WILMER, CUTLER & PICKERING

Corporate Law Developments NEWSLETTER

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THE POTENTIALLY NARROWING DISTINCTION BETWEEN PUBLIC AND PRIVATE COMPANIES

The Sarbanes-Oxley Act[1] has spawned speculation about whether more companies will go private to avoid the Act's new disclosure requirements but a more interesting issue is how Sarbanes-Oxley might narrow some of the differences between public and private companies. The once broad demarcation between public and private companies is thinning. In the area of public disclosure and reporting requirements, the distinction between a public company and a private company remains wide. But the once broad demarcation between public and private companies is narrowing in the corporate governance arena. That delineation between public and private companies may now shrink further as a result of new requirements related to the Sarbanes-Oxley Act, market forces, the New York State legislature and a recent federal court decision. All of these may dramatically affect corporate governance standards of private companies, bringing them closer to the standards applicable to public companies.

Who should care about the thinning line between public companies and private companies?

- Private companies
- Private equity firms
- Public companies with equity positions in, joint ventures with, and/or representation on private company Boards of Directors

Sarbanes-Oxley and Beyond

The vast majority of the provisions of Sarbanes-Oxley, its implementing regulations and the related new exchange listing standards[2] apply only to public companies, however, certain aspects of Sarbanes-Oxley apply directly to private companies. For a variety of reasons, the marketplace may eventually demand that private companies adopt certain public company Sarbanes-Oxley corporate governance features, as these features become best practice standards.

Direct Application to Private Companies

- Signature for Federal Tax Returns
- New and Enhanced Criminal Penalties
- ERISA Notification
- Whistleblower Protection

Potential Market Implications for Private Companies

- Officer Certifications
- Internal Controls
- Independence Requirements for Directors
- Independence Requirements and New Authority for Audit Commitees
- Approval of Related Party Transactions

Sarbanes-Oxley: Direct Application to Private Companies

The Sarbanes-Oxley Act imposes the following obligations or penalties on private companies:

- *CEO Certification of Tax Returns.* The language in Sarbanes-Oxley is not an affirmative obligation but does state that "[i]t is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation."[3] This proclamation was not limited to public companies.

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[1] Sarbanes-Oxley Act of 2002, Public Law 107-204, July 30, 2002, 116 STAT 745.

[2] New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotation (NASDAQ).

[3] 116 STAT 807, § 1001.

- *New and Enhanced Criminal Penalties.*

  - *Documents:* Sarbanes-Oxley includes a new criminal provision that subjects to criminal prosecution any person who "knowingly alters, destroys, mutilates, conceals, covers, falsifies, or makes a false entry" in any record or document "with the intent to impede, obstruct, or influence" a federal investigation or bankruptcy. This criminal provision, not limited just to public companies, applies to (a) a private company that is the subject of a federal agency investigation as well as (b) any private company that is a customer, vendor or partner with another company, public or private, that is being investigated by a federal agency.

  - *Enhanced Penalties:* Certain existing criminal penalties for mail fraud, wire fraud and ERISA are increased in terms of maximum years of imprisonment and the amount of fines.

  - *ERISA Notification:* Private companies with retirement and profit sharing plans subject to ERISA must provide participants and beneficiaries with at least thirty (30) days notice of any blackout period. A blackout period is defined as "any period for which the 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" for more than three (3) consecutive business days.[4] This requirement would be triggered if a private company needed to freeze a plan in order to change plan administrators or consolidate plans after a merger or acquisition.

  - *Whistleblower Protection:* Sarbanes-Oxley imposes new criminal penalties for retaliation against informants of securities law violations by a public company. The protected informants include the employees of contractors, subcontractors and agents of a public company. If a private company is a vendor or in a joint venture/strategic alliance with a public company, then the private company's employees may be in the class protected by the whistleblower provisions. This whistleblower protection would only be of significance if the private company engaged in retaliation that aided and abetted the public company's securities law violation.

Sarbanes-Oxley: Potential Market Implications for Private Companies

The marketplace can be a more powerful regulator than a federal statute. There are reasons to believe that market forces could begin to impose on private companies some of the new corporate governance requirements and/or principles of Sarbanes-Oxley. The new corporate governance regime under Sarbanes-Oxley is based upon, among other things, the following themes:

- Board of Directors Independence from Management
- Audit Committee Independence and Increased Authority
- Senior Management Accountability

Specifically, Sarbanes-Oxley, its implementing regulations and related proposed exchange listing requirements, among other things:

- Create new certification requirements for CEOs and CFOs
- Create new financial reporting requirements for issuers
- Require that the majority of directors be independent
- Require that director nominations and compensation decisions be conducted by independent directors
- Require that Audit Committees be composed of directors who meet a heightened test of independence
- Empower Audit Committees to hire outside counsel and other advisers
- Require that Audit Committees to establish a process to hear complaints and reports regarding accounting and auditing concerns
- Require more rapid disclosure of certain events and new disclosure of insider transactions
- Mandate disclosure of codes of ethics for financial officers, and, perhaps more important, specific waivers for any departures from such codes

[4] 116 STAT 780, § 306(b).

Even though the vast majority of the Sarbanes-Oxley Act applies by definition only to public companies, there is reason to believe that market forces may require that private companies adopt at least some of the corporate governance reforms the Act has generated. For example:

- Lenders: Commercial lenders may require that borrowers adopt some of the Act's requirements for (i) Board of Directors independence; (ii)Audit Committee independence, authority and competence; (iii) internal controls; and/or (iv) senior management accountability.

- Private Capital Market: Private equity and other institutional investors may incorporate Sarbanes-Oxley standards as components of their investment guidelines. Relatedly, the salability and liquidity of private equity or debt may be affected by whether or not a private company complies with Sarbanes-Oxley produced corporate governance best practices. These key features are most likely to be requirements for (i) Board of Directors independence; (ii) Audit Committee independence, authority and competence; (iii) senior management accountability; and/or (iv) disclosure of related party transactions.

- D&O Insurance: Insurance providers may require financial statement certifications as a condition for director's and officer's coverage.

Potential State Sarbanes-Oxley Statutes

The New York State Attorney General has introduced several bills in the state legislature that would apply the following features of Sarbanes-Oxley to private companies, both non-profit and for-profit, incorporated in or registered to do business in New York:

- Protecting Whistleblower Employees Who Report Illegal Activities

- Preventing Securities Fraud

- Preventing Evidence Tampering

- Preventing Corporate Bribery

- Improving Oversight Over Accountants

Private Company Director and Officer Liability: Pereira v. Cogan

In May 2003, a federal judge in the influential Southern District of New York issued an opinion in John S. Pereira (Trustee of Trace International Holdings, Inc.) v. Cogan et. al.,[5] applying Delaware corporate law that extended to a private company Board of Directors and officers the traditional public company standards for corporate governance. While there are reasons to believe the decision is limited in its general application (the company at issue was a holding company with a material position in a public company, the trial judge's decision is on appeal, and it is only one federal district judge), this case may prove to be a significant precedent regarding merging of public company and private company corporate governance standards.

In Pereira, the judge held several officers and directors liable for damages for breaches of fiduciary duties in their roles at an insolvent private holding company and for their failure of oversight concerning a number of self-dealing transactions by the company's chief executive officer. Some of the trial judge's findings appear to hold the private company officers and Board of Directors to fiduciary standards that have been more traditionally applied to officers and directors of public companies. For example, the following court findings echo the corporate governance themes of the Sarbanes-Oxley Act:

- Failure of Compensation Committee to Be Independent: The court faulted the Compensation Committee (i) for not being composed of completely independent directors and (ii) for not hiring outside consultants to establish the CEO's compensation, which the court found to be excessive. The court noted that all but one of the Compensation Committee members was an employee and even the non-employee was a long time business associate and personal friend of the CEO. The court's ruling was not based upon any requirement in the Delaware General Corporation Law that requires that a private company have a certain number of independent directors, a Compensation Committee or a certain number of independent directors on the Compensation Committee.

- Senior Management Accountability: The court imposed liability on senior management based in part on its conclusion that certain officers should have known about unauthorized loans to insiders and/or reported them to the Board of Directors. In addition, the court held that the company's general counsel failed in his obligation to discuss with the Board of Directors its duty (i) to establish a compliance and monitoring program or an Audit Committee; (ii) to supervise and evaluate the CEO; and (iii) to inform themselves about insider transactions with the CEO.

- Board of Directors Independence and Accountability: Liability for certain members of the Board of Directors was established by imputing knowledge to the directors of information found in

[5] Opinion dated May 8, 2003 (00 Civ. 619 (RWS), S.D.N.Y.) 2003 WL 21039976.

the company's audited financial statements. The court held that the Board of Directors could not shield itself from liability by relying on financial information provided by officers when that information was inconsistent with information in the company's audited financial statements.[6] In addition, the court found that the Board of Directors breached its fiduciary duties by failing adequately to play a "watchdog" role an Audit Committee is expected to play. In particular, the court complained that the Board of Directors had failed to establish (i) reporting and monitoring systems; (ii) codes of conduct; and (iii) compliance policies.

Time will tell whether state legislatures, courts and/or market forces will continue to shrink the boundary between public and private companies.

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[6] The court rejected the directors' defense in which they argued that they could rely upon the financial information presented by the company's officers under the safe harbor in Section 141(e) of the Delaware General Corporation Law: "A member of the board of directors ... shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees ..."

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