

Sarbanes-Oxley for Private Companies

A Compliance Guide Tailored Towards the Growth of Your Company

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In July 2002 Congress passed the Sarbanes-Oxley Act (“SOX”) in response to widespread concerns regarding corporate governance in light of the Enron and WorldCom financial scandals. SOX was intended to make the financial reporting of public companies more transparent for investors and to add layers of checks and balances within company management aimed at avoiding these types of scandals in the future. While the provisions of SOX

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are intended to mainly apply to public companies, SOX has had the unintended effect of becoming the standard of “best practices” for all companies, public or private. As a result, more and more private companies are becoming, to some extent, SOX-compliant.

The cost of compliance, however, is not always easily absorbed by a private company, particularly those private companies in a start-up stage. Nor is the cost easily measured. Yet, any private company that believes its future growth scenario involves a merger or sale with a public company or an initial public offering must be SOX-compliant by the time of such transaction. This would likely include most companies with venture capital investors. Additionally, many lenders and insurers are now requiring some level of SOX compliance for financing transactions and obtaining insurance, particularly D&O liability insurance. This has created a tension for start-up or early-stage companies: When does the company need to comply with SOX and with which portions? Not all SOX provisions need to be complied with at once. What follows is a discussion of the various SOX requirements and a suggested framework for their adoption by start-up and early-stage venture-backed companies.

SOX Applies to Everyone

Many business people are surprised to learn that certain SOX provisions apply to all companies. Section 1107

establishes criminal penalties for retaliation against a person who provides information regarding a federal offense or potential federal offense to a law enforcement officer and Section 806 of SOX provides protection for employees who disclose information about fraudulent activities within his or her employer. Additionally, the statute of limitations for securities fraud was extended to five years under SOX and any liabilities associated with securities fraud violations cannot be discharged in bankruptcy. Section 802 of SOX provides criminal sanctions for private companies engaged in illegal destruction of documents prior to the commencement of litigation. Clearly, all companies need to be SOX-compliant to some extent.

Basic Provisions of SOX for Public Companies

Most of the provisions of SOX, however, are directly applicable to public companies only and are quite broad in scope. These provisions include those affecting business conduct and ethics, composition of the board of directors, loans to officer and directors, and financial reporting and controls.

Code of Business Conduct and Ethics

Under Section 406 of SOX, public companies are required to adopt a Code of Business Conduct and Ethics that will apply to the company's chief executive officer and all senior financial officers. This code should provide standards that promote honest and ethical conduct; full, fair, accurate, timely, and understandable disclosure in the periodic reports the company files with the SEC; protection for whistleblowers; and compliance with all applicable laws, rules, and regulations. A company must affirmatively disclose if it has adopted such a code and make the code available for distribution. If a company does not have a code of ethics, it must explain why not.

The requirement that a company adopt a written code and disclose its content to its shareholders is intended to encourage each company to carefully consider the ethical and operational standards that it wants to live by. These address, among other things, the specific steps to be taken by employees when handling conflicts of interest, financial reporting, and compliance with laws. It sets the tone for the company's management.

Unfortunately, many companies have adopted a standard, "off the shelf" code of ethics, without reflecting on its appropriateness and applicability to the culture and personality of the company's own business. At times, this decision has had dire consequences, as unnecessarily sweeping ethical standards were violated by the very executives who adopted them—resulting in their own embarrassment, discipline or, even, termination.

In today's litigious world, directors, and especially financial experts, are highly sensitive to the risks they take by becoming board members, and for the most part, tend to limit that risk by only agreeing to be nominated for boards of highly established companies with extensive and sophisticated Sarbanes-Oxley compliance procedures.

Composition of Board of Directors

Section 301 of SOX emphasizes the role of independent directors on the board, requiring at least one member of the board of directors to be an independent director with financial expertise and all members of the audit committee to be independent directors. The role of the audit committee was enhanced under the new SOX rules and it now serves as the principal liaison between the company's independent accountants and the full board of directors. An outside director with financial expertise must serve as the chair of the audit committee, and such director's presence on the board needs to be separately disclosed in financial reports filed with the SEC. Additionally, SOX encourages the various stock exchanges to require that the majority of a company's board of directors be independent, a requirement that has been adopted by the New York Stock Exchange and NASDAQ. While each listing stock exchange may differ slightly in the particulars of board and committee compositions, they all require public companies to have at least three separate committees: compensation, nominating/corporate governance, and audit committees. The audit committee must be comprised of at least three outside directors and, with limited exceptions, NASDAQ and the New York Stock Exchange require that all members of the three mentioned committees be independent.

The emphasis on independent outside directors is a direct response to the WorldCom and Enron financial scandals and assumes that independent directors will

act objectively and serve as a shield between a runaway management and the stockholder/investor. There are obvious gains to be had for a company with outside director involvement. With the right directors, a company can gain valuable insight from a seasoned executive who has seen it all before and perhaps avoid common pitfalls with creative solutions the executive has used previously. There are costs associated with this experience, however, as these outside board members will likely require payment for their services (and payment with equity could jeopardize their independence) and they will surely require the company to obtain and maintain directors and officers liability (“D&O”) insurance, which has become significantly more expensive in recent years. Also, there is no assurance that an outside director will actually help avoid an Enron-type scandal; in fact, Enron had experienced outside directors on its board. Lastly, it may be difficult for companies to secure financial experts to serve as outside directors as these financial experts are becoming a valuable and rare asset in the business world.

Eligible director candidates and, especially, financial expert candidates, are quite cognizant of the risks involved in serving on boards. They gravitate toward the least risky and most remunerative situations—perceived as those companies that have elaborate Sarbanes-Oxley infrastructures: dedicated personnel, sophisticated tracking software, and the like. This puts smaller and emerging public companies at a disadvantage. Inevitably, they do not have the resources committed to SOX compliance that a larger company can—and does—afford.

Loans to Directors or Officers

Under Section 402 of SOX, public companies may not make any loans, or arrange for the extension of credit, to any of its officers or directors. Loans in existence prior to July 20, 2002 were grandfathered in, as long as the loan was not renewed or there were no material changes to the terms of the loan. This rule aids in the transparency of a company’s financial statements and the compensation packages made available to the executives and avoids any conflicts between the company’s best interests and those of management.

Financial Reporting and Controls

The most sweeping changes under the SOX rules are those related to a company’s financial reporting and internal financial controls. These are the SOX requirements that are the most costly to comply with as well. Under Sections 302 and 906 of SOX, for each annual and quarterly report filed by a public company, its chief executive officer and chief financial officer must personally certify (1) the compliance of the company’s financial statements with the Securities and Exchange Act of 1934 as amended (the “34 Act”); (2) that the financial statements fairly and accurately present, in all material respects, the financial results and operating condition of the company; (3) that there are no untrue statements or omissions of a material fact in the reports; and (4) as to the efficacy of the company’s internal financial controls. Further, under Section 404 of SOX, a public company’s independent accountants must certify as to the management’s assessment of its company’s internal financial controls. This certification is filed annually with the company’s Form 10-K reports.

Since a company’s principal executives must vouch for the accuracy of their company’s financial statements, they are forced to bear some risk for ensuring the accuracy of these statements. With the certification, it is thought that the executives will be less likely to overstate results and ask the necessary questions to ensure the accuracy of the statements. In fact, there may be some inclination to follow a more conservative approach and understate results, which would not achieve the goal of the SOX requirements. Nevertheless, there is no harm in causing the company’s executives to review the financial statements, ask questions, and then certify that the statements are accurate.

SOX for Private Companies

While most of the costly aspects of SOX compliance are not directly applicable to private companies, any early-stage or start-up company, particularly one backed by venture capital, has a growth strategy for the future. If this strategy includes taking financing in the future, whether by going public, seeking a merger or acquisition partner, or obtaining further equity or debt financing, the company will need to move towards SOX compliance.

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creditor claims, monetizing assets, release of any liens, insurance matters (including a director and officer “tail” policy), dissolution of the corporate entity, distributions to stockholders and related stockholder issues, and responding to other matters affecting the company.

Outside professional firms can provide the experience and detachment necessary to negotiate with creditors and resolve outstanding company obligations firmly and promptly, and are conversant with the matters to be attended to by outside accountants and legal counsel during this period. They also bring to bear their considerable experience in addressing and resolving the issues facing insolvent companies and can do so on a cost efficient basis. Such firms must, however, be supervised by the board or the officers, as appropriate.

10. When Dissolving the Company, Retain Assets for Administrative Expenses and Unforeseen Liabilities

When implementing a wind-down and subsequent dissolution of a company, directors must ensure that any distributions to stockholders are effected at a time and in a manner consistent with the company’s prior obligations to creditors. In the course of a liquidation and dissolution, stockholders may attempt to pressure venture-backed companies to distribute assets prematurely. Directors must ensure that, before any amounts are distributed to stockholders, all corporate liabilities have been paid or adequate funds have been reserved to satisfy them, and that a reasonable reserve has been established to cover unforeseen liabilities and the expenses that will be incurred as part of the dissolution process. If a court were to later conclude that a reasonable reserve to cover such amounts was not set aside by the directors, both the directors and the stockholders receiving the improper distribution could be liable to creditors for the amounts distributed to stockholders. One way to minimize this risk is to make a partial distribution to stockholders once directors are confident that most known corporate liabilities have surfaced and have been satisfied, to be followed by a final distribution at the end of the dissolution process when directors have more confidence that all unforeseen liabilities have emerged and have been satisfied. ©

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In fact, many venture capitalists are insisting on some level of compliance from the earliest points of investment both to facilitate a liquidity scenario at a later date and to ensure that the company is managed in accordance with what are fast becoming the “best practices” standards for corporate governance. In a recent survey by Foley & Lardner LLP of 9,000 private companies, 78 percent indicated that they have adopted some self-imposed SOX compliance. The reasons given by respondents for adopting these standards range from preparation for future events (such as an IPO or sale of the company) to a determination that a world-class organization should follow the best practices whenever possible.

When and How the Early-Stage Company Should Be SOX-Compliant

There is a wide range of SOX regulations and full compliance with some of the SOX provisions is costly, both in time and money. There are many other SOX provisions, however, where compliance is not costly and helps investors and business partners feel more confident about the management of the company. While a private company may not become fully SOX-compliant with the internal control audit provisions of SOX (which are the most costly of the regulations to comply with), meeting the intent of SOX can be done from the beginning of the business and increase over time as funds are more readily available.

From the Beginning ...

Since SOX rules related to document retention and whistleblower protection apply to all companies, every business, public or private, should adopt policies relating to these rules from the beginning. The document retention policy needs to articulate clear procedures for when to retain documents and what types of documents must be retained, even in the period prior to the commencement of a lawsuit or other proceeding. A company must also adopt a written policy for how employees may report wrongdoings within the company. The whistleblower policy should provide an avenue for reporting the

activity to an independent person not directly related to management, such as a designated outside director, the company's independent accountants, or an independent compliance phone hotline. Due to attorney-client privilege issues, the company's counsel should not serve as the designated person for the whistleblower. The adoption of these policies is not a costly requirement for any company, including a start-up.

While the SOX rules regarding the adoption of a Code of Business Conduct and Ethics applies only to public companies, private companies should adopt one from the outset as well. The adoption of such a policy is an inexpensive way to provide comfort to the business world, including venture funds, that the start-up company is being operated in accordance with the best business practices and with the intent of complying with SOX, even if the company cannot afford to comply to the letter with all SOX rules. The Code of Business Conduct and Ethics should be a written policy stating the standards of the company and the steps to follow in certain situations, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair, accurate, timely, and understandable disclosure in financial reports; and compliance with applicable laws, rules and regulations.

The SOX prohibition on loans or arrangement of credit to or for a company's officers and directors should also be adopted by private companies at the beginning of operations. Like the adoption of the Code of Business Conduct and Ethics, adherence by a start-up company to this SOX provision is not costly and sends the appropriate compliance message to the investment community. Since this provision technically applies to IPO candidates at the time of filing their initial S-1 with the SEC, which is before their registration statement is declared effective and they are deemed "public" in the eyes of the investment community, failure to address these issues early on could delay a public offering. For example, companies that permit insiders to purchase restricted stock with promissory notes may be forced to either forgive these loans or delay their IPO filings until these insiders obtain the resources to make repayments in full.

Lastly, the private company should engage independent accountants for the preparation of its financial reports as early as possible. While many start-ups simply cannot afford the costs associated with, and may not feel the need for, audited financial statements at this early stage of its business, the independent accountants should, at a minimum, review and compile the company's financial reports and aid the company in establishing the financial systems the company will need as it grows and a plan for implementing those financial systems over time.

Undoubtedly, an emerging company cannot afford a "Big Four" accounting firm. In fact, such a firm may not be the most appropriate for auditing a small company. There are, however, many firms in the next tier: local and regional firms with 10 to 100 professionals who focus on the emerging and middle markets. Some of these firms serve as auditors for emerging technology companies and middle market business; many continue to represent some of these companies after an IPO. Ideally, it is these types of firms that would best service any emerging company desirous of adopting SOX-type "best practices."

As Funding Increases ...

One of the changes with SOX is an emphasis on an independent outside board of directors. This can be a difficult requirement for an early-stage company as it rarely has the money to pay an outside director for his or her time, and even less money to pay for the D&O liability insurance that an outside director will surely insist upon. Further, in a first round of equity financing, a board member will likely want to receive an equity stake in the company to enjoy the increase in value for the company. This equity stake, however, may render the director an insider, or at least disqualify such person from benefiting from certain safe harbors applicable to the SEC's independence standards. While the ownership of a significant amount of stock does not, in itself, render a director an insider, the ability to control the voting power of the company, together with other operational approvals and consents, may render it difficult for the director to exercise independent judgment in carrying out his or her duties as a director. The SEC and the exchanges have detailed standards of "independence" that public companies need to follow; however, the inability to exercise such independent judgment, or

the existence of a “material relationship” is a common standard for determining if a director is an insider. As a result, a representative of a venture investor who sits on a company’s board may be considered an insider, particularly in the very early stages of the business where the venture investor has significant control and input regarding the company’s operations.

As a company enters its second or third round of financing, however, the company should give serious thought and effort towards engaging outside independent directors with appropriate financial expertise and industry experience. First, there is no harm in obtaining an experienced outsider’s input into the management of a company, whether private or public. Second, as a company obtains more funding and continues to grow, there will be more pressure placed upon it to comply with corporate “best practices,” which include the retention of independent directors. Third, the company’s independent accountants will want the company to establish an audit committee to act as a liaison between the accountants and the full board. At the time the audit committee is established, the company’s board should also form a compensation committee. Each committee should have its own written, board-approved charter and meet at least quarterly.

At this stage, when outside directors join the board, the company should consider having the independent accountants prepare audited financial statements if they aren’t doing so already. It is also likely that the outside directors will insist upon audited financial statements to ensure the company’s compliance with generally accepted accounting principles. Certainly, the financial statements will need to be audited within a year prior to either an initial public offering or acquisition by a public company, if either of these are likely liquidity scenarios. If they are not likely liquidity scenarios, then audited financial statements can wait until a third or fourth round of financing.

Late Stage ...

If a company’s financial statements are not yet audited, they should be at this point. A seasoned company with several rounds of financing should comply with the SOX financial reporting requirements to ensure that accurate

and fair financial disclosure is made to its investors/stockholders. Additionally, if the company is contemplating an acquisition strategy (where the company could be the acquired entity) or an initial public offering, the company will need to have an internal control audit by its independent accountants and be fully SOX-compliant for the year prior to such transaction. If neither of these transactions are remotely possible, a company does not need full SOX compliance with the internal controls audit provisions, although such internal controls, even if not audited, are becoming a “best practices” standard and, over time, may be required by a company’s investors and business partners.

Conclusion

While much of the SOX rules and regulations do not apply to private companies, there is a range of SOX requirements that apply to public companies that are being adopted in the private sector as the “best practices” standard. Many of these provisions do not require a company to expend much in order to comply and yet compliance sends a strong message to the investment community regarding the financial and ethical position of the company. As the company grows and obtains further funding, the extent of compliance can be increased and tailored to match the company’s available funds. ©