The Sarbanes-Oxley Act and Private Companies

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The passage of the Sarbanes-Oxley Act heralded sweeping changes for corporate governance and the securities and accounting industries. Enacted in July 2002, and interpreted by several rules promulgated by the Securities and Exchange Commission (the "SEC"), the Act seeks primarily to rectify "the systemic and structural weaknesses affecting our capital markets revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years," according to the Senate committee charged with its review. Perhaps the most widely-reported provisions of the Act address perceived abuses in the areas of public company governance and financial reporting. The Act also focuses on auditor oversight and independence, financial analyst conflicts of interest, and fraud and related crimes. This article seeks briefly to review selected provisions of the Act with implications for the *private* company.

With the issuance of the SEC's interpretive regulations over the last few months, many an entrepreneur has put the question to his lawyer or accountant, "The Sarbanes-Oxley Act seems to be important for large, public corporations, but what relevance does it have for my privately-held business?" A simple answer is that most provisions of the Act address only public companies. Indeed, one of the co-authors of the Act told his Senate colleagues during floor debate: "This bill applies only to public companies that are required to report to the SEC." A better answer is that the Act ushers in a host of changes which affect public companies, some of which, to an as yet uncertain degree, cascade to their private counterparts. Moreover, a small number of the Act's provisions directly affect private companies.

The Act and associated new and proposed regulations issued by the SEC, New York Stock Exchange and National Association of Security Dealers compel a host of changes to public company governance standards. One such rule requires that a majority of the directors of a public company to be "independent," meaning, among other things, that a director is, 1) not an employee of, or recently-employed by, the company, 2) not an owner of more than a specified percentage of the company's shares and 3) not recently employed by the company's auditors. Many public companies not currently in compliance with the new director independence standards are adapting to the new regulatory regime only with difficulty. The public company director independence requirements cast their shadow over private companies as well. Many private companies with hopes of an initial public offering ("IPO") must now reconfigure their boards in anticipation of having to comply with the new public company standards. For many, this may hamper an IPO and a close off an important source of new capital.

Consider the case of a venture capital-backed company reaching critical mass. Market conditions may be perfect for an IPO (recall that this is a hypothetical scenario). Venture investors, founders, and executive officers, all typically large shareholders, likely dominate the board of directors as they attempt to guide the growth of their company and profit from a public offering. As a closely-held company, there is no investing public "requiring" the protection afforded by independent directors. Indeed, the aims of the board and the few shareholders may be close to unified. In order to go public, however, one or more of the foregoing director constituencies will need to share power with independent directors, or even relinquish board seats altogether. None of these actors may be wish to be the first to do so, especially a venture capital investor who fears losing control of a blossoming investment.

Another provision of the Act requires the CEO and CFO of a public company to certify personally the truthfulness and "fair presentation" of their company's financial reporting. The Act subjects those who knowingly certify false or incomplete financial statements to civil and criminal penalties, including the forfeiture of performance-based pay. While theoretically of little concern to the officer who has a good faith belief in the quality of his company's financial reporting, in practice, this new requirement may prove troublesome. Where, for example, a public company "X" acquires a private company "Y" (whose officers are not subject to the Act's certification requirement), the certifications by X's CEO and CFO for future, consolidated financial statements will include Y's uncertified financials for pre-acquisition reporting periods. The records of Y may or may not have been maintained according to the standards (both of truthfulness and technical accuracy) required of X. To the extent that Y has maintained its books in a problematic or simply non-standard manner (e.g., using pro forma numbers without reconciliation to GAAP), its value as an acquisition target may be greatly diminished.

At least one lesser-known provision of the Act has direct application to private companies. In response to the document shredding which hampered the Enron and Arthur Andersen investigations, the Act imposes federal criminal penalties on individuals who alter or destroy documents or electronic records with the intent of frustrating actual or potential official investigations and court proceedings. There is no requirement that the records in question belong to a public company, nor that an investigation actually have begun. Because the Act's prohibition on destroying or altering documents extends beyond traditional notions of obstruction of justice and destruction of evidence, all companies, public and private, should adopt – and follow – a document retention and disposal policy in order to avoid later appearing to have destroyed records to frustrate a government investigation.

In addition to the effects on private companies outlined above, the Act and associated rules may also portend changes in the areas of auditing and other services provided by accountants. The Act seeks, for example, to reduce conflicts of interest involving accountants. It mandates that accountants who serve as auditors for a public company refrain from most types of non-audit work, including financial information systems design and implementation, bookkeeping services, internal audit outsourcing, and expert services unrelated to auditing. In these and other areas of prohibited work, the Act seeks to prevent auditors from auditing their own work and from taking part in management decisions, as they necessarily would should they design the very systems which they routinely audit or take an active role in internal audits. Regulators in several states have expressed an interest in imposing similar restrictions on auditors of private companies. Private companies typically have a relatively small number of shareholders and users of their financial statements tend to be financially sophisticated. Most commentators on the subject therefore feel that the potentially costly strict separation of audit and other accounting services for private companies – and limited investor protection potential – should defeat such proposals.

In light of the provisions of the Sarbanes-Oxley Act outlined above, private companies must stay informed regarding the Act, related regulations and any state legislation which they inspire. While all private companies may be subject to increased scrutiny in areas such as document retention, most affected will be those with aspirations of either an IPO or acquisition by a public company. Finally, should the reforms contained in the Act and related regulations come to be seen as the "gold standard" of corporate governance, private companies may find that certain of the Act's requirements increasingly represent best practices, if not legal mandates.