leading the transaction should discuss with transaction counsel at the beginning of the process what types of communications will and will not be privileged.
- Remember that all internal communications among business people will not be privileged. Labeling something as “privileged” does not in and of itself make it so.
- Privilege issues are especially important in the context of hostile public transactions which very frequently generate litigation. Special care should be taken to obtain advice from the onset of the transaction and throughout.