

SOX and the Private Company

Private Company Corporate Governance: New Requirements, Evolving Standards and Best Practices

The recent revelations of corporate misconduct and criminal wrongdoing - and the Congressional enactment of the Sarbanes-Oxley Act - have led to heightened expectations regarding corporate governance for public companies. While the Sarbanes-Oxley standards largely are directed to public companies, some of the Act's changes also apply by their terms to *all* companies, public and private. In addition, changing expectations, developing case law, and a growing appreciation for the benefits of adopting "best practices" are further affecting governance standards for private companies.

This article reviews the Sarbanes-Oxley provisions that expressly apply to all companies, public and private, and then reviews the reasons why other public company governance requirements increasingly are being applied to private companies.

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Sarbanes-Oxley Requirements Expressly Applying to Private Companies

For the most part, the Sarbanes-Oxley Act's governance reforms and procedural requirements are applicable only to corporate issuers of securities registered under the Exchange Act. However, certain Sarbanes-Oxley provisions broaden the scope of liability or increase penalties for officials at any company, public and private, for activities that interfere with the enforcement of federal laws and regulations.¹

- ☛ **Criminal Liability for Document Destruction:** Sarbanes-Oxley provides criminal penalties for anyone who intentionally destroys, alters or falsifies records or documents with the intent to impede or otherwise influence a federal agency investigation (such as an EEOC or IRS matter) or bankruptcy proceeding. Penalties include up to 20 years' imprisonment, fines or both.
- ☛ **Liability for Retaliation against Whistleblowers:** Sarbanes-Oxley makes it a crime punishable by a fine and up to ten years in prison to knowingly retaliate against any person who provides a law enforcement officer truthful information relating to the commission or possible commission of any federal offense.

The Sights

Inside:

Evolving Standards
Page 2

Practical
Considerations for
Private Companies
Page 4

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- Increased Penalties for White Collar Crime:** Sarbanes-Oxley increases the monetary penalties and prison sentence for fraudulent violations of ERISA reporting and disclosure requirements and increases the maximum prison sentence for mail and wire fraud from five to 20 years.
- Blackout Notice Requirements:** Department of Labor rules issued under Sarbanes-Oxley require 401(k) plan administrators to give employees 30 days' advance written notice of any suspension of trading in an account or of access to funds in the account for more than three business days and authorizes civil penalties for failure to provide timely notice.

Other Sarbanes-Oxley provisions that are not necessarily limited by their terms to public companies include the lengthening of the statute of limitations for a private securities action and the Act's provision that liabilities for violations of the federal securities laws are not dischargeable in bankruptcy.

Evolving Standards

While most of Sarbanes-Oxley's other provisions are directed specifically toward public companies, the Act's reforms increasingly are the benchmark against which all corporate financial reporting and governance practices are measured. In a recent private company survey 86% of respondents said that Sarbanes-Oxley or other corporate governance reform requirements have impacted their companies.² The motivations for private companies to adapt to the new standards arise from a variety of sources and for a variety of reasons.³

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Third Parties: Key business partners may insist on certain compliance and governance practices as a precondition to instituting or continuing their relationship with the private company:

- A lender may require independent directors and an independent audit committee before approving a loan;
- A potential candidate for the board may require the adoption of certain governance measures as a condition to his or her agreement to go on the board;
- State and federal governments may require a broad range of assurances from private companies involved in government procurement activity;
- Auditors, conscious of their increased exposure in the new environment, may exert pressure on the private company clients to adopt new reporting and governance practices;
- Prospective investors in a private placement of securities increasingly will insist on audited financials, assurances of auditor independence and the inclusion of Management Discussion and Analysis ("MD&A") to explain financial statements.

Business Strategy: Some private companies' business strategies will militate more directly in favor of accelerated adoption of a broader range of Sarbanes-Oxley requirements:

- *IPO Companies:* Companies planning a public offering may advance their interests by accelerating their state of Sarbanes-Oxley readiness. Accelerating the compliance process assures that they will have the governance foundation in place when compliance is required. Indeed, Sarbanes-Oxley compliance also could impact IPO valuation or timing to market.
- *Acquisition Candidates:* A private company's financials, sophistication and internal controls may be a material issue in a public company's decision whether to acquire the private company. A target company's adaptation to Sarbanes-Oxley requirements may significantly reduce the acquirer's risks associated with consummating the deal, particularly with regard to realizing the appropriate value for the business and reducing post-deal disruptions.

Case Law: As Sarbanes-Oxley has established higher standards of conduct in matters such as board independence, financial statement review, insider transactions and disclosures, these higher standards are likely to affect the legal duties of directors and officers of private companies. Evolving case law suggests that courts have begun to elevate private company standards to public company corporate governance levels.⁴ For example, in *John S. Pereira (Trustee of Trace International Holdings, Inc.) v. Cogan, et al.*,⁵ a federal judge in the Southern District of New York applying Delaware law extended traditional public company governance standards to a private company. The judge held several directors and officers liable for damages for breaches of fiduciary duties in their roles at an insolvent private company, for their failure of oversight concerning a number of the company's CEO's self-dealing transactions.

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Among other findings with Sarbanes-Oxley echoes, the court concluded that the company's compensation committee was insufficiently independent of the CEO and that several officers and the company's general counsel should have known about and reported to the board certain loans and other self-dealing transactions. The court also complained that the board had failed to establish reporting and monitoring systems, codes of conduct and compliance policies.

Best Practices: Some private companies are finding that the new corporate governance environment provides them an opportunity to outperform their competitors. The best practices associated with the new governance standards can help private companies' owners to protect and preserve their wealth and can contribute to more efficient and effective business processes and even increased profitability. Well-documented governance practices can help attract capital or credit at lower cost, safeguard the company against misappropriation of assets, and increase credibility with

regulators and third-party business partners. For that reason, many private companies are voluntarily choosing to adopt corporate governance best practices for the benefit of their own enterprise.

Practical Considerations for Private Companies

While adopting all of Sarbanes-Oxley's requirements would be impractical for all but the largest private companies, there are many aspects of the Act's requirements that may benefit private companies. Not all of these requirements and standards fit all private companies equally; private companies must decide what makes sense for them. In general, well-advised private companies will be guided by the principal objectives of governance reforms – independence, improved performance and enhanced disclosure. Private companies, particularly those with a broad shareholder base or that expect to go public or sell to a public company in the future, may wish to consider discussing the adoption of the following measures with their outside counsel:

Independent Directors: Many private companies lack directors who are independent of the company's management. Adding independent directors will, among other things, improve audit and compensation committee functioning.

Audit Committee: An audit committee with independent members will improve financial reporting and oversight. Some private companies might also consider including a financial expert on the audit committee and adopting an audit committee charter that specifies that they will follow rules and procedures similar to those that public company audit committees are now required to follow.

Internal Accounting Controls: Periodic reviews of the adequacy and scope of internal controls and their implementation are prudent practices for any company. An adequate system of internal controls will deter disloyal or negligent employee conduct. Additional benefits of addressing control issues may include reducing errors, increasing service quality, and improving processes.

Inclusion of Financial Statement MD&A: The incorporation of MD&A into financial statements will improve transparency around the company's critical accounting policies and encourage clearer financial statements. Private companies might consider adding MD&A to accompany their financial statements after having the draft MD&A reviewed by experienced counsel, to provide management's assessment of the company's performance, trends in the business and the effects of critical accounting policies.

Auditor Review: Auditor independence is a critical consideration within the larger topic of auditor integrity and reliability. Private companies or their audit committees may consider prohibiting their auditing firm from performing certain non-audit services (including investment advice, appraisal, internal audit or legal services).

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Codes of Business Conduct: Private companies facing allegations of corporate misconduct will have stronger defenses if they can demonstrate that they adopted a code of business conduct and ethics that they diligently attempted to follow. The code would encourage senior management to comply with applicable laws and deter wrongdoing. It is important to ensure that employees are advised of the code and that it is enforced.

Insider Transactions: Private companies may consider the adoption of policies requiring that all transactions involving officers, directors and significant shareholders are “arms-length” transactions. In addition, companies contemplating an IPO or sale to a public company might consider prohibiting transactions that are barred by Sarbanes-Oxley, such as loans to officers or directors.

Conclusion

Even though most of the corporate governance reforms and procedural requirements in the Sarbanes-Oxley Act target public companies, evolving governance standards and requirements are affecting the way many private companies conduct themselves. Changing expectations and developing case law will encourage many private companies to adapt to these new standards. Well advised companies will consider taking steps now to make appropriate changes with an eye to best practices in corporate governance.

¹ “The Impact of Sarbanes-Oxley on Private Companies,” *Perkins Coie Update*, <http://www.perkinscoie.com/content/ren/updates/corp/091604.htm> (Sept. 16, 2004).

² Paul D. Broude, “The Impact of Sarbanes-Oxley on Private and Nonprofit Companies,” *Foley & Lardner*, http://www.foley.com/files/tbl_s31Publications/FileUpload137/3261/ndi%202006%20private%20study.pdf (March 9, 2006).

³ Andrew G. Humphrey, “The Effect of Sarbanes-Oxley on Private Companies,” *Faegre & Benson*, http://www.faegre.com/articles/article_838.aspx (March 12, 2006).

⁴ Glynn D. Key, Jonathan Wolfman, “Private Company Corporate Governance: Closing the Gap with Public Companies,” *Wilmer Hale*, <http://www.wilmerhale.com/files/Publication/50677c14-1cb8-4f83-8222-106c50ccc246/Presentation/PublicationAttachment/ce1b2d3c-aa91-439c-984d-195a69bd6c6a/CorpSecLit.pdf> (Oct. 18, 2005).

⁵ 2003 WL 21039976 (S.D.N.Y. 2003). The trial judge’s decision was reversed and remanded on procedural grounds by the Second Circuit, but the case nevertheless increasingly is regarded as a significant precedent regarding the adaptation of private company companies’ corporate governance standards to those of public companies. *See Pereira v. Farce*, 413 F. 3d 330 (2nd Cir. June 30, 2005).

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