

FROM THE FIELD

# Private Companies Toe the

# SOX LINE



By Guest Writers  
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**T**he Sarbanes-Oxley Act (SOX) raised the bar with regard to corporate governance, internal controls, and executive responsibility, among other features of business operations. Although SOX applies primarily to public companies, private companies do not completely escape its coverage, directly or indirectly. In mergers and acquisitions, for example, acquirers increasingly are demanding that private targets attest in the representatives and warranties sections of purchase agreements that their internal controls and other elements are in compliance with SOX provisions.

As a result, private companies should become familiar with SOX for two reasons. First, SOX directly applies to private companies in areas such as whistleblower protection and document retention. Second, implementation of SOX provisions that seem to apply strictly to public companies may be required by some business partners of private companies, buyers for example. In general, SOX compliance may make good business sense.

Demands for SOX compliance are falling across a broad front.

Lenders, for example, are beginning to require compliance with some SOX provisions before providing financing. Lenders particularly are interested in accurate financial reports and may require officers to certify the accuracy of these reports similar to the way certification requirements are imposed on public company officers. Financiers also are requiring corporate governance measures that meet SOX standards and may require representations and warranties or covenants in financing agreements to ensure compliance. If an acquirer wants financing to buy a private firm, it may be required to assure lenders that the target passes SOX tests.

Venture capital investors are interested in SOX compliance by companies in which they hold an interest as well as potential new investment targets, with a particular focus on accurate financial reports and prohibition of related party transactions, which the law bars. Insurers are looking to SOX in providing directors and officers (D&O) coverage. Certified financial results and various corporate governance measures, such as the proper num-

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ber of independent directors, may be required as conditions to coverage. Finally, some governmental entities are requiring a level of compliance before awarding contracts to private companies.

In the M&A area, SOX compliance must be addressed as part of the transaction when there is a publicly traded acquirer and a privately owned tar-

get. Because SOX compliance is costly and time-consuming, a public buyer is likely to place a lower value on a privately owned candidate if significant time and expense will be needed to bring the target up to standards. A "SOX-ready" private target, conversely, will make for an attractive candidate and even may fetch a premium, if the acquirer is spared post-deal cost and trouble and faces reduced risk of SOX liability.

A potential target with inadequate internal controls and financial reporting procedures will cause particular concern for a publicly held acquirer. Once an acquisition is completed, officers of the acquirer will be required to personally certify the accuracy of the target's financial results. An improper certification can result in fines and possible criminal penalties. That risk provides a strong incentive for public company officers on the buy side to place a premium on strong financial reporting procedures and internal controls of their target.

As a result, acquirers are incorporating SOX compliance into their due diligence processes and requiring targets to fully document internal controls and correct deficiencies as a condition of closing the deal.

Acquirers may require representations and warranties that cover SOX-related matters, including the buyer-friendly "10b-5" representation. The 10b-5, or "full disclosure," representation is often insisted on by a buyer to ensure that a seller has not omitted out anything important, even after making voluminous representations. The "full disclosure" representation might read as follows:

"No representation or other statement made by the Sellers in connection with the Transaction contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances under which it was made, not misleading."

Specific representations and warranties also being required on such matters as:

- Adequacy of internal financial controls;
- Corporate governance issues, e.g., establishment of independent committees, such as audit, nominating, and compensation committees;
- Whether there are any off-balance-sheet items;
- Loans to officers or directors; and
- Policies on receiving and investigating “whistleblower” complaints.

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Often, a definitive agreement will require sellers of a private company to indemnify the acquirer if representations or warranties are breached. As with other due diligence elements, indemnification obligations may be secured by a holdback or escrow of a portion of the purchase price for some period of time after closing.

A private company that is contemplating selling itself should consider consultation with experts on how to apply SOX internally in advance of a transaction. To reiterate, these measures make the company a more attractive target and help the seller secure the best purchase price.

Second, outside experts can educate business owners and management regarding applicable SOX provisions so that they are prepared to understand representations and warranties they may have to offer in the acquisition agreement. The seller and its advisers then are in a good position to negotiate the representations and make required disclosures that are appropriate but don't unnecessarily expose them to unreasonable indemnification liability.

At a minimum, private companies should look to SOX as a “best practices” guide and implement provisions that are applicable and cost-effective. Many of the law's corporate governance measures, such as establishing board committees and developing a code of ethics for senior officers, make sense because they can be accomplished at reasonable costs that are significantly outweighed by the benefits provided. Good corporate governance provides legitimacy to corporate records and actions, provides for the standardization of processes to improve efficiency and accuracy, and results in more accurate financial reporting for internal management to evaluate.

Some proactive private companies have even incorpo-

rated a Management Discussion and Analysis (MD&A) section into their financial reports, which is an SEC requirement for public companies. A final point to consider is director liability because private company directors owe duties of care and loyalty to shareholders just like directors of public companies. Complying with SOX provisions may provide directors with protection from plaintiff's attorneys who point to the law as a basis for arguing how a director should or should not have acted.

Implementation of SOX in its entirety is not feasible or cost-effective for most private companies. However, many are being forced to comply with certain parts of the law SOX or are complying as part of their ongoing business planning to more easily realize goals of a public offering or acquisition. Companies that are considering implementing certain practices that have resulted from SOX should seek the advice of knowledgeable counsel.

SOX requirements and other “best practices” that private companies may consider adopting include:

- Recruiting independent directors for boards and board committees;
- Establishing audit, nominating, and compensation committees;
- Adopting a code of ethics;
- Ensuring proper registration of an outside auditing firm;
- Evaluating and documenting internal controls and procedures and improving them if necessary;
- Reviewing services provided by outside auditors and adopting policies regarding the awarding of non-audit services;
- Engaging auditors to perform “pre-review” of internal controls before a public offering;
- Adding MD&A to financial reports;
- Putting corporate governance information on the company web site; and
- Requiring executive officers to certify financial reports. ■

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