

SARBANES MAY AFFECT PRIVATE COMPANY CORPORATE GOVERNANCE AND COMPLIANCE

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You've probably heard about the Sarbanes-Oxley Act of 2002 (sometimes called "SarboX") and the dramatic changes it has brought to the world of corporate governance and compliance. But you may not have paid much attention since these corporate governance and compliance provisions are only applicable to companies registered with the Securities and Exchange Commission (SEC).

Let's say that you're a CEO or CFO of a company having annual revenues of about five million dollars. A dozen investors and members of senior management, including you, own all of the stock of the company. Your company has never registered its stock with the SEC and SarboX is not applicable to your company. Is there any reason why you should be concerned about corporate governance and compliance?

Many of your peers think so. In a July 15, 2004 article, *THE NEW YORK TIMES* mentioned some of the reasons why at least some private companies have decided to adopt voluntary corporate governance and compliance standards comparable to those required of public companies.

The main reason is that the corporate governance and compliance standards mandated by SarboX have quickly been co-opted as a "best practices" standard and may ultimately be used by courts when dealing with private company cases. Everyone has an interest in maintaining the integrity of a company's business and third parties who have business and financial dealings with companies want transparency in financial and corporate disclosure.

Accordingly, investors and lenders to private companies now frequently require private companies to adhere to these standards as a condition of financing. In addition, representations regarding corporate governance and compliance are also appearing in joint venture and strategic alliance agreements. Audit firms are also asking companies and their legal counsel about the corporate governance and compliance standards employed by the company in connection with their audit review of financial statements. Insurance companies that underwrite directors' and officers' liability policies are also concerned about corporate governance and compliance.

Another reason for adopting SarboX's corporate governance and compliance standards is that many private companies aspire to access the public markets or to become acquired by public companies. In that regard, entrepreneurs, venture capitalists and private equity firms that own interests in private companies who are positioning them for a public offering or sale, frequently require compliance with SarboX's corporate governance and compliance standards.

For these reasons, it may be a good idea to adopt at least some of these corporate governance and compliance standards. So, what are the standards that your company should consider?

Many companies have added independent outside directors that are not affiliated with management or any of the major investors in the company, and, particularly, directors with some measure of financial expertise. In addition, they have formed an audit committee of the board, generally comprising independent directors who have responsibility for oversight of the company's financial statements, including interaction with the company's outside audit firm.

In connection with the preparation of the company's financial statements, many companies have adopted stricter internal controls to ensure the integrity of the financial statements and have restricted some practices that are endemic in private companies such as loans by the company to management and shareholders. Companies have also adopted stricter practices for the use of pro forma financial information and off balance sheet transactions, particularly those between the company and unconsolidated entities controlled by affiliates to enhance the transparency of the financial statements.

Some companies have even gone so far as to adopt a procedure to protect corporate whistle-blowers.

If you would like to learn more about SarbOx and why private companies may find it beneficial to adopt some of its corporate governance and compliance provisions, or if you need assistance in developing these provisions, Contact Rob Brighton or other attorneys in the Firm's Securities Practice Group.

Corporate Governance Standards

- Independent Directors
- Appointment of Independent Audit Committee
- Stricter Internal Controls
- Financial Statement Transparency
- Code of Ethics
- Whistle-Blower Protection