

Sarbanes-Oxley and the Non-Public Company

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I. INTRODUCTION

An avalanche of publicity and commentary within the legal community followed last summer's adoption of the Sarbanes-Oxley Act of 2002. Adoption of the Act was in many respects a response to the burgeoning high-profile corporate scandals such as those involving Enron, WorldCom, Tyco, Adelphia and Global Crossing. However, the Act contains a number of concepts regarding corporate governance and accounting regulation that had been proposed even before these scandals became public.

The Act mainly applies only to corporations with a class of securities registered under the Securities Exchange Act of 1934, those required to file public reports under Section 15(d) of the Securities Exchange Act of 1933, and those with registration statements pending under the Securities Act. However, there are some provisions that are not limited to publicly-held companies. In addition, many of the concepts found in Sarbanes-Oxley may eventually be brought to bear on privately-held companies through state regulation, changes in delivery of accounting and auditing services, adaptation of bank lending covenants, insurance requirements and court decisions in state law fiduciary duty lawsuits.

II. BACKGROUND OF SARBANES-OXLEY

A. Adoption of Act

On July 30, 2002, President Bush signed Sarbanes-Oxley into law. The Act represents the most far-reaching and extensive amendment of Federal securities regulation since the adoption of the Federal securities laws seventy years ago. It includes a variety of regulations with differing scope and application. Some provisions of the Act became immediately effective upon its adoption, though most required SEC rulemaking for implementation. Some provisions apply to all companies with reporting obligations under the Federal securities laws and some only to companies with securities admitted to trading on national exchanges or Nasdaq. In this regard, the New York and American Stock Exchanges and the Nasdaq Stock Market have proposed extensive new rules that would apply many of the same principles found in Sarbanes-Oxley, and in some instances would go beyond those requirements.

The Act seeks to improve investor confidence by tightening government regulation of the accounting and corporate governance practices of public companies. The Act adds new regulation to the public accounting profession by creating a new, five-member Public Accounting Oversight Board. The Act is broad in scope and creates significant new requirements for public companies, their officers and directors, and the public accountants who audit public companies. Many of the Act's provisions require the SEC to adopt implementing rules, which has been occurring over the months since the Act's adoption.

The Act is significant not only because of its breadth and scope of topics but also because of the material shift it signifies in the balance of Federal and state regulation of corporations. Historically, substantive regulation of corporate procedure and governance has been the province of state regulation and the Federal securities laws have regulated disclosure. Indeed, some

previous attempts by the SEC to impose substantive regulation through rulemaking have been struck down by courts as exceeding the Commission's statutory authority. Sarbanes-Oxley demonstrates Congressional intent to move into the field of corporate governance regulation, at least for certain corporations.

B. Applicability of Act

The Act generally applies only to companies with reporting obligations under the Federal securities laws and to companies in the process of going public. Some of the provisions (such as those related to retaliation and record destruction, discussed below) apply to all companies whether public or private. Certain of the provisions (for instance, those applying to audit committee composition) are administered through the securities exchanges and Nasdaq and therefore apply only to publicly held companies with securities listed on or included in those trading forums.

C. Regulatory Provisions of the Act

Sarbanes-Oxley includes the following provisions:

- Audit Committee Requirements

Section 301 of the Act requires the exchanges and Nasdaq to adopt rules requiring that each listed company have an audit committee consisting solely of members who are independent. To be independent, audit committee members may not receive consulting, advisory or other compensatory fees (other than fees as a director or committee member) and they cannot be an "affiliated person" of the company or any of its subsidiaries.

The SEC has proposed rules to implement the audit committee requirements. These confirm the independence criteria for all members of a listed issuer's audit committee and in connection with the requirements of Section 301 would additionally:

- Require the audit committee to be directly responsible for the appointment, compensation, retention and oversight of the work of the issuer's external auditors.
- Require that the auditors report directly to the audit committee.
- Require that the audit committee establish procedures for receiving and handling complaints relating to accounting and auditing matters, including procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.
- Require that the audit committee have authority to engage independent counsel and other advisors, and require issuers to provide appropriate funding for their audit committees.

The rules would allow companies that first go public to have one non-independent audit committee member for a period of 90 days following effectiveness of their IPO

registration statement. They also contain an exemption that would permit one non-independent member of audit committees of foreign private issuers under certain circumstances and would completely exempt certain foreign private issuers who have “boards of auditors” or similar bodies established under home country regulatory requirements.

- Regulation of Public Company Auditors

Section 101 of the Act establishes a five- member Public Accounting Oversight Board. All accountants and firms that deliver audit reports for public reporting companies will be required to register with the Board. The Board will be responsible for establishing rules and standards regarding auditing practices, quality control, ethics and independence, will have responsibility for conducting periodic inspections of accountants registered with the Board and will conduct investigations and impose penalties for violations by registered members.

- Auditor Independence Requirements

Sections 201 through 206 of Sarbanes-Oxley also impose new requirements for independent auditors that audit financial statements included in SEC reports, and the SEC has adopted implementing rules. To retain their status as “independent,” auditors are forbidden from providing any of the following services to their audit clients:

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information system design and implementation;
- appraisal or valuation services or fairness opinions;
- actuarial services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit.

Beyond these, a registered public accounting firm may engage in other non-audit services, including tax services, only if the audit committee approves the activity in advance. Permitted tax services include tax compliance, tax planning and tax advisory services to clients but not acting as an advocate on the client’s behalf for tax matters (such as in tax court proceedings).

The Act and rules impose a mandatory five-year rotation schedule for the auditor’s lead and concurring partners on the client’s audit engagement team. Once those individuals have completed five years in such capacity, they may not again be involved with that client’s audit for five years.

An auditor further will not qualify as “independent” for a client’s audit if (i) any of the client’s management involved in overseeing financial reporting matters, within the one-year period preceding the commencement of the current audit, was a lead or concurring

partner on the audit engagement team, or another member of the team who provided more than ten hours of audit, attest or review services, or (ii) at any time during the audit engagement, any audit partner earns or receives compensation for procuring engagements for non-audit services.

The Act and rule require auditors to report to an issuer's audit committee on certain specified matters, including critical accounting policies and the effect of alternate treatments, and require issuers to disclose in their periodic reports the amount of fees paid to their auditors for audit, tax and non-audit services.

The purpose of these rules is to avoid situations in which auditors are beholden to audit clients for significant streams of income that might impair their objectivity in performing audit functions, and to avoid situations in which auditors are required to audit their own work performed in other capacities.

- Retention of Records

Section 802 of the Act and related rules require that accountants who perform an audit or review of an issuer's financial statements retain the records relevant to the audit or review for a period of seven years. The rule covers both written and electronic records and extends to workpapers, other documents forming the basis of the audit or review, and memoranda, correspondence, communications and certain other documents and records.

In addition, Section 801 of the Act makes it a felony to "knowingly" destroy or create documents to impede, obstruct, or influence an existing or contemplated federal investigation.

- Disclosures

Sarbanes-Oxley and related rules impose numerous additional disclosure requirements for SEC reports. Among these are:

- Sections 302 and 906 of Act and related rules require chief executive officers and chief financial officers of reporting companies to certify, among other things, that company filings under the Securities Exchange Act do not contain misstatements or omissions of material facts; that financial statements and other financial information included in the reports fairly represent the company's financial condition; that they have designed the issuer's internal controls to ensure that material information concerning the company is made known to the signing officers; and that they have evaluated the effectiveness of the company's "disclosure controls and procedures" within 90 days prior to the certification. These rules replaced earlier proposals by the SEC that would have required certifications only for larger reporting companies.¹

¹ False certification is a criminal offense under Section 906, which can result in fines of \$1million and prison sentences of up to 10 years, or \$5 million in fines and 20 years in prison if the action is willful. The SEC commenced its first enforcement action under this provision onenforcement action under this provision on March 19, 2003 in proceedings relating to accounting fraud at HealthSouth Corp.

- Section 401(a) of the Act and related rules relating to disclosure of off-balance sheet arrangements and aggregate contractual obligations. An issuer's disclosure documents must include a separately captioned discussion as part of Management's Discussion and Analysis explaining off-balance sheet arrangements, a term defined in the rules. Issuers (other than small business issuers) will also be required to present an overview of certain known contractual obligations in tabular format. The rules relating to off-balance sheet arrangements will require disclosures in documents relating to fiscal years ended after June 15, 2003, while those requiring a tabular overview of contractual obligations will require disclosure in documents relating to fiscal years ending after December 15, 2003.
- Section 406 of the Act and related rules 10 require issuers to disclose whether they have codes of ethics for their principal executive officers, principal financial officer, and principal accounting officer or controller or persons performing similar functions. Issuers adopting such codes must make them publicly available and must disclose any changes to or waivers of the code within five days of occurrence, by filing a report on Form 8-K or by posting on the company website.
- Section 407 of the Act and related rules 11 requires issuers to disclose whether their audit committees include an audit committee financial expert and if not, why not. The rules define the term "audit committee financial expert," including the capabilities that such an expert must possess and the experience on which such expertise can be based.
- Section 409 of the Act and related rules require issuers to disclose on Form 8-K any releases they choose to issue or announcements they choose to make disclosing material nonpublic financial information (such as earnings releases). The rules do not require issuers to make such releases or announcements.
- New Regulation G requires issuers releasing non-GAAP financial information (such as pro forma earnings) to include reconciliations to GAAP treatments of the measure in question. Non-GAAP financial information is defined as a numerical measure of financial performance that excludes amounts that would be included if the presentation complied with GAAP, or includes amounts that would be excluded under GAAP.
- New rules accelerate the filing dates for periodic reports under the Securities Exchange Act. The accelerated dates are phased in over a period of three years and apply only to reporting companies with public floats of at least \$75 million. The filing deadline for annual reports on Form 10-K is shortened from the current 90 days following fiscal year end to 75 days in year two and 60 days in year three. The deadline for quarterly reports on Form 10-Q is shortened from the current 45 days following fiscal quarter end to 40 days in year two and 35 days in year three.

- Rules Relating to Trading

Sarbanes Oxley imposes certain new rules relating to trading by directors and executive officers in their company's securities. These include:

- Section 403 of the Act and related rules dramatically shorten the reporting time for directors, executive officers and 10% shareholders to report trades in company securities on Form 4 pursuant to Section 16 of the Securities Exchange Act. For transactions after August 29, 2002, directors, officers and principal shareholders are required to file any change in the ownership of the company's securities before the end of the second business day following the day the transaction is executed. Previously, insiders were only required to file Form 4's by the tenth day of the month following the month in which the subject transaction was executed, and reporting for certain types of trades could be delayed until 45 days after year end. After July 30, 2003, Form 4's must be filed electronically and posted on the company's website not later than the end of the business day following the filing.
- Rules issued under Section 306 of the Act create new Regulation BTR, which prohibits directors and executive officers from buying or selling an issuer's securities during any pension plan blackout period in which participants are prevented from trading issuer securities in their plan accounts. The restriction applies only to issuer securities that an officer or director acquires in connection with his or her service or employment. Exceptions exist for certain non-discretionary and other transactions. Profits from trades made in violation of the rule will be forfeited to the issuer in an action brought by the issuer or a security holder on its behalf (similar to enforcement of Section 16(b) of the Securities Exchange Act).
- The Act requires a company to disclose, on a current basis and in plain English, information about material changes in its financial condition or operations. The SEC may require this "real time" disclosure to include trend or qualitative information. Even before the adoption of Sarbanes, the SEC had issued proposed rules to expand the items for which Form 8-K requires mandatory disclosure and to accelerate the filing deadlines for the form.

- Attorney Conduct

Section 307 of the Act and related rules require attorneys "appearing and practicing before the Commission" to report evidence of violation of securities laws and breach of fiduciary duty. The rules impose requirements both on outside counsel and on an issuer's chief legal officer. They require an attorney, who becomes aware of evidence leading him or her reasonably to believe that a material violation has occurred or will occur, to report the violation to the issuer's chief legal officer or, if one is established, to the issuer's legal compliance committee. The chief legal officer must conduct an inquiry into the reported violation and advise the reporting attorney of the actions taken in response to the report. In the event of a response that is not "appropriate," the reporting attorney must escalate the report "up the ladder" in the issuer's organization to the audit committee, another

committee composed entirely of independent directors or the full board if no fully independent committee exists.

The final rules modify somewhat the rules proposed in November, among other ways by restricting the definition of “appearing and practicing before” the commission to attorneys having an attorney-client relationship with the issuer and who have notice that documents they prepare or assist in preparing will be filed with or submitted to the SEC. The rules make clear that they do not provide a private right of action and become effective 180 days after publication in the Federal Register.

The November proposed rules had proposed a “noisy withdrawal” requirement for attorneys when issuers provided an insufficient response to a report of a violation. This proposal generated significant comment and opposition. The new rules do not implement that proposal. Instead, the SEC issued a separate release seeking further comment on the concept.

- Executive Compensation

- *Prohibition of Loans to Directors and Executive Officers*

Section 402 of the Act makes it unlawful for an issuer “directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.” An extension of credit that was in place when the Act was enacted is exempt from the prohibition, provided that there is no material modification or any renewal of the extension of credit thereafter. Section 402 includes an exemption for certain types of consumer credit provided in the ordinary course to the public if made on market terms and for loans by insured depository institution if the loan is subject to Federal Reserve insider lending restrictions.

Section 402 has created considerable speculation and commentary about the extent of its proscription. Many types of arrangements provided by issuers to their executives could be deemed to be extensions of credit in the form of personal loans. The SEC has indicated that it does not intend to provide guidance on the interpretation of the section in the foreseeable future.

On September 25, 2002, Senators Susan Collins (R-ME) and Carl Levin (D-MI) wrote to then-SEC Chairman Harvey Pitt urging him to resist attempts to weaken Section 402 through regulations. This was in response to their perception of a lobbying effort to persuade the Commission to issue regulations clarifying and restricting the extent of the prohibition. The letter stated that “...the statutory prohibition makes it clear that publicly traded companies are not supposed to be using company funds to provide personal financing to company directors or officers for any reason...Congress enacted and the SEC must enforce this bright-line measure to end corporate loan abuses by top executives.”

On October 15, 2002 a number of prominent law firms signed their names to a memorandum that discussed various issues arising under Section 402 and reached numerous conclusions. There is no separate authority for the conclusions reached in this memorandum and whether the Commission or a court would concur is unknown. This has left many companies to struggle with questions as to whether particular arrangements are impermissible extensions of credit. Among these arrangements are the following:

- *Travel advances*
 - *Personal use of company credit cards.* Is an extension of credit involved if executives are permitted to charge personal expenses to company credit cards and then reimburse the issuer? Examples might be personal expenses incurred in the course of a business trip.
 - *Personal use of a company automobile.*
 - *Payment of relocation advances*
 - *Stay or retention bonuses given to key executives.*
 - *Indemnification advances*
 - *Deferred compensation arrangements*
 - *Tax indemnity payment*
 - *Loans to executives from company-sponsored 401(k) plans*
 - *Cashless option exercise provisions for issuer stock options*
 - *Existence of demand loans.* Even if these were in place in July, 2002, does the issuer's failure to demand payment constitute a "renewal" or "modification" of the credit?
 - *Drawdowns on committed lines of credit.* May an executive make a draw on existing credit otherwise permitted under the documentation of an arrangement that was in place when the act was adopted? Would this be a new loan, a modification of an existing loan or a grandfathered arrangement? How can issuers reconcile the statutory proscription with contractual obligations they may have under existing arrangements?
 - *Forgiveness of existing loans.* While this might seem to be a classic example of a modification of an existing loan, the 25 Firms memo takes the position that forgiveness of a loan in place in July, 2002 is not prohibited by Section 402. The rationale is that once forgiveness occurs, the loan hasn't been "modified," it has been eliminated, and that the practical effect of forgiveness is the same as if the issuer granted the executive a cash bonus which was then used to repay the loan.
- *Forfeiture of Incentive Compensation*

The Act provides direct financial penalties on certain officers if a company is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with regard to any financial reporting

requirement under the securities laws. In such event, the chief executive officer and the chief financial officer of the registrant must reimburse the issuer for (a) any bonus or other incentive-based or equity-based compensation received by him or her during the 12 months following the first public issuance or filing of the restated financial information and (b) any profits realized by him or her from the sale of the company's securities during that 12-month period.

- Whistleblower Protection

Section 806 of the Act protects employees of publicly traded companies when they lawfully disclose information about fraudulent activities within their company. The Act applies to publicly traded companies, or "any officer, employee, contractor, subcontractor, or agent" of such a company. A protected "lawful act" includes providing information or otherwise assisting in an investigation regarding any conduct that the employee reasonably believes constitutes a violation of the Act, any Securities and Exchange Commission regulation, or any federal law relating to fraud against shareholders. The information or assistance is protected if provided or related to:

- o an investigation conducted by a Federal regulatory or law enforcement agency;
- o a Congressional member or committee; or
- o a person with supervisory authority over the employee or another employee of the company who has the authority to investigate, discover or terminate misconduct.

An employee who is discharged or disciplined in response to a protected act may bring a complaint with the Department of Labor within 90 days of the violation. If the Department fails to rule within 180 days, the employee may file a lawsuit in Federal court.

In addition, Section 1107 of the Act makes it a criminal violation if any person "knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense." This prohibition is *not* limited to matters regarding compliance with the Federal securities laws.

III. IMPLICATIONS FOR NON-PUBLIC COMPANIES

The Sarbanes-Oxley Act by its terms applies in most regards only to publicly-held reporting companies. However, some of its terms reach beyond such companies. In addition, the requirements of the Act and related rules may develop into normative standards for corporate best practices and/or requirements imposed on privately-held companies by lenders, insurers, contracting parties themselves subject to the Act, and others.

The impact on privately-held companies is likely to be uneven, with larger privately-held companies more extensively affected than smaller, closely-held entities. Many privately held

companies have already begun to consider or implement changes based on Sarbanes provisions.² There follows a discussion of the means by which Sarbanes-Oxley provisions could be applied to privately-held companies and business areas in which those rules may impact the course of business.

A. Sources of Possible Impact on Non-Public Companies

Through what authority or means might Sarbanes-Oxley concepts be applied to privately held companies? Among the possibilities are the following:

- Direct Federal Regulation

Certain provisions of Sarbanes-Oxley are directly applicable to privately held companies. Among these are Section 1107 providing criminal penalties for retaliation related to an employee's whistleblowing activities; Section 802, which makes it a criminal violation to alter, destroy, mutilate, conceal or make a false entry in a record, document or tangible object with the intent to impede, obstruct or influence any investigation or bankruptcy matter; and Section 904, which increases the potential criminal monetary penalties from \$5,000 to \$100,000 for individuals and from \$100,000 to \$500,000 for other violators, and the potential prison sentences from one year to 10 years, for ERISA violations.

In addition, the Internal Revenue Service, in Announcement 2002-87,²⁴ requested comment on the possibility of amending IRS Form 990 to require tax-exempt organizations to make corporate governance disclosures. The release notes corporate governance trends relating to publicly held for-profit companies. It suggests that the principles militating in favor of greater transparency for public investors who make investment decisions in for-profit companies apply also to contributors who make decisions about exempt organizations. In the release the IRS asks for comments on measures that would require exempt organizations to disclose whether they have adopted conflict of interest procedures, whether they have independent audit committees, information about transactions with related parties, including contributors, and requests comments on other changes to Form 990 to improve public confidence in exempt organization disclosures. The comment period expired January 28, 2003.

- Direct State Regulation

Section 209 of the Sarbanes-Oxley Act asks appropriate state regulatory authorities, in their regulation of non-registered public accounting firms, to "make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms." Numerous states are exploring the

² A survey reported on March 10, 2003 by International Communications Research of Media, PA revealed that 58% of CFO's are implementing changes to their accounting and internal audit functions. See <http://www.electronicaccountant.com/ElectronicAccountant/index.cfm?txtFuse=dspShellContent&fuseAction=DISPLAY&numContentID=22145>.

possibility of imposing Sarbanes-style corporate governance regulations on local companies not otherwise subject to Sarbanes-Oxley, and several states have taken steps in that direction. State regulators have already begun to implement or consider state-level regulation of the accounting industry based on Sarbanes-Oxley precedents, with mixed results. These address issues such as consulting services provided to audit clients, falsifying financial statements, prohibiting “revolving door” employment between auditors and audit clients and requiring certification of financial statements or reports filed with the state.

Although a survey of all such activities is beyond the scope of this article, here are some examples:

- New York State Attorney General Eliot Spitzer has stated that he will propose legislation requiring nonprofit chief executive officers to certify the organization’s financial reports and the adequacy of internal controls. The nonprofits also would be required to demonstrate the independence of their audit committees, whose members would have to be free of contracting relationships with the nonprofit. The proposed legislation would affect New York State nonprofits with annual revenue of at least \$250,000, which is a low threshold. Spitzer also called for increased auditor scrutiny of nonprofits.
- California has adopted a Corporate Disclosure Act that became effective January 1, 2003. It requires “publicly traded companies” incorporated or qualified to do business in California to provide certain substantive information in their annual statements filed with the state. The definition of “publicly traded company” is broad enough to cover some companies that are not reporting under the Federal securities laws. In addition, California has adopted accounting regulations imposing certain restrictions on auditors and accountants similar to some of those found in Sarbanes-Oxley, such as restrictions on an auditor’s ability to take employment with a former audit client.
- A bill introduced in the New Jersey legislature in the fall of 2002 was withdrawn in February, 2003 in the face of significant opposition from the New Jersey State Society of CPA’s. The bill would have prohibited auditors from providing certain services to privately held as well as publicly held audit clients.

Other areas where Sarbanes-style regulations could be imposed by state regulation include banking regulations requiring lenders to impose certain standards on borrowers and employment laws instituting whistle-blowing provisions and penalties.

- Companies That Intend to “Go Public”

Companies that anticipate going public in the future or that may be acquired by publicly held companies must concern themselves with Sarbanes-Oxley compliance. The Act applies to companies that have filed registration statements under the Securities Act of 1933 even before those registration statements become effective. Thus, companies conducting IPO’s must be Sarbanes-compliant. In addition, privately held companies that

do not meet certain Sarbanes-Oxley standards become less attractive targets for acquisition by publicly held companies. For instance, if an acquisition target does not have sufficient disclosure controls and procedures and internal controls to facilitate post-closing certification of consolidated financial statements, a publicly held buyer must factor into its acquisition costs the amounts it will need to expend to implement those controls, which may affect the price the buyer is willing to pay or even its willingness to make the acquisition.

- Doing Business with Certain Parties

Privately held companies doing business with public companies subject to the Act or with governmental entities may have certain Sarbanes-based provisions imposed as a matter of contract. For political considerations if no other, governmental entities may insist on provisions regarding independence of directors and auditors, financial ethics, procedures for handling complaints and financial reporting controls. This could include prohibiting state pension or retirement funds – or, of more direct impact on privately-held firms, prohibiting state incubator or venture funds – from investing in companies that do not meet certain Sarbanes-style requirements.

Similarly, publicly held companies subject to Sarbanes-Oxley may require some of these controls in key contract relationships, especially as they affect contracts that may implicate the independence of the public company’s directors or executives.

Finally, private venture capital firms may insist on imposing Sarbanes-type requirements on companies in which they invest. These might include, among others, inclusion of independent directors, audit committee functions, accountant independence issues, executive compensation restrictions and codes of ethics.

- Lending Relationships and Loan Covenants

Even if not required by state banking regulators, financial institutions may begin to revise loan agreement covenants to require compliance with corporate governance standards modeled on Sarbanes-Oxley provisions. Compliance with Sarbanes will be part of standard “legal compliance” loan agreement covenants for publicly held companies that are subject to the Act. From there it is a short step to begin to impose Sarbanes-based covenants on privately held borrowers. It has long been common to have covenants, for instance, which prohibit related party transactions, restrict increases in executive compensation or require certification of financial statements. Strengthening these covenants on the basis of Sarbanes-Oxley, and adding covenants regarding director or auditor independence and procedures for handling complaints may give lenders greater tools to monitor covenant compliance and detect problems.

- Insurance Standards

Insurers also may require Sarbanes-type initiatives as conditions to coverage. This could involve various types of insurance. Bonding and surety companies, for example, may require accounting and disclosure control procedures and financial statement certifications. Insurers for public bond issues will almost certainly impose more stringent accounting and financial control measures. Directors' and officers' liability insurers may impose requirements patterned on Sarbanes provisions regarding director independence, related party transaction approval, committee structure, ethics codes, procedures for handling complaints and whistle blowing. Recent corporate governance scandals and the increased demands of Sarbanes-Oxley have caused significant increases in D&O premiums as well as more tightly drawn exclusions. Privately held companies maintaining such insurance will feel these effects. Among the effects on D&O coverage may be the following:

- *Elimination of Entity Coverage.* Typical D&O policies cover both the individual directors and officers for amounts for which they may be found liable but not indemnified, and the corporation itself for amounts payable to its directors and officers under indemnity standards. Eliminating the second of these insuring clauses would force corporations to furnish primary coverage to officers and directors and convert d&o policies largely to excess coverage policies, since policies generally require the corporation to indemnify to the extent permissible.
- *Denial of Coverage in Event of Restatement.* Additionally, to the extent that increased scrutiny of financial accounting practices may lead to restatements of previously issued financial statements, d&o insurers may assert fraud in the application process in an attempt to deny coverage for claims made.
- *Elimination of Severability Clause.* Many d&o policies contain "severability" clauses, which provide that the acts or knowledge of one insured party won't be attributable to other insured parties in determining whether coverage should be denied either because of excluded conduct or because of misleading or untruthful information included in the application for insurance. These provisions are likely to greatly increase in cost or perhaps will become unavailable from some insurers.
- *Additional Exclusions.* Typical policy exclusions include claims based on fraud, violations of ERISA or environmental laws or the receipt of an improper personal benefit. Additional exclusions may develop for improper loans to executives, failure to properly address employee complaints about accounting policies or whistleblowing claims and claims related to accounting irregularities where the board has failed to insure auditor independence

- Labor and Human Resources

Some of the strongest critics of the corporate governance shortcomings exposed by the recent highly-publicized scandals have been labor unions. A common refrain has been the

enrichment of management at the expense of the rank and file workforce. Private companies with collective bargaining units may find that corporate governance standards become part of the bargaining process as contracts are renewed. Among areas likely to be addressed are conflicts of interest and related party transactions, executive compensation and performance-related pay, codes of ethics, improved financial reporting systems, controls and procedures for handling complaints and protections for whistleblowers.

- Accounting Profession Regulation

Aside from state- imposed regulations, most accounting professional organizations are also considering self- imposed rules that incorporate Sarbanes-Oxley concepts, particularly as they relate to auditor independence. To some extent this may be a case of trying to head off state regulation, but it is also true that these organizations appreciate and think about the nuances distinguishing accounting and auditing for different types of organizations much more than do legislators.

In addition, Sarbanes-Oxley will continue to spur accounting firms to consider reorganizing their business models to separate traditional consulting activities from auditing functions to comply with the auditor independence rules. These changes may result in privately held companies being unable to obtain certain services from their historical auditors even when not prohibited. Voluntarily adopted standards on rotation of auditing partners, prevention of employment with audit clients and the like may affect private companies as well as public companies.

Accounting professional organizations at the national and state level are closely studying the so-called “cascade” effects of Sarbanes-Oxley amid concerns that similar regulations will be imposed on auditing relationships for privately held clients. These organizations argue that the nature of public and private companies, and the relationships that each type of organization has with its auditors, are significantly different. To impose Sarbanes-type restrictions on relationships with privately held audit clients would, according to them, in many cases simply deprive the clients of the benefits of consulting and related services. The private clients, in their view, would be unlikely to go to the time and expense of seeking other accountants to provide such services and the learning curve costs would be uneconomical given the limited scale of such engagements.

- Legal Profession Regulation

As noted above and discussed further below, Sarbanes-Oxley imposes obligations on attorneys to report evidence of violations of Federal securities laws and breaches of fiduciary duty. The original rules proposed to implement these provisions created considerable controversy, including provisions requiring attorneys to engage in so-called “noisy withdrawals” if clients failed to take sufficient action regarding a reported violation and an expansive definition of when an attorney would be deemed “appearing and practicing” before the SEC and thus subject to the rules. The final rules adopted in January backed off some of these provisions a bit. However, state bar associations are

studying these rules and considering whether to adopt similar rules for attorneys as part of their professional codes of ethics. Attorneys and their privately held clients should expect that some of these concepts will filter into professional responsibility rules.

- Nonprofit Regulation

The nonprofit sector has suffered accounting and financial statement scandals of its own. Three years before the Enron failure, the Allegheny Health, Education and Research Foundation, a Pennsylvania-based healthcare system with revenues in excess of \$2 billion, declared bankruptcy. Charges followed that directors had failed to oversee management, that management covered up the system's financial deterioration and that auditors participated in the accounting misstatements. The SEC brought securities fraud charges against several of the key players (AHERF had issued bonds to the public). Other prominent incidents involving nonprofit entities were the bankruptcy of Baptist Foundation of Arizona and resulting litigation against Arthur Andersen and the Minnesota Attorney General's compliance review of and settlement with Allina Health System.

As noted above, both the IRS and the New York attorney general have focused specifically on non-profit organizations as needing improved financial oversight and corporate governance procedures. Given the historical governmental roles in overseeing nonprofit organizations, this scrutiny will likely continue and spread. In addition, nonprofits engaged in tax-exempt bond financing will probably find Sarbanes-type governance and accounting provisions imposed on them by auditors, underwriters, insurers and credit enhancers as a condition to the financing.

B. Areas Likely to be Impacted

- Fiduciary Duty Standards

For the last seventy years, matters of substantive corporate law have traditionally been relegated to state law while Federal securities laws have governed disclosure matters. There has been some overlap, particularly in the area of proxy and tender offer regulation. However, the Supreme Court held years ago that state law fiduciary duty claims could not be bootstrapped into Federal securities claims simply by alleging that they constituted an "artifice to defraud," without evidence of disclosure violations. Previous attempts by the SEC acting on its own to impose substantive regulations were struck down by a Federal court as exceeding the Commission's authority.

Sarbanes-Oxley has changed this balance significantly. It imposes the most comprehensive substantive Federal regulation of corporate governance matters ever. Nonetheless, standards of fiduciary duty discharge and breach continue to be governed by state corporate law. Although in most regards Sarbanes-Oxley does not create private rights of action, the standards and requirements it imposes may become models for shaping of fiduciary law principles under state laws. The practices required under Sarbanes may be held up as "best practice" standards even for companies not directly

subject to the Act, and failure to observe those standards may be cited by plaintiffs as evidence of breach of duty.

Particularly susceptible to these types of claims are the various Sarbanes provisions that deal with independence of directors and auditors. Failure of even privately held companies to have some component of independent review, especially for related party transactions, may be alleged as evidence of breach of duty in the post-Sarbanes environment.

Similarly, it remains to be seen whether significant non-audit relationships with auditors will be found to be evidence of a board's failure to assure independence in the presentation of its financial information. This may take on added significance to companies that become insolvent or subject to bankruptcy proceedings, since at some point directors in such companies assume fiduciary duties to creditors, thus creating an additional class of potential claimants. In privately held companies, principal shareholders are frequently both directors and significant creditors, adding yet another complicating factor.

Other Sarbanes provisions that may find their way into some state fiduciary law concepts include codes of ethics for executive officers, independent director oversight of key functions such as auditing, creating systems for submission of anonymous complaints and the handling of those complaints and executive compensation, forfeiture and loan prohibition.

- Whistleblower Provisions

The Act contains two separate whistleblower-related provisions. The provision most directly applicable to privately held companies is Section 1107. This section, which provides criminal penalties for retaliation, is not limited to public companies, to violations related to the Act or financial or accounting issues or even to matters related to the Federal securities laws. Rather, it punishes retaliation towards any person who provides to a law enforcement officer any truthful information relating to the commission or possible commission of *any* Federal offense. Penalties include fines and/or imprisonment for up to ten years. ***These provisions apply to all privately held companies and should be immediately communicated to human resources managers or others with supervision of employees.***

As indicated above, Section 806 of Sarbanes-Oxley protects employees of publicly traded companies who lawfully disclose information about fraudulent activities within their company. This could become a model for parallel state regulation, especially since many states, including Michigan, already have whistleblower protection statutes.

Finally, Section 301 of Sarbanes-Oxley requires audit committees to establish procedures for the receipt and treatment of complaints regarding accounting or auditing matters and "the confidential, anonymous submission by employees" of the corporation of concerns regarding "questionable accounting or auditing matters." While this provision only

applies to exchange or Nasdaq-listed public companies, it also could serve as a model for state regulation. In addition, since it deals not only with employee issues but also with financial reporting irregularities, it may become a model for loan agreement covenants or contracts with governmental entities.

- Financial Matters

- *Certification of Financial Statements*

Most loan agreements require some sort of compliance certification on a periodic basis from borrowers relating to financial statements and compliance with financial covenants of the loan agreement, including those dealing with financial ratios, cash flow coverage multiples, minimum net worth amounts and collateral coverage and draws against specified assets in asset-based lending relationships. Insurance policies for various types of insurance also require submission of certified financial statements as part of the applications process. These types of provisions may be modified based on officer certification provisions of Sections 302 and 906 of the Act. Initially, lenders, insurers and others may simply seek to be made beneficiaries of the certifications made by their publicly held borrowers or clients.

Eventually, however, they could decide to apply these certification standards to privately held companies also. Many privately held companies lack the control procedures to be able to make these certifications.

- *Disclosure Controls and Procedures*

In addition to certification of financial statements, privately held companies may find themselves pressured by either lenders or their own independent accountants to implement a system of disclosure controls and procedures, and to describe and certify the effectiveness of the procedures.

- *Off-Balance Sheet Transactions*

The elaborate and extremely obscure set of related-party and off-balance sheet transactions that characterized Enron were significant catalysts for the disclosure requirements of Section 401 of Sarbanes-Oxley. Financing agreements often contain specific limitations or prohibitions on related-party transactions and on contingent liabilities such as guaranties or surety relationships. Nevertheless, to further the goal of transparency in financial disclosures, private parties such as lenders and insurers may decide to require these types of transactions to be disclosed. This is also an area where regulation of nonprofits may require additional disclosure and where organized labor may bargain for disclosure due to concerns over the effect of such unrecorded contingent liabilities on the financial strength of employers.

- Accountant Independence

One of the most salient features of Sarbanes-Oxley is its emphasis on the importance of independence in the auditing process. Auditors certifying audits of public companies will become subject to unprecedented Federal regulation as a result of the requirement to register with the Public Company Accounting Oversight Board created under Section 101. In addition, the Act imposes specific prohibitions and requirements on such auditors, including forbidding them from providing certain services to their audit clients and requiring them to report on certain matters to audit committees.

The meltdown of Arthur Andersen obviously was an important factor in this new regulation, but not the only factor. For a number of years, commentators and regulators have expressed concern over the business model under which the (then) Big 5 appeared to be operating, which involved using audit services (often priced on a commodity basis) as an entrée for the provision of more lucrative consulting services. During his tenure in the late '90's, former SEC Chairman Arthur Levitt campaigned for controls similar to those included in Sarbanes-Oxley, but was met with bitter resistance from the industry. The political climate for such regulation changed as a result of the various accounting scandals at Enron, WorldCom, Adelphia, Global Crossing and Tyco and earlier problems at companies such as Sunbeam, Cendant and Waste Management.

Self-regulatory organizations within the accounting profession have read the handwriting on the wall and are likely to some extent to try to pre-empt additional regulation of the profession from the outside by imposing rules of their own. New rules will be considered relating to the following:

- The scope of services that auditors can provide to audit clients
- The relationship that auditors maintain with client management and independent directors.
- Retention periods for audit workpapers and related documents.
- Required disclosures that must be made to clients.
- Strengthened review and reporting on control systems.
- Mandatory rotation of audit review partners.
- Restrictions on employment by audit clients of the auditor's former employees.

These self-imposed rules will likely affect at least some privately held companies and so may limit interactions that private companies have with their auditors.

- Board Independence

In addition to the Sarbanes-Oxley Act, there are a number of other rulemaking initiatives and private studies and reports that have focused on the importance of director independence in corporate governance matters. Among these other sources are rule changes relating to corporate governance proposed by the Nasdaq Stock Market and the New York Stock Exchange, the American Stock Exchange, the Preliminary Report of the

ABA Task Force on Corporate Responsibility, and the Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations, Part 1 (Executive Compensation), Part 2 (Corporate Governance) and Part 3 (Audit and Accounting).

Each of these has stressed the importance of independence among board members to insure the protection of shareholder interests. As noted above, Sarbanes-Oxley requires the exchanges and Nasdaq to require that audit committee members be independent. The rules initiatives and reports have recommended variously that Compensation and Nominating Committees be independent, that the full Board consist of at least a majority of independent directors, that the position of Board Chair be separated from the chief executive position and that the Chair be independent, that the independent directors meet periodically in executive session without the inside directors and that Boards appoint a “lead independent director” who would serve as liaison to management and the inside directors and would oversee the independent directors as a group.

Clearly, the dynamics of boards of privately held companies differ from those of publicly held companies, as do those of boards of widely held and closely held private companies. Boards of privately held companies normally are not expected to have the same extensive committee structure as public boards, and the availability of truly independent directors willing to serve on private company boards is considerably less than for public companies.

Nevertheless, lenders, insurers, government contracting entities, venture capital investors and auditors may all insist on some modicum of independence on private boards. Areas of particular scrutiny are likely to be approval of related party transactions, management of the audit relationship and certification of financial statements, approval of executive compensation and establishment of complaint procedures. For larger privately held companies, establishment of committee structures to govern key functions such as audit and executive compensation may also be required.

- Document Retention Policies

Sarbanes-Oxley creates criminal penalties for altering or destroying documents in an attempt to impede or influence a federal investigation or bankruptcy proceeding. These restrictions apply to all persons whether or not affiliated with a publicly held company. Parallel state legislation is probable. In response to these developments, all companies, including those that are privately held, need to make sure they have policies in effect dealing with document retention and responses to investigations or litigation.

- Attorney Whistle Blowing

The controversial and extensive attorney whistle blowing provisions⁴⁸ will affect lawyers in private practice more so than directly affecting privately held companies. Those regulations impose a series of escalating reports required of attorneys “appearing and practicing before” the SEC who receive evidence of violation of Federal securities laws or breach of fiduciary duty.

The concept of appearing and practicing before the SEC is broader than might be assumed. It includes all of the following:

- Transacting any business with the Commission, including communications in any form.
- Representing an issuer in a Commission administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena.
- Providing advice in respect of Federal securities laws or SEC regulations regarding any document that the attorney has notice will be filed with or submitted to the SEC or incorporated by reference in such a document, including providing advice in the context of preparing or participating in the preparation of such documents.
- Advising an issuer as to whether information, statements, opinions or other writings are required to be included in such documents.

Note that these definitions can include, for instance, a litigator asked to provide a description of pending litigation for inclusion in an SEC report or an environmental lawyer asked to describe an investigation or report regarding environmental matters. If the attorney has notice that the information will be included or incorporated into an SEC filing, he or she is appearing and practicing before the Commission by furnishing such description and becomes subject to the rules.

Fortunately, the final rules are less onerous than the proposed rules that were promulgated in November of 2002. The proposed rules contained an even more sweeping definition of appearing and practicing before the Commission and would have required attorneys reporting violations that were insufficiently addressed by the corporation to engage in a so-called “noisy withdrawal” from representation. The attorney would have been required to withdraw, notify the SEC of the withdrawal and disaffirm any “opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.”

These proposals caused substantial controversy and were not included in the final rules adopted in January. Instead, the Commission issued a companion release seeking further comment on the proposals and also setting forth alternative proposals that would require an attorney to withdraw in writing from representation but would require the issuer, rather than the attorney, to report the withdrawal to the SEC. The withdrawing attorney would be permitted, but not required, to report the withdrawal to the SEC if the issuer failed to do so.

The final rules do, however, permit an attorney to reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary

- to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
- to prevent the issuer, in a Commission investigation or administrative proceeding, from committing or suborning perjury or committing any act likely to perpetrate a fraud upon the Commission; or
- to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

The rules go on to provide that an attorney who complies in good faith with the provisions of the rules is not subject to discipline or otherwise liable under inconsistent standards imposed by any state or other jurisdiction where the attorney is admitted or practices. These provisions appear to pre-empt conflicting state rules of professional responsibility and may raise questions about the authority of the Commission to promulgate such rules. In any event, any attorney who represents publicly held issuers in any respect should be aware of these rules. ***In addition, in-house counsel for privately held companies that anticipate going public or being acquired by public companies should also familiarize themselves with the rules.***

- Executive Compensation

The perception that executives and/or directors enriched themselves despite the financial problems of their companies added to public outcry over the significant recent accounting and financial scandals and fueled a number of the Sarbanes-Oxley provisions. Some of these could easily find their way into private company proscriptions as well in loan covenants, public contract provisions and insurance requirements or exclusions. Among these could be:

- *Prohibition on Loans to Insiders.* Sarbanes-style prohibitions could be implemented to prohibit extensions of credit in the form of personal loans to executive officers and directors, even on arm's length terms. Many loan agreements currently restrict a borrower's ability to engage in related party transactions and to increase executive compensation beyond stated limits, so these could be viewed as natural extensions of those provisions. State regulation could also impose these types of limits.
- *Requirement of Ethics Policies for Financial Executives.* These could also be imposed by insurers or lenders or mandated by state laws.
- *Forfeiting Compensation in the Event of Restatement.* To the extent previous financial statements are found to require restatement, state law or loan covenants might mandate forfeiture of certain executive compensation, particularly bonus compensation. This is an area where nonprofit entities could be particularly affected.

- Statute of Limitations for Securities Fraud Claims

The Securities Exchange Act of 1934 includes Section 10(b), and Rule 10b-5 was promulgated under this Section. Courts have long recognized a private right of action under these provisions for securities fraud actions. Given the resource limitations of the SEC, private actions have served a major role in policing fraud.

Because the private right of action is implied rather than express, however, the Exchange Act contained no express limitation of actions period for these fraud claims. For many years Federal courts borrowed the most analogous limitations period under the law of the forum state, which resulted in different results in different Federal forums, even within the same circuit.

The Supreme Court ended this practice in 1991 by imposing a uniform period under which actions had to be brought within one year after discovery of the claim and in any event no later than three years after the acts forming the basis of the claim.⁵¹ Section 804 of Sarbanes-Oxley creates an express limitations period for private actions that expands the period to two years after discovery and five years after the fraud.

This period will affect privately held as well as publicly held companies. The scope of Section 10(b) and Rule 10b-5 is not limited to public companies, public offerings or transactions on public exchanges or markets. It can apply to private offerings of securities by privately held companies, repurchases by such companies of their own securities from existing holders, transactions by private companies in the securities of other companies or any other transaction involving the purchase or sale of a security.

C. Recommendations

In light of the possible future application of Sarbanes-Oxley principles to privately held companies, here are several recommendations for privately held companies.

- Consider Independent Directors

Larger privately held companies should consider adding independent directors to their board where possible. It may not be feasible to achieve a majority of independent directors, but having some may enable delegation of certain sensitive matters to the independent directors to avoid the appearance of self-interest. Matters which might be delegated include consideration of related-party transactions and oversight of the audit function and executive compensation.

Smaller privately held companies will find it very difficult to recruit independent directors. These companies tend not to have established and documented governance policies, often have poorly defined internal procedures and controls and financial reporting systems and often do not have directors' and officers' liability insurance. Persons are usually willing to serve on the boards of these types of companies only because of a financial interest in or relationship with the company. Independent persons

will frequently view board service for these companies as little more than opportunities to assume gratuitous liability.

Private companies may want to consider advisory boards as a device to help mitigate this problem. Such a body would consist of independent persons without formal authority to take action on behalf of the board but who could be used to evaluate issues presenting potential conflicts. Such bodies could serve as reality checks on inside directors and perhaps even support the appropriateness of actions in litigation. Although such persons would not have the authority of directors, and should not therefore be subject to fiduciary liabilities of directors, companies considering such structures should make sure that adequate indemnification provisions exist to cover advisory board members.

- Focus on Board Function and Qualifications

Directors should understand what is expected of them and should be recruited for purposes specifically related to the corporation's business interests. A director whose only qualification is being a close friend or relative of the founder contributes nothing to the effective functioning of the board and may actually make the job of the remaining directors more difficult (especially if there is no severability clause in a D&O policy).

Purely celebrity directors should also be avoided. This is not to say that persons with public recognition cannot serve a useful function on the board; these types of persons can sometimes open important doors for the company with their connections. Including a board member just because the other directors or officers enjoy rubbing elbows with celebrity is quite a bad idea, however.

Finally, directors must be able to commit sufficient time to do the job right. "I was too busy" won't excuse civil or criminal liability. Persons who have too many commitments to other directorships or whose regular jobs don't permit them sufficient time to stay informed of corporate matters simply invite future problems.

- Be Creative with Director Compensation Packages

Private companies that intend to recruit independent directors will probably have to design attractive director compensation packages. These companies suffer in some regard in comparison to their public counterparts from their inability to provide an element of compensation related to the public marketplace.

Put rights or other liquidity features must accompany options or restricted stock for directors of private companies, to give the directors an opportunity to realize the value of the holdings. These impose higher costs on the issuing companies since the company itself, rather than the public market, must provide the consideration when directors cash out.

- Review and Strengthen D&O Insurance

The availability and cost of directors' and officers' liability insurance will be negatively affected by Sarbanes-Oxley, as described above. It will not be possible for private companies to recruit independent, or perhaps any, directors without reasonable insurance protection.

The amount of protection required will depend on the nature of the company and the composition of its equity holders. Very closely held companies in which management and ownership are not significantly separated may not need D&O insurance, but those with any substantial number of unaffiliated shareholders must consider it.

Among the features to seek are severability provisions that do not impute one insured party's actions or conduct to other insured parties. Companies must also closely review policy exclusions and may need to buy endorsements to limit or eliminate some of these.

Company D&O policies that provide coverage both to the company and the individual directors (a fairly common feature of such policies) may be considered assets of a bankruptcy estate and therefore not available to the individuals in the event of the company's bankruptcy. For this reason, companies may need to consider so-called "Side A" or individual director policies which are not exhausted by payments to the company and which may be personal to the directors and therefore not subject to claims by the bankruptcy estate.

- Review and Improve Financial Reporting

Private companies also need to review their financial control and reporting systems and their general systems for communicating enterprise-critical information to management and the board of directors. One of the frequent defenses offered by directors of the companies that suffered the well-known recent scandals is that they didn't know what was going on in the company. Absent deliberate collusive fraud and concealment, this defense is unlikely ever to be very persuasive. Directors are responsible for oversight of the corporation and insuring the existence of adequate reporting systems as well as checks and balances is an integral element of that role.

- Implement Ethics Measures

Private company boards should also seek to implement ethics measures such as related party transaction guidelines, ethics codes for executives, independent review of executive compensation, document retention policies, policies for responding to investigations or complaints and whistleblower policies. Appearing unprepared or unable to respond to investigations or complaints or worse, appearing to conceal or destroy relevant information, will greatly increase the chance of civil or criminal liability if problems arise.

- Prepare Now if There's an IPO in Your Future

If your company harbors any ambitions of going public in the future, start preparing for Sarbanes-Oxley at your earliest opportunity. Many of the rules will apply as soon as a registration statement is filed and the success of the company post-offering will depend in part on its ability to hit the ground running with systems in place to meet the myriad Sarbanes requirements.

To prepare for going public, be ready to address the following:

- *Upgrading the Board.* The Board will require an independent majority, with completely independent audit, compensation and nominating committees.
- *Committee Structure.* The audit committee must be given authority for retention and discharge of the auditors. The company will have to disclose whether or not the audit committee includes a financial expert meeting SEC definitions. The audit committee must also establish procedures for receiving and handling complaints regarding accounting matters.
- *Disclosure Controls and Procedures.* The company must have sufficient disclosure controls and procedures and internal controls to enable the chief executive officer and the chief financial officer to certify the financial statements as well as the functioning of those control systems. The Company will also have to disclose whether it has a code of ethics for executive officers and if not, why not.
- *Auditor Independence.* The company's relationship with its auditors must be reviewed to ensure that no prohibited services are provided and that any non-prohibited non-audit services have been approved by the audit committee.