

UPDATE

News of Developments in the Financial Sector and Related Areas

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What is Due Diligence?

Due Diligence is a term we hear thrown around in business circles, but what does the term really mean? Due diligence has been defined in many ways, but the best definition I have seen of it is *the level of judgment, care, prudence, determination, and activity that a person would reasonably be expected to do under particular circumstances*. Due diligence involves exercising the degree of care in investigating a matter in order to eliminate unknown risks. The purpose of exercising due diligence is to cut down the risk to a manageably small level. A considerable measure of judgment is involved, not only in deciding what to do, but in determining the level of investigation into a particular matter. Due diligence investigations frequently arise in a number of different contexts. These include (i) acquiring a company, (ii) loaning monies to a company, and (iii) marketing a new product. For instance, in the acquisition of a company, a careful analysis of the target company would involve an analysis of financial statements, environmental reports on real estate, existing contracts, pending litigation and regulatory proceedings and a review of contingent

liabilities not reflected on the financial statements. In loaning money to a company, due diligence would involve reviewing the business plan of the company, analysis of financial statements, possible environmental issues if real estate is involved, and making sure that the lender is the first lienholder on any collateral for the loan. Due diligence in marketing a new product may involve such things as whether the product would infringe upon the rights of other similar products and whether a patent or trade mark is available for the new product. In connection with the issuance of stock by a company, due diligence is a requirement on the part of the company as the issuer to insure that their offering does not misstate or omit material information to a prospective purchaser of their securities. To some degree, due diligence is involved in the day-to-day activities of everyone as they relate to a purchase of a car or home such as obtaining an appraisal, inspections and making sure that everything works. In more complicated transactions, the due diligence will take place between the time of the signing of an agreement outlining the terms of the transaction, sometimes referred to as a letter of intent, and the execution of a definitive agreement which sets forth, among other things, the representations and warranties of the parties to the transaction. In its most basic application, due diligence may involve just kicking the tires.

SEC Interpretive Rulings

The Securities and Exchange Commission ("SEC") is now posting its No-Action, Interpretive and Exemptive Letters on its web site. These responses provide informal advice from the staff of the SEC. A no-action letter generally provides an analysis of a specific transaction and an interpretive letter provides an analysis of a specific statute, rule or

regulation in the context of a fact situation. An exemptive letter will state that based upon a specific fact situation that the staff will deem it exempt from the requirements of a statute, rule or regulation. In a decision in *New York City Employees' Retirement System v. SEC*, 45 F. 3d 7 (2d Cir. 1995), the Court held that the informal responses by the staff of the SEC does not amount to an official statement of the views of the SEC. These informal responses by the SEC in the form of Non-Action, Interpretive and Exemptive Letters are available on its web site at www.sec.gov by clicking on the heading *SEC Divisions*.

Covenant Not to Compete Lack of Geographic Restriction

HRR Arkansas, Inc. v. River City Contractors, Inc., 2002 Ark. Lexis 520 (2002) followed previous decisions of the Arkansas Supreme Court which hold that in connection with noncompetition agreements, the failure of a covenant to contain a geographic restriction will render it overbroad and unenforceable. The facts in this case, involved, among other things, violation of a covenant not to compete arising from employment agreements by Tom McGee and Donna Wright, both with HRR Arkansas, Inc. Because the agreements signed by McGee and Wright contained covenants not to compete which were not limited to a geographic area, the court held the covenants to be overbroad and unreasonable. This case provides a good background of previous decisions by the Arkansas Supreme Court relating to covenants not to compete.

Cases, Releases and Rulings

The Internal Revenue Service ("IRS") now allows a business to apply for an employer identification number ("EIN") by telephone. The IRS toll-free telephone number for obtaining an EIN is (866) 816-2065. Prior to calling the IRS, the IRS suggests that Form SS-4 be completed in order that the

information will be available to provide to the IRS when the call is made. The Form SS-4 is the application for an EIN and is available on the web site of the IRS at www.irs.ustreas.gov. Utilizing the telephone to obtain an EIN eliminates the delay in time of an application by mail which takes approximately four weeks.

The Financial Accounting Standards Board ("FASB") is soliciting comments on changes that may be required to its accounting standards for stock-based compensation based on the fair value method of accounting. The *Invitation to Comment* which compares the similarities and differences between the standards of the International Accounting Standards Board and the FASB on accounting for stock-based compensation is available on its web site at www.fasb.org.

In Release 2002-165, the Securities Exchange and Commission ("SEC") issued proposed rules regarding auditors performing audits for publicly traded companies. The proposed rules require, among other things, auditors to maintain information for a five-year period following completion of an audit, requiring the audit committee of the publicly traded company to pre-approve all audit and non-audit services provided by the auditor, prohibiting an accounting firm from auditing a company's financial statements if a member of management of the company had been a member of the accounting firm's audit team within one year preceding the commencement of the audit, and requiring disclosures to investors of information related to an audit and non-audit services provided by, and fees paid to, an auditor by a publicly traded company. The proposed rules are available on the web site of the SEC at www.sec.gov.

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