



FOLEY & LARDNER LLP

SOX Impact on Private Companies

FOLEY & LARDNER'S 2005 NATIONAL DIRECTORS INSTITUTE

Corporate Governance Reform:

What's Next?

THE IMPACT OF SARBANES-OXLEY ON PRIVATELY HELD COMPANIES

The Sarbanes-Oxley Act of 2002 (SOX) was designed principally to bolster public confidence in corporate governance and financial reporting of public companies by rebuilding public trust in corporations and capital markets. Enacted in the wake of several high-profile corporate scandals involving Enron, WorldCom, and others, SOX has had a ripple effect through corporate America. While SOX was intended to apply only to public companies, the reforms the law imposed on public companies have begun to dramatically affect the way private companies address internal control and corporate governance issues.

The effects on private companies were discussed at the fourth annual Foley & Lardner LLP National Directors Institute (NDI) held March 10, 2005 in Chicago, during a breakout session titled "The Impact of Sarbanes-Oxley on Privately Held Companies," featuring James A. Williams, the President and CEO of Gold Toe Brands, Inc.; Gary J. Levin, a partner in the Chicago office of Deloitte and Touche LLP; Jack Lasater, Foley Business Law partner; and Eric Newsom, Foley senior counsel.

Private Companies Most Affected by SOX

The companies most affected by SOX are those:

Preparing for an Initial Public Offering — those companies planning on executing an initial public offering must be compliant with SOX upon filing. The reports on internal control systems and document retention policies required by Section 404 of SOX must be in the company's first 10-K filing.

Preparing for a Merger With a Public Company — those companies preparing for a merger with a public company have a strong interest in achieving compliance with SOX. The management of potential public acquirors will view the private company to be acquired as needing to be SOX compliant. Potential public buyers will take into consideration a private company's compliance with SOX when considering that company's suitability as a target. Private company sellers should realize the importance of implementing SOX-compliant measures as a means of increasing their attractiveness to potential buyers.

Issuing Publicly-Registered Debt — those companies issuing publicly registered debt are increasingly being asked by underwriters to tailor their required disclosures to include a discussion of the SOX-compliant measures implemented.

Reporting to Federal Regulatory Agencies — those private companies regulated by federal regulatory agencies have started to see numerous government agencies use SOX requirements as the standards for internal controls and corporate governance under their regulatory regime. For

example, the Federal Deposit Insurance Corporation (FDIC) has recommended that companies over which it has regulatory power use different firms to perform accounting and audit duties.

Relying on Lenders or Insurers for Capital Access or Business Insurance Renewal — one recent development has seen banks using measures closely resembling SOX requirements to give them additional comfort when making loans as part of their higher-risk portfolios. The SOX provisions, despite their intended use for public companies, are being implemented in the forms of representations and warranties in the loan documents presented to private companies, especially in larger loans to highly leveraged private companies. Additionally, insurance companies have increasingly begun to request SOX provisions to give them further protection when private companies are seeking to renew their business insurance.

Dealing With Disgruntled Shareholders — in future litigation brought by shareholders or other interest holders in a business, litigants increasingly will use the standards of corporate governance and internal control mechanisms as required by SOX as the standard against which private companies should be judged. Any departures from the standards set by SOX are sure to be attacked by litigants in suits against private companies.

Doing Business With Government Entities — after the enactment of SOX, many predicted that state governments would enact regulatory regimes requiring those businesses engaged in commerce with the state to enact SOX-type measures for internal controls and corporate governance. While this has not happened on the scale that many predicted, there are several states — including California — which have passed SOX-type laws affecting companies doing business with them.

Provisions Most Directly Affecting Private Companies

The first SOX provision most directly affecting private companies is that imposed for improper document destruction. SOX imposes fines, plus up to 20 years in prison for the knowing destruction, alteration, or falsification of records with the intent to impede or influence a federal investigation. As Mr. Newsom pointed out, this includes any existing or contemplated government proceeding against a private company. Mr. Lasater advised that all companies need to adopt specific document retention procedures to avoid potential problems with the document retention provisions of SOX.

Another important issue affecting private companies is protection for whistle-blowers. As Mr. Lasater noted, “Sarbanes now provides protection for whistle-blowers and new criminal penalties for actions taken in retaliation against whistle-blowers.” SOX imposes fines and up to 10 years in prison for knowing retaliation against anyone who provides information relating to a commission or possible commission of any federal offense. Mr. Lasater also noted that compliance in this area is very difficult area to monitor.

Mr. Levin cautioned that private companies must be careful when they communicate the details of their whistle-blower protection measures to their employees. The companies should stress that these measures are not being used to watch over employees, but are an important part of the company's ethics in compliance program. He also mentioned that care should be given not to allow the whistle-blower service to be used, whether an internal or external hotline, as a means of reporting minor personal employment type problems. The company should communicate the types of issues they consider appropriate for employees to report through the whistle-blowing systems implemented.

Mr. Levin further advised that for those companies having an audit committee, the calls should go to the chairman of the audit committee. If the company does not have such a committee, the calls should go directly to the chairman of the company.

An additional change in the provision of SOX which could affect private companies is the extension of the statute of limitations for securities fraud. The statute of limitations for securities fraud actions has been extended to two years after discovery of the fraud or five years after the commission of the fraud. Because of this extension, Mr. Lasater advised those involved in drafting representations and warranties, or who are involved in mergers and acquisitions such that they will be purchasing insurance coverage for a period of time following a transaction, to purchase the coverage such that it covers the extended five-year statute of limitations.

Two additional changes mentioned by Mr. Lasater are (1) that state and federal securities law violations are no longer dischargeable in bankruptcy and (2) 401(k) administrators now have to give 30 days' notice of any suspension of trading or access to accounts for trading purposes.

Indirect Impacts of SOX on Private Companies

While the provision of SOX are not expressly applicable to private companies, many of the requirements imposed by SOX have become "best practices" and are now considered industry standards. The pressures on private companies to comply with SOX are coming from many different directions. As was previously discussed, lenders, insurers, public merger partners, potential litigants, and state governments are all looking at the SOX-type controls and mechanisms installed by private companies. Several other groups of people have indirect impacts on compliance with SOX by private companies as follows:

Auditors and Accountants — as Mr. Levin noted, currently the auditing standards for public and private companies are the same. The American Institute of Certified Public Accounting has been pushing for different standards for financial accounting and auditing procedures applicable to private companies. In addition, the Public Company Accounting Oversight Board is set to release new auditing standards, which could possibly include differences in the standards between auditing public and private companies.

Mr. Levin also noted that the independence requirements of SOX requiring the public company's auditors to be independent of the firm performing the company's tax accounting are being adopted by some private companies, and those companies are being forced to disrupt their long-standing relationships with firms who have previously handled all of their auditing, tax, and accounting work.

Quality Directors - as Mr. Williams explained, the increase in the number of private companies looking for quality independent directors combined with the tendency of directors to limit their directorship positions in the wake of SOX, has made attracting quality outside directors a key focus of companies both public and private.

Quality directors, many of whom sit on the boards of public companies, are increasingly aware of new standards governing directors and are wary of incurring liability for their directorships on companies without the types of controls and mechanisms required by SOX. In order to attract these quality directors, the more SOX-compliant a private company can be, the more likely the company can attract they type of independent directors that will most benefit the company.

Investors - investors and private equity funds are increasingly concerned with and aware of the internal controls and governance mechanisms used by private companies. As Mr. Newsom explained, investors are looking for strategies, and the venture capitalists and private equity funds are looking for companies that have a goal of either being acquired or going public. The closer a private company is to being in compliance with SOX, the sooner the company could go public — making it much more attractive to a potential public company buyer.

Key SOX Provisions Being Implemented by Private Companies

Though technical compliance with many provisions of SOX is not required, many private companies have examined their business risks and have implemented certain provisions based upon the costs and potential benefits of the implementations. Progressive companies see these steps as an opportunity to improve governance and internal control processes. The provisions these companies are implementing or considering implementing based on the costs are:

- **Section 401** — ensuring that financial statements fairly present the condition of the business
- **Section 301** — sourcing independent, knowledgeable directors to provide oversight and form the basis for an audit committee
- **Section 305** — establishing audit committees
- **Section 404** — establishing strong internal control systems and document retention policies

- **Sections 201, 202, 206** — separating professional services by ceasing the use of external auditors for non-auditor services in order to avoid actual or perceived conflicts of interest

Implementation Problems

As Mr. Lasater observed, because private companies are not required to be in technical compliance with SOX, they can pick and choose those provisions they want to adopt. In choosing which measures to adopt, private companies have the option of gauging the relative cost of compliance and the cultural issues arising from compliance with the SOX provisions. As Mr. Lasater noted, private companies are implementing most of the easier changes such as adopting a code of ethics for the officers, appointing independent directors, and appointing audit committees.

The provision that is the most burdensome for private companies to implement is Section 404. Section 404 of SOX requires companies to report on the effectiveness of internal control over financial reporting at the end of each fiscal year. This requires a report of an external auditor attesting to management's assertion of the effectiveness of the internal control regime.

As Mr. Levin explained, he is seeing many private companies establish the building blocks of internal controls, such as establishing audit committees and appointing independent directors, but because of the costs, are stopping short of having an auditor perform an internal controls function audit. Companies are looking at their business risk matrices, are deciding what areas should be closely monitored, and are implementing those "best practices" building blocks of SOX compliance to cover their biggest concerns and business risks first.

If the company has a strategy to become publicly owned or sell to a public company, it has then achieved much of the process that would be necessary for SOX compliance with Section 404 that would be required before an initial public offering or sale of the company.

For More Information

To learn more about “The Impact of Sarbanes-Oxley on Privately Held Companies,” feel free to contact the session speakers.

Richard W. (Jack) Lasater
Foley & Lardner LLP
310.975.7726
rlasater@foley.com

Eric A. Newsom
Foley & Lardner LLP
415.438.6432
enewsom@foley.com

Gary J. Levin
Deloitte and Touche LLP
312.228.5474
glevin@deloitte.com

James A. Williams.
Gold Toe Brands, Inc.
212.692.8962
jimw@goldtoe.com

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