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CLIENT ADVISORY

The Effects of the Sarbanes-Oxley Act of 2002 on Private Companies

The most sweeping accounting and corporate governance reform legislation to impact public companies in nearly 70 years was enacted in July 2002 in response to various high profile corporate and accounting scandals and frauds. Although most of the Sarbanes-Oxley Act of 2002 (the "Act") directly impacts only public companies, their accountants and lawyers, private companies will be affected directly by several of its provisions and indirectly by the cultural changes that have resulted from it.

To Whom Does the Act Apply?

Most provisions of the Act apply to "issuers" or those serving issuers, such as audit committees of issuers, auditors and attorneys. The Act defines issuers to include not only public companies, but also companies that have filed registration statements, as well as companies required to file periodic reports under the federal securities laws. It does not distinguish among companies based on size or whether domestic or foreign. A company thinking of going public in the foreseeable future must be aware of how the Act would affect it because upon the filing of a registration statement, that company would immediately become subject to *all* of the provisions of the Act. A company that has filed a registration statement but no longer intends to go public will nonetheless be subject to the Act until it formally withdraws the registration statement. In addition, a private company that is acquired by a public company will also indirectly become subject to the Act. For a summary of the Act, see the August 2002 ZAG/S&W LLP client advisory: "The Sarbanes-Oxley Act of 2002: Reforms in Corporate Governance, Accounting and Disclosure," available at www.zag-sw.com.

If a Company is Not Public or Going Public, How Does the Act Affect It?

a. *Some Provisions Directly Apply to Private Companies.*

New Penalties for Retaliation Against Whistleblowers. The Act provides for fines or imprisonment to be imposed against any person who knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with employment or the person's livelihood, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense. This section of the Act is not limited to type of federal offense or type of law enforcement officer.

New Penalties for Destroying Documents. Destroying, altering, mutilating, concealing, covering up, falsifying or making a false entry in any record, document or tangible object with the intent to impede, obstruct or influence the investigation or proper administration of any matter within the jurisdiction of any federal agency or department or in any bankruptcy case can now result in fines or imprisonment for up to 20 years. Similarly, if any of these actions is taken with the intent to impair the object's integrity or availability for use in an official proceeding, the offender will be subject to the same types of punishment. These penalties emphasize the need for effective, well-understood company-wide document retention and destruction policies, even for private companies.

Notice Requirement for ERISA Plan Blackout Periods. The Act amends ERISA by requiring administrators of ERISA plans (e.g., 401(k) plans and pension plans) to notify plan participants and beneficiaries who are affected by any blackout period with respect to an individual account plan. Notice must be furnished at least 30 days in advance of the blackout period. The notice must be written in plain English and include the reasons for the blackout, an identification of the investments and other

rights affected, the expected beginning date and length of the blackout period, and a statement that the participant or beneficiary should evaluate the appropriateness of his or her current investment decisions in light of the inability to direct or diversify assets credited to his or her accounts during the blackout period. A blackout period is defined as any period for which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of such plan, to direct or diversify assets credited to their accounts, to obtain loans from the plan, or to obtain distributions from the plan is temporarily suspended, limited or restricted, if such suspension, limitation or restriction is for any period of more than three consecutive business days, with some delineated exclusions. These requirements will be effective sometime in January 2003. In the meantime, the U.S. Secretary of Labor has issued interim rules and is required to issue model notices. Plan administrators could be subject to fines of up to \$100 per participant or beneficiary per day for failure or refusal to provide notice. The Act also increases penalties for other violations of ERISA.

Statute of Limitations for Securities Fraud Extended; Other Criminal Penalties Increased. The Act increases the statute of limitations for securities fraud lawsuits to two years after the discovery of the facts constituting the violation or five years after the violation. Private companies are subject to the antifraud rules of federal securities laws when they engage in any offering of securities, even if the offering is completely private. In addition, debts resulting from a violation of any of the federal or state securities laws or regulations or from common law fraud, deceit or manipulation in connection with the purchase or sale of any security will no longer be dischargeable in bankruptcy proceedings. The Act also creates new criminal fraud offenses and increases the criminal penalties for mail and wire fraud.

b. *The Act is Creating "Best Practices" That are Subject to Due Diligence By Venture Capitalists, Potential Investors, Lenders, Business Partners and Others.*

Although most of the Act does not directly apply to private companies, many entities that work with private companies are viewing the dictates of the Act as "best practices" that should be followed, even if not required. For example, lenders to private companies may more closely scrutinize the makeup of the board of directors or audit committee of a private company or a company's internal controls and procedures when arranging or renewing a credit facility. Similarly, venture capitalists, investment banks and other investors are performing increased due diligence in response to specific items under the Act such as reviewing any loans to directors and officers, auditor independence and codes of ethics. Potential merger partners are also adding many Act-related items to their standard due diligence of private companies. For example, acquirors may want to make sure a potential target has in place processes, policies and procedures called for by the Act that will transition well to the acquiror's own processes backing up its financial statements or the CEO and CFO certifications filed by public companies under the Act. Insurance companies have begun adding corporate governance and financial reporting items to their risk assessment of customers. Insurance companies are also dramatically increasing premiums for director and officer insurance for all companies as a result of increased exposure under the Act and the current regulatory and scandal-ridden economic climate. As a result of the Act and the Arthur Andersen conviction, auditing fees, even for private companies, will likely increase. Auditors will be required to perform more services under updated accounting standards. Potential directors, even for private companies, are indicating greater reluctance to serve on boards that don't have sound corporate governance structures and policies, strong financial processes and sufficient director and officer insurance coverage.

As referenced above, the Act bans issuers from directly or indirectly making, arranging for or renewing an extension of credit in the form of a personal loan to executive officers and directors. This prohibition can be read quite broadly and some have argued that it could prohibit practices such as cashless exercises of stock options and split dollar life insurance policies. It is not unusual for private companies to make loans to executives or directors. For example, private companies often allow executives to pay for a portion of the purchase price of shares of stock with a promissory note. As noted above, the term issuer can encompass a company in the process of going public. Upon filing a registration statement, a private company may not have any loans to executive officers or directors, no matter how small or whatever the purpose. In addition, if a private company employee will become an executive officer or director of a public company in a merger, the same concerns will arise. Investors in private companies that have an IPO or merger with a strategic partner as an exit strategy need to be aware that loans made to executive officers and directors while the company is private will need to be unwound or paid off before it goes public or is

acquired by a public company. This could have adverse accounting consequences and negatively impact the company's financial statements. Loans to employees who might later become executive officers or directors need to be considered also. Investors may also disfavor these loans as a general matter due to the corporate governance implications of such related-party inside transactions. For a summary and discussion of the prohibited loans, see the August 2002 ZAG/S&W LLP client advisory: "Prohibition on Personal Loans Under the Sarbanes-Oxley Act of 2002: Cashless Exercises and Other Potential Pitfalls," available at www.zag-sw.com.

Private companies should also carefully review their board of directors and committee structures. Proposed New York Stock Exchange and Nasdaq listing standards would require a majority of the board to be independent. The definition of independence would be expanded to exclude many persons receiving payments from the company directly or indirectly, former partners of auditors who worked on the audit, family members of officers and many others. In addition, these requirements would look back as much as five years to exclude former officers or auditors from being deemed independent. As noted above, potential directors have become more reluctant to serve on boards of directors, even more so for public companies than private companies. A private company that has a board composed mostly or entirely of non-independent directors will have a difficult time recruiting a requisite majority in time for initial listing on a stock exchange if it does not start the process early. As private companies grow, they should begin to consider gradually adding outside directors to their boards.

Similarly, the Act, SEC regulations and stock exchange listing standards will increase independence requirements and the responsibilities applicable to members of public company audit committees, compensation committees and nominating committees. Audit committee independence requirements for public companies may prevent representatives of large stockholders, such as venture capital firms, from being deemed independent. Public companies will also need to disclose whether their audit committee members are "financial experts," a narrowly defined term that will require significant accounting background and experience.¹ This may further narrow the pool of available qualified audit committee members. Larger private companies should strongly consider as a "best practice" establishing audit committees with at least some independent directors as members, and consider creating other independent committees to review executive compensation and board composition. Audit committees should be directly responsible for the oversight, appointment, compensation, retention and termination of the outside auditors. Due to the increased scrutiny of audit committees, private company audit committees should as a best practice become actively involved in overseeing the outside auditors and the financial statements and have an active dialogue with the outside auditors, management, and any internal audit staff. Public company audit committees will be required to establish procedures to handle complaints regarding accounting, internal accounting controls and auditing matters. Private companies may want to do the same. This will also create a monitoring process that may prevent publicly embarrassing disclosure by a whistleblower by addressing problems earlier and allowing for the correction or punishment of ongoing improprieties.

Other requirements under the Act and related rules that will affect public companies that private companies may want to consider as best practices now include:

- establishing codes of conduct and business ethics and processes for granting waivers thereunder,²
- creating formal disclosure controls and procedures for ensuring that information publicly released (such as in press releases) is complete and accurate,
- providing greater disclosure when publicly released information includes non-GAAP financial information or information about unconsolidated or off-balance sheet entities with which the company is involved,

¹ For a discussion of the proposed SEC rules relating to financial experts, see the October 2002 ZAG/S&W LLP client advisory: "SEC Proposes New Disclosure Regarding Financial Experts, Internal Controls and Codes of Ethics," available at www.zag-sw.com.

² For a discussion of the proposed SEC rules relating to codes of ethics, see the October 2002 ZAG/S&W LLP client advisory: "SEC Proposes New Disclosure Regarding Financial Experts, Internal Controls and Codes of Ethics," available at www.zag-sw.com.

- obtaining stockholder approval of option plans and amendments. While many public company option plans could previously be established or amended with the approval of only the board of directors, new stock exchange requirements will require most to be approved by stockholders and will limit brokers' ability to vote on such plans and amendments without client instructions. As a private company, stockholder approval may be much easier and less expensive to obtain,
- restricting the types of non-audit services performed by the outside auditors consistent with the new restrictions on public company auditors designed to prevent conflicts of interest and impairment of independence. For private companies, however, the cost-savings and efficiency of using one firm to perform both audit and non-audit services may outweigh the benefits of separating the services. The services will need to be separated, however, before the company becomes an "issuer,"
- having the audit committee pre-approve all non-audit services performed by the outside auditors, and
- having an independent board committee pre-approve any transaction with a director, officer, affiliate or other related party.

Private companies should consider carefully reviewing the independence of their outside auditors, as well as the internal procedures and policies of their outside auditors' firm. Companies may want to consider whether rotation of auditors or audit partners is helpful to ensure independence and whether hiring policies for former employees of the auditing firm are appropriate. Proposed SEC rules under the Act would require that no accounting firm partner work on an audit for a company for more than five consecutive years. This could be a problem for a company about to file a registration statement that has had the same audit team for many years, as the rules will look back five years and cover even the period that the company was private. In addition, under proposed SEC rules under the Act, an auditing firm will not be independent if the company's CEO, CFO, chief accounting officer or controller was employed by the outside auditor and worked on the audit within the last year.

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The Sarbanes-Oxley Act of 2002 provides numerous changes to existing law which not only affect public companies, but also impact private companies. This advisory addresses the most significant elements of the Act and related rules affecting private companies. For a more comprehensive discussion of the topics covered in this advisory, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or the lawyer below.

Howard E. Berkenblit
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