Option Dating – A Further Look at the Implications for M&A

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October 2007

The discovery and disclosure of widespread misdating and misreporting of stock options has raised challenges for mergers and acquisitions, ranging from financial uncertainty and the potential for organizational disruption and distraction to exposure to civil and even criminal penalties, damages and expense.

More than 200 companies have announced internal or external investigations of their stock option granting practices. Many of these companies have been required to restate past financial statements and amend past SEC filings, and a significant number of senior executives have been forced to relinquish their positions. A number of companies have been delisted, and many more face possible delisting if they are unable to regain compliance with SEC filing requirements. Many companies face stockholder litigation and possible SEC enforcement action and even criminal prosecution, and a growing number of company executives have either been convicted or agreed to plead guilty to criminal charges relating to stock option backdating.

At the same time, more and more companies are emerging from option-dating investigations and restatements; where the SEC has determined not to pursue enforcement actions, it is notifying companies of that fact; and settlements are being reached in the stockholder derivative litigation and class actions that have been brought in the wake of option-dating investigations. Worst-case scenarios have generally not come to pass. As a result, although option-dating situations still pose challenges to M&A activity, the level of uncertainty appears to be lessening.

This outline reviews some of the major recent M&A transactions involving companies with option dating issues, and collects some of the provisions and approaches that have been crafted by buyers and sellers to address option dating issues and the "collateral damage" resulting from option-dating investigations and restatements.[1]

Backdating and misdating disclosures cover a wide range of practices ranging from fraud, manipulation and falsification of documents to innocent errors, inattention and procedural and documentation deficiencies. New terms have been coined (e.g., bullet-dodging, spring-loading) to describe practices that raise governance and investor relations (if not legal) issues. One-size solutions cannot address the diversity of situations that have arisen and may arise.

Despite the uncertainties, stock option dating issues have not altogether prevented M&A deals from moving forward. Companies have – at least in some instances – found ways to overcome the challenges of delinquent filing status and pending restatements, and to allocate the risks of option-dating "fallout" between the buyer and target in ways that allow transactions to move forward.

MAE Provisions

A threshold issue for transactions involving companies with option dating issues has been how – and where (to which party, buyer or target) – to allocate the various risks that option-dating issues pose for companies and transactions. Stock option backdating and misdating has been addressed in closing conditions and "MAE" provisions – provisions dealing with the possibility of material adverse changes and effects. To a

[1] This outline is a summary for general information only. It is not a full analysis of the matters presented and is not intended as, and may not be relied upon for, legal advice. The views expressed herein are solely those of the author and are not the views of any firm or client.

significant extent, buyers have agreed to bear a significant amount of the risk of stock option dating issues.

Stock option backdating and misdating risks were first addressed in three transactions in the summer of 2006:

- EMC-RSA Security (June 29, 2006);
- HP-Mercury Interactive (July 25, 2006); and
- SanDisk-msystems (July 30, 2006).

Since then, additional transactions have been announced or completed involving companies with option-dating issues. At least one transaction – Verint Systems' acquisition of Witness Systems (announced February 12, 2007) – involved not one but three companies with option-dating issues, namely, the target, the buyer, and the buyer's majority stockholder, which agreed to provide part of the financing for the all-cash transaction.

EMC-RSA Security[2]

In the EMC-RSA Security transaction, EMC agreed on June 29, 2006 to acquire RSA Security for cash in a transaction valued at approximately $2.1 billion. RSA's proxy statement soliciting the approval of its stockholders for the transaction describes a competitive bidding process with at least two active bidders and multiple rounds of price increases, in which initial indications of interest in the high teens eventually culminated in two bids of $28 per share.

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[2] The author's law firm at the time of writing served as counsel to RSA in the transaction with EMC. The description in this outline is derived entirely from public filings, and the views expressed in this outline are entirely the author's and do not reflect the views of any other member or employee of any firm or of any client or former client.

At the time of the transaction, RSA was the subject of pending inquiries into its stock option granting practices, and this is reflected both in the proxy statement and in the merger EMC-RSA agreement. Stock option dating issues are specifically address in the "MAE" provisions, i.e., the provisions dealing with events that might have a "Company Material Adverse Effect."

The MAE definition was cited in RSA's proxy statement as a factor considered by the RSA board reaching its decision to approve the merger agreement with EMC:

> "In the course of reaching its decision to approve the merger agreement and the merger, our board of directors consulted with our management and our financial and legal advisors and considered a number of factors, including . . . the terms and conditions of the merger agreement, including: . . . specific exclusion from the definition of material adverse effect as to us, of all matters relating to or arising out of the inquiries and claims regarding out option grant practices or any other matters relating to or arising out of the option grant practices that are the subject matter of those inquiries, meaning that the effect of any such matters would not be considered in determining whether certain conditions to EMC's obligation to complete the merger have been satisfied . . ."

RSA Proxy Statement page 22. RSA's proxy statement makes clear that the merger discussions were conducted against the backdrop of stock option dating issues; specifically, the chronology of events set forth in the proxy statement refers to a number of discussions regarding the SEC's ongoing inquiry into RSA's option grant practices and related matters. RSA Proxy Statement page 18.

The EMC-RSA merger agreement defines "Company Material Adverse Effect" (i.e., material adverse effect on RSA) as follows:

> "For purposes of this Agreement, the term " Company Material Adverse Effect " means any change, event, circumstance, violation or development that, individually or taken together with all other changes, events, circumstances, violations or developments, has a materially adverse effect on (i) the business, financial condition, operations or results of operations of the Company and its Subsidiaries, taken as a whole, or (ii) the ability of the Company to consummate the transactions contemplated by this Agreement; <u>provided</u>, <u>however</u>, that none of the following, or any change, event, circumstance or development resulting or arising from the following, shall constitute, or shall be considered in determining whether there has occurred, a Company Material Adverse Effect:
>
> (a) economic factors affecting the national, regional or world economy or acts of war or terrorism (provided that such factors or acts do not affect the Company in a substantially disproportionate manner as compared to its competitors);
>
> (b) factors generally affecting the industries or markets in which the Company operates (provided that such factors do not affect the Company in a substantially disproportionate manner as compared to its competitors);
>
> (c) actions required to be taken by the parties under this Agreement or the pendency or announcement of the transactions contemplated by this Agreement, including actions of customers or any delays or cancellations of orders for products or losses of employees;

(d) any matters relating to or arising out of the inquiries and claims regarding the Company's option grant practices described in Section 3.12 of the Company Disclosure Schedule, as well as any other matters relating to or arising out of the option grant practices that are the subject matter of such inquiries;

(e) changes in law, rules or regulations;

(f) changes in generally accepted accounting principles;

(g) any action which is specifically required by this Agreement (including Section 6.6) or at the written request of the Buyer;

(h) any fees or expenses incurred in connection with the transactions contemplated by this Agreement;

(i) any failure by the Company to meet any projections, guidance, estimates, forecasts or milestones or published financial or operating predictions for or during any period ending (or for which results are released) on or after the date hereof (provided that the underlying causes of any such failures may (subject to the other provisions of this Agreement) be taken into account in making a determination as to whether there has been a Company Material Adverse Effect);

(j) any stockholder litigation arising from or relating to the Merger based on allegations that either the Company's entry into this Agreement or the terms and conditions of this Agreement constituted a breach of the fiduciary duties of the Company Board or that the disclosures in the Proxy Statement were inadequate; and

(k) a decline in the price of the Company Common Stock (provided that the underlying causes of any such decline may (subject to the other provisions of this Agreement) be taken into account in making a determination as to whether there has been a Company Material Adverse Effect)."

(EMC-RSA Merger Agreement § 3.1; emphasis added.)

In addition to provisions specifically dealing with stock option dating, the EMC-RSA merger agreement contains standard representations and warranties, including a number of particular representations and warranties that indirectly address or encompass matters that could be implicated in option-dating. These provisions include representations and warranties on capitalization (§ 3.2)[3], the accuracy of SEC filings, financial statements, and Sarbanes-Oxley certifications, compliance with GAAP and related matters (§ 3.5)[4], the absence of undisclosed liabilities (§ 3.6), the absence of any Company Material Adverse Effect (§ 3.6), accuracy and completeness of tax returns and payment of taxes (§ 3.7), the absence of material litigation (§ 3.12), and compliance with laws (§ 3.15). The

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3 "The Company has made available to the Buyer a complete and accurate list, as of June 29, 2006, . . . of . . . (ii) all Company Stock Options . . . , indicating for each Company Stock Option . . . the exercise price [and] the date of grant . . . ."

4 "The Company SEC Reports [filed with the SEC since January 1, 2003] . . . did not . . . contain any untrue statement of a material fact or omit to state a material fact required to be stated in such Company SEC Reports or necessary in order to make the statements in such Company SEC Reports, in the light of the circumstances under which they were made, not misleading." "Each of the consolidated financial statements . . . contained . . . in the Company SEC Reports . . . at the time filed (i) complied . . . as to form in all material respects with applicable accounting requirements and published rules and regulations of the SEC with respect thereto, (ii) was . . . prepared in accordance with U.S. generally accepted accounting principles . . . and (iii) fairly presented . . . in all material respects the consolidated financial position of the Company and its Subsidiaries as of the dated indicated and the consolidated results of their operations and cash flows for the periods indicated . . . ."

merger agreement also contains covenants requiring RSA to use commercially reasonable efforts to continue the company's quotation on The Nasdaq Stock Market (§ 6.3) and to give notice of certain matters including occurrences that are reasonably likely to cause any representation or warranty to be untrue or inaccurate in any material respect and material investigations, actions and other proceedings (§ 6.9).

Some of these representations and warranties (e.g., absence of any Company Material Adverse Effect) would appear to be directly qualified by whatever disclosures appear in the Company's schedule of exceptions concerning option-related matters, which are incorporated into the carve-outs to the definition of Company Material Adverse Effect. But even more importantly, the closing conditions largely shift option-related risks to the Buyer. Thus, section 7.2(a) of the EMC-RSA Merger Agreement provides that

> "The representations and warranties of the Company set forth in Sections 3.2(a), (b) and (c) and Section 3.4(a) of this Agreement shall be true and correct in all material respects as of the Closing Date as though made on and as of the Closing Date (except to the extent such representations and warranties are specifically made as of a particular date, in which case such representations and warranties shall be true and correct in all material respect as of such date). The other representations and warranties of the Company set forth in this Agreement shall be true and correct as of the Closing Date as though made on and as of the Closing Date (except (i) to the extent such representations and warranties are specifically made as of a particular date, in which case such representations and warranties shall be true and correct as of such date, (ii) for changes contemplated by this Agreement, and (iii) where the causes of any failure of such representations and warranties to be true and correct (determined without regard to any

> materiality or Company Material Adverse Effect qualifications contained therein), individually or in the aggregate, do not constitute, and would not reasonably be expected to constitute, a Company Material Adverse Effect)."

As noted above, the bringdown condition with respect to the representations and warranties in section 3.2 (the representation and warranty on capitalization) addresses stock option grant dates, but presumably the risk of inaccurately reported grant dates and/or exercise prices was amply disclosed. The bringdown condition on the remaining representations and warranties that implicate option-related matters are all subject to an MAE threshold – i.e., for the condition not to be met, the representation and warranty would not only need to be inaccurate, but the causes of such inaccuracy would need to constitute (or be reasonably expected to constitute) a Company Material Adverse Effect. Since disclosed option-related matters are expressly carved-out of the definition of Company Material Adverse Effect and cannot constitute a Company Material adverse Effect or even be considered in determining whether a Company Material Adverse Effect has occurred, it would appear that under an EMC-RSA type merger agreement, options-related matters would need to involve a significant undisclosed development in order to give the Buyer grounds not to close.

Similarly, the termination provisions of the Merger Agreement are largely tied to the standard of the closing conditions. Thus, Section 8.1(g) allows the Buyer to terminate the Merger Agreement "if there has been a breach or failure to perform any representation, warranty, covenant or agreement on the part of the Company," but only if the breach "(i) would cause the conditions set forth in Section 7.2(a) or 7.2(b) not to be satisfied, and (ii) if curable, shall not have been cured within 20 days following receipt by the Company of written notice of such breach or failure to perform from the Buyer." Here again, option-related risks appear to be largely if not almost entirely carved out.

The closing conditions and termination provisions both contain standard provisions relating to the existence of injunctions and other legal restraints (§ 7.1(d) (absence of injunctions against transaction as mutual closing condition), § 8.1(c) (termination in event of injunction against the merger), and the termination provisions also allow the parties to terminate if the merger was not completed by February 28, 2007 (eight months after the signing of the Merger Agreement). But given that the transaction was an all-cash deal, the potential for an injunction or regulatory delay seems remote. As an all-cash deal, the transaction was not subject to a vote of the Buyer's stockholders and did not require a registration statement to be declared effective.

In a "public-public" transaction, with almost vanishingly rare or extremely narrow exceptions, representations and warranties have essentially no effect after the closing. This is implicit in the transaction structure and in the dispersion of share ownership in public companies, but is also made explicit in section 9.1 of the EMC-RSA Merger Agreement, which sets forth a standard "nonsurvival" provision, stating that "None of the representations, warranties and agreements in this Agreement or in any instrument delivered pursuant to this Agreement shall survive the Effective Time, except for the agreements contained in Article II, Sections 6.8 and 6.11 and Article IX."

HP-Mercury Interactive

On July 25, 2006, a little less than a month after EMC agreed to acquire RSA, HP agreed to acquire Mercury Interactive. Mercury Interactive was one of the initial generation of companies to disclose option-dating issues. Like the EMC-RSA transaction, HP-Mercury

Interactive was an all-cash transaction and appears to have largely shifted the risk of option-related fallout to the acquirer. But the details of the agreement differ from EMC-RSA, which are examined below, and unlike the EMC-RSA transaction, it was structured as a tender offer rather than a merger.

The HP-Mercury Interactive merger agreement contains a number of representations and warranties by Mercury Interactive that could implicate matters relating to stock option dating, including representations and warranties on capitalization (§ 4.4), the accuracy and completeness of Mercury Interactive's SEC filings (§ 4.6) and financial statements (§ 4.7), internal controls (§ 4.7(c)), the absence of undisclosed liabilities (§ 4.9), the absence of any Company Material Adverse Effect other and changes since a specified date (§ 4.10), the absence (except as set forth in the Company Disclosure Schedule) of litigation as of the date of the merger agreement, including, specifically, litigation relating to stock options, and taxes (§ 4.18), including disallowance of deductions under Section 162(m) of the Internal Revenue Code. Some of these representations and warranties are narrower than their counterparts in the RSA-EMC merger agreement, others are broader, and some have no direct counterparts.[5]

As in the case of the EMC-RSA merger agreement, the HP-Mercury Interactive merger agreement largely appears to place the risk of option dating developments on the acquiror. As in EMC-RSA, HP-Mercury Interactive does this in the definition of "Company Material Adverse Effect," which is defined as follows:

> "any fact, circumstance, change or effect that, individually or when taken together with all other such facts, circumstances, changes or effects that exist at the date of determination of the occurrence of the Company Material Adverse Effect, has or is reasonably likely to have a material adverse effect on the business, financial condition or results of operations of the Company taken as a whole

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[5] For example, unlike RSA's representation on capitalization in the EMC-RSA merger agreement, Mercury Interactive's representation on capitalization does not speak to the grant date or exercise price of its options (at least not on its face); the representation on Mercury Interactive's financial statements is qualified by reference to "Selected 2005 Financial Statements" that are set forth in the Company Disclosure Schedule; and Mercury Interactive made a representation and warranty that "Neither the Company nor any of its Subsidiaries nor, to the Company's Knowledge, any director, officer, auditor, accountant, consultant or representative of the Company or any of its Subsidiaries has received or otherwise had or obtained Knowledge of any substantive complaint, allegation, assertion or claim, whether written or oral, that the Company or any of its Subsidiaries has engaged in questionable accounting or auditing practices. No current or former attorney representing the Company or any of its Subsidiaries has reported evidence of a material violation of securities laws, breach of fiduciary duty or similar violation by the Company or any of its officers, directors, employees or agents to the current Company Board or any committee thereof or to any current director or executive officer of the Company." (§ 4.7(e).) In addition, the HP-Mercury Interactive merger agreement contains a number of provisions relating to the treatment of stock options under Section 409A (§ 7.11) and a more extensive obligation to maintain D&O liability insurance for Mercury Interactive directors and officers after the closing (with a cost cap of 300% of the last annual premium, versus a cost cap of 150% in the RSA-EMC agreement).

with its Subsidiaries; provided, however, that no facts, circumstances, changes or effects (by themselves or when aggregated with any other facts, circumstances, changes or effects) resulting from, relating to or arising out of the following shall be deemed to be or constitute a Company Material Adverse Effect, and no facts, circumstances, changes or effects resulting from, relating to or arising out of the following (by themselves or when aggregated with any other facts, circumstances, changes or effects) shall be taken into account when determining whether a Company Material Adverse Effect has occurred or may, would or could occur: (i) general market, economic or political conditions (including any changes arising out of acts of terrorism or war, weather conditions or other force majeure events) to the extent that such conditions do not have a materially disproportionate impact on the Company taken as a whole with its Subsidiaries; (ii) general market, economic or political conditions in the industries in which the Company or any of its Subsidiaries conduct business (including any changes arising out of acts of terrorism, or war, weather conditions or other force majeure events) to the extent that such conditions do not have a materially disproportionate impact on the Company taken as a whole with its Subsidiaries relative to the industries in which the Company or any of its Subsidiaries conduct business; (iii) general market, economic or political conditions in Israel (including any changes arising out of acts of terrorism or war, weather conditions or other force majeure events); (iv) the announcement or pendency of this Agreement or any of the transactions contemplated hereby, including the Offer and the Merger; (v) changes in GAAP, or changes in the interpretation of GAAP with respect to Tax matters or as a result of or arising from an audit review of the consolidated financial statements of the Company and its Subsidiaries, in either case pursuant to which the Company is required to change its prior accounting policies or practices; (vi) changes in any Legal Requirements; (vii) the failure to take any action as a result of any restrictions or prohibitions set forth in Article VI; (viii) any legal claims made or brought by any Company Stockholders or any former stockholders of the Company (on their own behalf or on behalf of the Company) or other Legal Proceedings arising out of or related to this Agreement or any of the transactions contemplated hereby (including the Offer and the Merger); or ***(ix) (A) actions, claims, audits, arbitrations, mediations, investigations, proceedings or other Legal Proceedings (in each case whether threatened, pending or otherwise), (B) penalties, sanctions, fines, injunctive relief, remediation or any other civil or criminal sanction (in each case whether threatened, pending, deferred or otherwise, and whether financial or otherwise), or (C) facts, circumstances, changes, effects, outcomes, results, occurrences and eventualities (whether or not known, contemplated or foreseeable, and whether financial or otherwise), in each case with respect to (A) through (C), resulting from, relating to or arising out of: (1) the Company's restatement of its historical consolidated financial statements for the fiscal years ended December 31, 2002, 2003 and 2004 (the "Restatement"), the matters referred to in Item 9A, Note 3 or Note 19, or the Company's pending restatement of the unaudited financial statements contained in its quarterly report on Form 10-Q for the quarter ended March 31, 2005; (2) the Company's failure to file in a timely manner its Annual Report on Form 10-K for the fiscal year ended December 31, 2005, the Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30, and September 30, 2005, and the Quarterly Report on Form 10-Q for the quarters ended or ending March 31, June 30, and September 30, 2006; or (3) the Company's historical stock-based compensation practices, including with respect to the grant of stock options and the purchase of Company stock by***

> ***employees; the recording of, accounting for and disclosure relating to the stock option grants and Company stock purchases by employees, remedies determined by the Company's Special Committee or Special Litigation Committee of the Company Board or the Company Board relating to the Company's investigation of such stock-based compensation or in connection with the Restatement, and the Company's tax practices with respect to such compensation practices, including the grant of stock options and the purchase of Company stock by employees***." (Emphasis added.)

The MAE carve-outs in the HP-Mercury Interactive agreement address option-related matters at somewhat greater length and in somewhat greater detail than the comparable provision in the text of the EMC-RSA agreement. The general intent appears to be similar – namely, to shift the risk of option-related "fallout" to the acquirer – but closer examination reveals a number of differences between EMC-RSA and HP-Mercury Interactive in their treatment of option-dating issues, some of them procedural, others substantive.

Procedurally, EMC-RSA was a one-step cash merger and HP-Mercury Interactive was a two-step transaction (tender offer followed by back-end merger). As a result, the conditions to HP's key obligations are not set forth in the merger agreement as conditions to the merger (which was a back-end merger), but in an annex to the agreement as conditions to the first-step tender offer. Those conditions contain a bringdown condition requiring Mercury's representations and warranties to be true and correct as of the date of the agreement and as of the expiration date of the offer – except where the failure to be true and correct "has not had and would not be reasonably expected have, individually or in the aggregate, a Company Material Adverse Effect." Annex A, condition (C)(1). The conditions also relieve HP of any obligation to accept or pay for tendered

Mercury interactive shares if "any Company Material Adverse Effect shall have occurred following the execution and deliver of this Agreement and be continuing." Annex A, condition (C)(5). But because these conditions use the defined-term "Company Material Adverse Effect," they incorporate all of the option-related carve-outs of the "Company Material Adverse Effect" definition.

The termination provisions in turn refer to events that would cause the conditions to the offer not to be satisfied. In so doing, the termination provisions indirectly – but equally effectively – incorporate the limitations and carve-outs of the "Company Material Adverse Effect" definition. Thus, the termination provisions allow HP to terminate "in the event . . . that any representation or warranty of the Company set forth in this Agreement shall have been inaccurate when made or shall have become inaccurate" – but only if the inaccuracy is "such that the conditions to the Offer set forth in clauses (C)(1) or (C)(2) of Annex A hereto, respectively, would not be satisfied as of the time of such breach or as of the time such representation and warranty became inaccurate." (§ 9.1(e).)

More substantively, where HP-Mercury Interactive and EMC-RSA diverge is in an additional condition to HP's obligations, which relieves HP from its obligations if --

> "(8) (x) the Company shall not have filed with the SEC its Annual Report on Form 10-K for its fiscal year ended December 31, 2005 (the "2005 Form 10-K"), and/or the 2005 Form 10-K, as so filed with the SEC, shall not comply as to form with the rules and regulations of the SEC applicable to annual reports on Form 10-K (including as a result of the absence of the financial statements required to be filed therewith) or (y) the 2005 Form 10-K shall fail to include: (1) an opinion of the Company's independent auditors relating to the financial statements of the Company for its fiscal

> years ended December 31, 2003, 2004 and 2005 included in the 2005 Form 10-K, which is not qualified because of a limitation on the scope of the audit and does not contain qualifications relating to the acceptability of accounting principles used or the completeness of disclosures made or with respect to "going concern"; (2) an opinion of the Company's independent auditors in respect of the Company's internal control over financial reporting at December 31, 2005; (3) the management certifications required by sections 906 and 302 of the Sarbanes-Oxley Act; and (4) the management assessments required by section 404 of the Sarbanes-Oxley Act."

Annex A condition (C)(8). This provision reflects that an element of risk was retained by the target (i.e., completion of the restatement of financial statements and delinquent SEC filings, auditor and SEC acceptance). Mercury's Schedule 14D-9 indicates that HP insisted on this condition from an early point in the two companies' discussions, and that Mercury initially resisted this condition.[6]

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[6] The 14D-9 discloses, among other things, that "[o]n March 1, 2006, Hewlett-Packard delivered to Mercury a preliminary non-binding term sheet, indicating . . . that the tender offer would be conditioned on the Company's filing of financial statements with the Securities and Exchange Commission (the "SEC") for all periods through the first quarter of 2005, including any required restatements of previously filed financial statements, and the completion of GAAP financial statements for each subsequent quarter of 2005. . . . At a meeting of the Mercury Board held later that day, . . . [t]he Mercury Board reaffirmed its prior conclusion that, in light of the uncertainty as to when the review of Mercury's financial statements would be completed, it would not be in the best interests of the Company and its stockholders to enter into an acquisition agreement that required completion of Mercury's financial review and the filing of restated financial statements with the SEC as conditions to closing. The Mercury Board determined that the conditions reflected in Hewlett-Packard's term sheet were not acceptable and authorized management, along with [outside legal counsel], to have further discussions with

As finally negotiated, the termination provisions of the agreement set an early initial checkpoint for possible termination at the three-month mark and an ultimate eight-month deadline for Mercury to complete its restatement and regain compliance with SEC filing requirements. Under these provisions, either party has the right to terminate if the first-step tender offer has not been completed within a little over three months -- by an "Initial Termination Date" of October 31, 2006. But either party also has the right to extend the termination date if "a condition to the Offer set forth in clause (A) or clause (C)(8) of the first paragraph of Annex A hereto shall not have been satisfied on or prior to the Initial Termination Date and all of the other conditions to the Offer set forth on Annex A hereto shall have been satisfied on or prior to the Initial Termination Date," but only one time and only until March 31, 2007. (By contrast, the EMC-RSA agreement has only a single termination date eight months after signing – February 28, 2007 – and no analog to condition (C)(8) of HP-Mercury Interactive.)

Mercury Interactive's Schedule 14D-9 cites the company's option-dating issues as a factor – in the first group of factors listed – in the board's recommendation of the HP offer.

> "In evaluating the Merger Agreement and the other transactions contemplated thereby, including the Offer and the Merger, and recommending that all holders of Common Stock accept the Offer and tender their Common Stock pursuant to the Offer and approve

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Hewlett-Packard and its counsel concerning the closing conditions and to report back to the Mercury Board. . . . On March 6, 2006, the Mercury Board reaffirmed at the meeting that the terms in Hewlett-Packard's non-binding term sheet of March 1 were not acceptable in light of the conditions to completion of the transaction relating to Mercury's filing of various financial statements with the SEC and the uncertainty as to when such financial statements would be completed, and directed that discussions with Hewlett-Packard be terminated."

the Merger and the Merger Agreement, the Mercury Board consulted with the Company's senior management and legal and financial advisors and considered a number of factors, including the following:

> Financial Condition and Prospects of the Company. The Mercury Board's knowledge and familiarity with the Company's business, financial condition and results of operations, as well as the Company's financial plan and prospects if it were to remain an independent company. The Mercury Board discussed and deliberated at length concerning the Company's current financial plan, including the risks associated with achieving and executing upon the Company's business plans, the competitive environment in which the Company operates, ***the timetable for becoming compliant with the reporting requirements under the Exchange Act, and the pendency of various litigation relating to the Company's past stock option practices and restatement of financial statements.***"

(Emphasis added.) The 14D-9 also cites the ability to extend the "drop dead date" as a further factor in the board's support for the transaction: "Under certain circumstances, Hewlett-Packard and Offeror are required to extend the Offer beyond October 31, 2006 to March 31, 2007, if certain conditions are not satisfied as of October 31, 2006."

SanDisk-msystems

The SanDisk-msystems merger agreement was signed two days after HP-Mercury Interactive. Like EMC-RSA and HP-Mercury, SanDisk-msystems relies heavily on MAE carve-outs to allocate the risk of option dating matters. The SanDisk-msystems definition follows:

"(f) "Material Adverse Change" or "Material Adverse Effect" means, when used in connection with the Company or the Parent, any change, effect, event, occurrence, condition, development or state of facts that (i) has a substantial, material and long-term adverse effect on the business, results of operations or financial condition of such party and its Subsidiaries, taken as a whole, ***other than any change, effect, event, occurrence, condition, development or state of facts arising from or relating to*** (A) general economic conditions, (B) the industry in which such party operates in general, (C) the negotiation, execution, announcement, pendency or performance of this Agreement or the consummation of the Merger or the other Transactions, including (1) the impact thereof on relationships, contractual or otherwise, with customers, suppliers, distributors or partners, and (2) any resulting shortfalls or declines in revenue, margins or profitability, but excluding for purposes of this clause (C) the departure of employees, (D) failure by such party to meet internal projections or forecasts, analyst expectations or publicly announced earnings or revenue projections, or decreases in such party's stock price (including as a result of failure to meet such projections, forecasts or analyst expectations), in and of itself (for the avoidance of doubt this clause (D) shall not preclude the other party from asserting that the underlying cause of any such failure or decrease in stock price is a Material Adverse Effect), (E) any declaration of war by or against, or an escalation of hostilities involving, or an act of terrorism against, any country where such party or its major sources of supply have material operations or where such party has sales, (F) changes in applicable Legal Requirements or in generally accepted accounting principles or accounting standards, or changes in general legal, regulatory or political conditions, ***(G) with respect to the Company, the matters described in Section 8.7(f) of the Company Disclosure Letter (the "Options Matters"), or any***

investigation, claim, suit, restatement, tax effect or any other matter arising therefrom or related thereto, (H) any claim or litigation arising from allegations of breach of fiduciary duty with respect to the Company or the Parent relating to this Agreement, the Merger or the other Transactions, or disclosure violations in securities filings made in connection with the Merger, (I) any action taken by Parent, the Company or any of their respective Subsidiaries as contemplated or permitted by this Agreement or with the Parent's consent, in the case of the Company, or the Company's consent in the case of the Parent, or any failure to take action which failure results from Parent's or the Company's, as the case may be, refusal to grant its consent to such action pursuant to Article 4, or (J) the failure to obtain the consent of a counterparty under any Contract listed in the Company Disclosure Letter in connection with the Transactions; or (ii) with respect to the representations and warranties contained in Section 2.1, 2.4, 2.19, 2.20, 3.1 and 3.3 and 3.9, that prevents the consummation of the Merger. ***Notwithstanding anything to the contrary contained in this Agreement, but without limiting the provisions contained in clauses (A) through (J) above, for purposes of determining whether the conditions set forth in Sections 6.3(a) or 6.3(c) have been satisfied and whether Parent may terminate this Agreement pursuant to Section 7.1(g), a "Material Adverse Effect" shall be deemed to have occurred with respect to the Company pursuant to clause (i) of the definition thereof if (and only if) the applicable change, effect, event, occurrence, condition, development or state of facts (or aggregation of changes, effects, events, occurrences, conditions, developments or states of facts) relates to the Company and its Subsidiaries and has resulted in or would reasonably be expected to result in aggregate liabilities (net of insurance coverage) to Parent or its Subsidiaries (including, for purposes hereof, the Surviving Company (or its***

Subsidiaries)) relating to the Company and its Subsidiaries and diminutions in the value of the Surviving Company (including its Subsidiaries) adding to $450,000,000 or more in the aggregate.

The SanDisk-msystems approach has elements in common with EMC-RSA (e.g., a brief but broad carve-out for what are called "Options Matters") and with HP-Mercury (cross-reference to the Company Disclosure Letter for elaboration on the scope of the carve-out of "Options Matters"), but it also diverges in significant respects (stock-for-stock, as opposed to cash), and it adds an element that does not appear in either EMC-RSA or HP-Mercury (namely, a specific dollar threshold in determining whether a Material Adverse Effect has occurred on msystems' business, results of operations or financial condition). The dollar threshold, moreover, was set at a significant portion of total deal value, which was variously reported at values ranging between $1.3 billion and $1.6 billion.

SanDisk's bringdown condition is subject to MAE baskets that effectively eliminate option-dating matters as a basis for SanDisk to refuse to close. At the same time, the structure of the transaction as a stock deal rather than a cash deal necessarily adds option-related conditions to the parties' closing obligations, since the issuance of stock requires either (i) an effective registration statement or (ii) exemption from the registration requirements under section 3(a)(10) of the Securities Act based on court approval of the merger in Israel, msystems' home jurisdiction. (§6.1(a).)[7]

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[7] "The respective obligation of each party to effect the Merger is subject to the satisfaction or waiver on or prior to the Closing Date of the following conditions: (a) (i) the Court Approval approving the Merger Proposal shall have been obtained, and (ii) if Section 5.2(f) applies, the Registration Statement shall have been declared effective by the SEC and no stop order suspending the effectiveness of the Registration Statement or any part thereof shall have been issued and no proceeding for that purpose and no similar

A registration statement would require the use of msystems' "Restated Financials" and would be subject to review and declaration of effectiveness by the SEC. Exemption from registration would require other "Company Disclosure Documents," which under the merger agreement must include msystems' "Restated Financials," with all SEC comments resolved[8].

These provisions do not, however, provide, a ready back-door exit from the transaction. Under the termination provisions of Section 7.1(b), the merger agreement can be terminated by either party "if the Merger shall not have been consummated by March 30, 2007 (the "End Date")," but the End Date is subject to open-ended extension. Thus, a proviso to Section 7.1(b) provides that "if the only condition to consummation of the Merger that has not been satisfied or waived (other than conditions that by their nature are to be satisfied at Closing which are reasonably expected to be satisfied by the End Date as it may be extended) is the condition set forth in Section 6.1(a)" – i.e., the requirement of Israeli court approval of the Merger or declaration by the SEC of the effectiveness of a registration statement for the transaction shares – "and such condition is not satisfied solely as a result of the Company's inability to finalize the Company Disclosure Documents (or Parent's inability to finalize the Registration Statement) due to a failure to complete any necessary Restated Financials and address to the satisfaction of the SEC any comments of the SEC related to any necessary Restated Financials, then, so long as the Company continues to use its reasonable best efforts to complete any necessary Restated Financials and resolve any such comments, as promptly as

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proceeding in respect of the Registration Statement shall have been initiated or threatened by the SEC."

[8] Section 5.1(b) provides that "The Company Disclosure Documents shall include: . . . (iii) the Restated Financials, which shall not be so included until any then outstanding comments of the SEC thereon shall have been resolved."

practicable, then the End Date shall be extended until the date that is 90 days after the Company is able to comply with the covenant set forth in Section 5.1(b)(iii)" – which provides that the Company Disclosure Documents must include the Restate Financials, with all SEC comments resolved.

On its face, the extension proviso of the SanDisk-msystems agreement appears to shift more option-related financial restatement risk to the buyer than the HP-Mercury agreement. At the same time, the risk of indefinite extension and delay appears to have been ameliorated by the fact that the "Restated Financials" had already been filed with the SEC.[9]

Verint Systems-Witness Systems[10]

Verint's acquisition of Witness Systems was announced on February 12, 2007, shortly after Witness Systems completed a restatement of its financial statements, an amendment of previous SEC filings, and the filing of delinquent SEC filings. At the time of deal announcement, all three parties had ongoing stock-option-dating matters: Witness Systems was subject to derivative and stockholder litigation and an informal investigation by the SEC; Verint was in the process of an option-related restatement, was delinquent in its SEC filings and had been delisted from the Nasdaq; and Comverse Tchnology, Verint's majority stockholder, was also in the process of an option-related restatement and was delinquent in its SEC filings and had also been delisted. In addition, three former senior

[9] "Restated Financials" means the Company's restated financial statements included in the Company's Form 20-F for the fiscal year ended December 31, 2005 filed with the SEC on July 17, 2006 (including the report of Ernst & Young, independent auditors to the Company, with respect to the audited consolidated financial statements included therein) and any further restatement of the Company's financial statements necessitated by the Options Matters.

[10] The author's law firm acted as outside counsel, and the author acted as lead outside counsel, to Witness Systems in this transaction. The matters described in this outline are limited to matters of public record.

Comverse executives had been indicted on criminal charges relating to option backdating, two had pled guilty, and one was a fugitive from justice. A number of aspects of the transaction are worth noting.

Risks related to option dating – The proxy statement indicates that the terms of the merger agreement relating option dating issues were a factor in the decision of the Witness Systems Board to approve the transaction:

> "In the course of reaching its decision to approve the merger agreement and the merger, our board of directors consulted with our management and our financial and legal advisors and considered a number of factors, including the following:
>
> . . . the terms and conditions of the merger agreement, including:
>
> - the absence of any financing condition to Verint's obligation to complete the merger and the strength of Verint's obligations to obtain funding under the debt and equity commitment letters;
> - the strength of Verint's obligations to obtain required approvals for the merger;
> - ***the definition of what would, and would not, constitute a material adverse effect as to us, and the exclusion of matters relating to stock option granting practices from our representations and warranties, meaning that the effect of any such matters would not be considered in determining whether certain conditions to Verint's obligation to complete the merger have been satisfied*** . . ."

The Merger Agreement in turn provides that for purposes of the Merger Agreement, the term “Company Material Effect” means --

> “any change, event, circumstance, effect, or development that has or would reasonably be expected to have a material adverse effect on (i) the business, assets, liabilities (contingent or otherwise), condition (financial or otherwise) or results of operations of the Company and its Subsidiaries, taken as a whole, or (ii) the ability of the Company to perform its obligations under this Agreement or consummate the transactions contemplated by this Agreement; provided, however, that none of the following, and no change, event, circumstance, effect or development resulting or arising from any of the following, shall constitute, or shall be considered in determining whether there has occurred, a Company Material Adverse Effect:
>
> (a) economic factors generally affecting the national, regional or world economy to the extent that such factors do not have a materially disproportionate affect on the Company or its Subsidiaries as compared to similarly situated companies in the industry in which the Company and its Subsidiaries participate;
>
> (b) factors generally affecting the industries or markets in which either the Company or any of its Subsidiaries operates to the extent that such factors do not have a materially disproportionate affect on the Company or its Subsidiaries as compared to similarly situated companies in the industry in which the Company and its Subsidiaries participate;
>
> (c) actions required by the parties pursuant to this Agreement or the pendency or announcement of the transactions contemplated by this Agreement, including actions of competitors or any delays or

cancellations of orders for products or losses of employees, provided, that, such actions would not result in a breach of the representations and warranties set forth in Section 3.4(b) and Section 3.4(c);

(d) any matters relating to or arising out of the matters described in the Forepart of the Company Disclosure Schedule or any of the proceedings, investigations, inquiries and claims regarding the Company's option grant practices described in Section 3.12 of the Company Disclosure Schedule, as well as any other matters relating to or arising out of the option grant practices that are the subject matter of such proceedings, investigations, inquiries or claims;

(e) any change in Law, rules or regulations;

(f) any change in generally accepted accounting principles or the interpretation thereof;

(g) any action required to be taken pursuant to or in accordance with this Agreement (including Section 6.5) or at the request of the Buyer;

(h) any fees or expenses incurred in connection with the negotiations leading to, or the transactions contemplated by, this Agreement;

(i) any failure by the Company to meet any projections, guidance, estimates, or forecasts for or during any period ending (or for which results are released) on or after the date hereof;

(j) any stockholder litigation arising from or relating to the Agreement or the Merger;

(k) any decline in the price of the Company Common Stock in and of itself (but not the underlying reasons for the decline thereof); or

(l) any outbreak or escalation of war, terrorism or armed conflict that directly or indirectly affects the business of the Company or its Subsidiaries, to the extent that such outbreak or escalation does not have a materially disproportionate affect on the Company and its Subsidiaries, taken together as a whole, as compared to similarly situated companies in the industry in which the Company and its Subsidiaries participate."

As in the SanDisk-msystems agreement, the Verint Systems-Witness Systems merger agreement refers to option-related matters disclosed in a "disclosure schedule" or "disclosure letter". The full precise scope of option-related risks allocated to the buyer therefore cannot be determined from the agreement or proxy statement in all details. At the same time, the description included in the proxy statement, the express wording of the MAE definition, and the wording of the MAE carve-out for option-dating matters all give an indication of the breadth of option-related risks allocated to the buyer. At the same time, the Verint-Witness deal was signed and announced *after* the completion of Witness Systems' option-related restatement and the filing of delinquent SEC filings; by contrast, the EMC-RCA, HP-Mercury and SanDisk-msystems transactions discussed above involved target companies that had not completed their pending restatements and were still delinquent in their SEC filings.

Transaction Structure – Other Option-Related Challenges: The transaction was structured as an all-cash deal, with no financing condition or "out," but because the full purchase price could not be financed from the buyer's balance sheet alone, the agreement contemplated both a debt financing by the buyer and an equity contribution to the buyer from the buyer's majority stockholder, Comverse Technology. As an all-cash transaction, the transaction as structured did not require a registration statement to be filed with the SEC, and as a one-step merger transaction (as opposed to a tender offer or two-step transaction), it did not require a tender offer filing with the SEC. In addition, no meeting of Verint stockholders was required, and there was no need for Verint to file a proxy statement with the SEC.

The transaction did, however, require approval of Witness Systems stockholders, which in turn entailed a proxy statement to be filed by Witness Systems. Given the structure of the transaction, buyer financial statements were not required by any line item of the proxy rules or Schedule 14A, and with no financing condition or "out," the parties would appear to have concluded that it was unnecessary to go beyond line-item requirements on this point and did not seek to include financial statement information concerning Verint or Converse in its proxy statement. Since both companies had restatements pending, requiring Verint's and/or Comverse's financial statements to be included in the proxy would either have not been possible, or would have required dispensation from the SEC to include non-GAAP-compliant financials, since GAAP-compliant financial statements were not available.

The Verint-Witness transaction demonstrates that it is possible, at least under certain circumstances, for buyers with pending option-dating investigations and pending restatements to successfully complete acquisitions, at least where the buyer can fund the transaction off its balance sheet or financing is available without full current GAAP-compliant financial statements.

Further Observations

None of these four agreements – EMC-RSA, HP-Mercury, SanDisk-msystems, Verint Systems-Witness Systems -- contains extensive new representations and warranties on option dating practices. This may reflect the allocation of risk in these agreements, or it may reflect a belief that existing representations and warranties already adequately address the major consequences of option dating issues.

Given the need to obtain sign-off from auditors on buyers', sellers' and combined companies' financial statements and internal controls, some lawyers have looked for precedent in the representations that auditors are requesting from the senior executives of audit clients.

> "All grants of share-based payments have been properly approved by the Board of Directors or its delegated representatives, and are in compliance with the terms of the plans from which they were granted. Delegation of the authority to grant share-based payments is within the Board's legal rights, and in accordance with the terms of the applicable share-based payment plans.
>
> "All share-based payments approved through the use of a unanimous written consent process were substantively approved by the appropriate authorized party on or before the measurement date or grant date used for accounting purposes under APB Opinion No. 25, Statement of Financial Accounting Standards No. 123, or Statement of Financial Accounting Standards No. 123(R), as appropriate. Dates indicated on all unanimous written consents represent the date the appropriate authorized party agreed to the corporate action indicated by the unanimous written consent. The requisite signatures required through the unanimous written consent process are considered perfunctory and, consequently, are

> obtained without changes to the terms of the previously approved awards.
>
> “The Company has properly determined the appropriate grant dates or measurement dates for all share-based payments in accordance with APB Opinion No. 25, Statement of Financial Accounting Standards No. 123, or Statement of Financial Accounting Standards No. 123(R), as applicable. The Company has recognized compensation cost, as well as liabilities for income taxes, payroll taxes, minimum tax withholding obligations, penalties and interest, as appropriate, under the applicable accounting standards.
>
> “Fair value and intrinsic value measurements under the applicable accounting literature are based on the grant date or measurement date share price as specified in such literature. The assumptions used in fair value measurements made in accordance with Statement of Financial Accounting Standards No. 123, or Statement of Financial Accounting Standards No. 123(R), represent the Company’s [management’s] [board’s] [compensation committee’s] best estimates as of the measurement date of expectations of future conditions.”

It remains to be seen whether more detailed option-related representations and warranties, either along the lines of the example above or along other lines, will appear in future transactions. At a minimum, such representations and warranties are likely to provide fodder for due diligence checklists.

Other Implications

The three agreements discussed in this outline focus heavily on MAE provisions, closing conditions and termination provisions, and, in the case of the lone stock-for-stock deal in the set, SanDisk-msystems, provisions affecting the issuance of stock in the transaction. These are not, of course, the only provisions that may be impacted or implicated by option-dating matters. Where the buyer is the company with option dating uncertainties, additional issues – practical as well as legal – are likely to arise or attract greater emphasis, including form of payment (cash versus stock, availability of registration statements, other means of liquidity, stock exchange listings); management focus and continuity; impact on employee retention and recruiting; ability to pursue additional acquisitions; continued ability to grant and exercise equity incentives; and other issues that are beyond the scope of the current outline.