PRIVATE COMPANY CORPORATE GOVERNANCE: CLOSING THE GAP WITH PUBLIC COMPANIES

*By Glynn D. Key**

In 2003, in the wake of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or the Act), I raised the question of whether the once broad demarcation between public and private companies would be narrowing in the corporate governance arena. Looking at this issue in 2005, it is clear that market forces and recent case law have significantly impacted private companies by imposing public company like corporate governance standards created or enhanced by the Act.

These governance issues are relevant to companies that do not have immediate plans to go public as well as alternative corporate forms like limited liability companies (LLCs). LLCs can be subject to corporate governance standards because either the LLC operating agreement explicitly adopts the fiduciary duties imposed under a particular state corporation law (usually Delaware) or because emerging case law has begun to impose on LLCs certain corporation based governance standards such as the fiduciary standards for members, managers and officers of LLCs.

Market Forces

The corporate governance provisions of Sarbanes-Oxley and the related regulations adopted by the U.S. Securities and Exchange Commission and stock markets apply only to public companies. However, the marketplace can be a more powerful regulator than a statute. There are signs that market forces have begun to impose on private companies some of the new or enhanced corporate governance requirements and/or principles of Sarbanes-Oxley.

The new corporate governance regime is based upon, among other things, the following themes:

- Board of Directors' independence from management;
- Audit Committee independence and increased authority; and
- Senior management accountability.

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These themes are translated into the following specific requirements under Sarbanes-Oxley, its implementing regulations and related stock market listing requirements:

- Requirement that the majority of directors be independent;
- Requirement that director nominations and compensation decisions be overseen by independent directors;
- Requirement that Audit Committees be composed of directors who meet a heightened test of independence;
- Empowerment of Audit Committees to hire outside counsel and other advisers; and
- Requirement that Audit Committees establish a process to hear complaints and reports regarding accounting and auditing concerns.

While pre-IPO companies will begin complying with Sarbanes-Oxley as part of the going public process,[1] market forces are requiring non-IPO private companies of material size and/or significant equity interests to adopt at least some of the corporate governance reforms the Act has generated.

Acquisition Exit Strategy

If a private company's strategic plan contemplates the possibility of ultimately being acquired by a public company, the company will likely want to adopt some Sarbanes-Oxley inspired improvements relating to the maintenance of effective internal controls and procedures and compliance programs. Taking these steps should facilitate an acquirer's due diligence process and help facilitate integration into the public company's Sarbanes-Oxley compliance programs.

Private Equity Market

Private equity and other institutional investors have begun to incorporate Sarbanes-Oxley standards as components of their investment guidelines. These key requirements are 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

Sarbanes-Oxley has had a direct impact on the underwriting process for Directors and Officers (D & O) insurance. Specifically, underwriters are seeking greater disclosure of financial transactions, reviewing Board of Director and Audit Committee minutes and attendance reports and conducting due diligence on the independence of Audit Committee members.

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1. A pre-IPO company becomes an "issuer" under the Sarbanes-Oxley Act when it *files* a registration statement.

Non-Profits

Under pressure from the marketplace of best practices, non-profits have begun to adopt Sarbanes-Oxley produced corporate governance practices. For example, at colleges and universities, "[h]igh on administrators' radar screens is the 2002 Sarbanes-Oxley law. . .As nonprofits, the schools are not bound by the law, but most opted to follow its spirit by instituting stricter accounting oversight and accountability practices."[2] A recent news report indicated that as a direct result of the Sarbanes-Oxley Act, schools have adopted new measures such as having the audit committee report directly to the Board of Directors, enhanced accounting internal controls, and Board training on the requirements of the Act.

These market forces are not just responding to the best practices emanating from Sarbanes-Oxley, but also to recent case law. Recent decisions are beginning to lay the foundation under case law to elevate private company corporate governance standards to public company levels.

Case Law: Private Company Director and Officer Liability

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.*,[3] that extended to a private company traditional public company standards for corporate governance. While the reach of this decision is still evolving (the company at issue was a holding company with a material position in a public company and the trial judge's decision was reversed on procedural grounds by the Second Circuit[4]), this case may prove to be a significant precedent regarding the 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. For example, the following court findings echo the corporate governance themes of the 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

2. AU Scandal Atypical in the Post-Enron Era, College Presidents Say, Washington Post A18 (October 9, 2005).

3. 294 B.R. 449 (S.D.N.Y. 2003) (applying Delaware law).

4. Vacated and remanded subnom. *Pereira v. Farce*, 413 F.3d 330 (2nd Cir. 2005) (holding that defendant officers had a Seventh Amendment jury trial right to hear breach of duty of claims).

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 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. In addition, the court found that the Board of Directors breached its fiduciary duties by failing adequately to play the "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.

Since the district court's May 2003 decision, subsequent court and commentary have applied components of the *Pereira* corporate governance holdings to private companies.[5]

5. *Growe v. Bedard* 2004 WL 2677216 (D.Me. 2004) (citing *Pereira* for holding characterizing abdication of directorial duty as evidence of disloyalty); American Law Reports 3d., Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees (2005) (citing *Pereira* for "one means by which corporate director may [breach] his duty of care under Delaware law is by failure to monitor."); Venture Capital and Small Business Financing, Robert Hoyt Chapter 14 Due Diligence and Civil Liability (August 2005) 2A Venture Cap & Bus. Fin §14:65.50 (citing *Pereira* for holding that a general counsel who was not a director had breached his fiduciary duties of due care, loyalty and good faith for failure to advise board concerning its monitoring duties stating that the "the role of General Counsel is to advise the board as to its statutory obligations and provide guidance and recommend measures necessary to meet those obligations."); Breach of Fiduciary Duty as Securities Fraud: SEC v. Chanceller Corp., 10 Fordham J. Corp. & Fin. L. 439 (2005) (citing *Pereira* for the standards for duty of care); CJS Corporation §478 Particular Duties, §480 Affirmative Nature of Duty, Reliance, §483 Standard of Care (citing *Pereira* for breach of fiduciary duties by directors for failure to monitor corporate information and reporting systems).