

More complications

Life isn't easy for general partners in the current environment, and the Sarbanes-Oxley Act, designed to restore confidence in the US public markets, isn't making it any easier. Prakash Mehta examines three areas in which the reforms will change the way things work in private equity.

Anxiety turned to relief when the opening bell at the NYSE rang to mark the end of the September 11 trading interruption, the longest since the Great Depression. But the sound of the bell said little about the soundness of the markets. Soon after September 11, Enron collapsed, and only a few months later WorldCom began to crumble too. Just as after the crash of 1929, restoring confidence in the US public markets seemed to require dramatic action. In the early 1930s, the US Congress, together with President Roosevelt, responded by enacting the Securities Act of 1933 and the Securities Exchange Act of 1934 and establishing the Securities and Exchange Commission (SEC). Today's equivalent comes in the form of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). This new law, signed by President Bush on July 30, revamps public company corporate governance, bolsters disclosure rules and enhances oversight of accounting firms. Like the reforms of the 1930s, Sarbanes-Oxley sets the stage for extensive follow-up rulemaking by the SEC and other regulatory bodies.

Sarbanes-Oxley's implications are wide-ranging. Among its highlights are requirements that CEOs and CFOs of public companies provide detailed certifications as to the accuracy and completeness of their company's financial statements and their internal information collection, verification and reporting controls. It bans companies from making personal loans to executive officers and directors in all but a few cases. Moreover, a new Public Company Accounting Oversight Board will license and review auditing firms and scrutinise their compliance with audit/non-audit service rules. Board audit committees will also need to review more proactively the work of corporate auditors. In terms of information reaching the

marketplace, public companies will now have to disclose, on a real-time basis, material changes in their financial condition and operations, describe all material off-balance sheet transactions and present pro forma financial information in a manner so as not to be misleading. To add teeth to its substantive provisions, Sarbanes-Oxley includes enhanced penalties for violations, including longer prison sentences and forfeiture of bonuses.

At the same time, Sarbanes-Oxley and the events driving its passage have led the NYSE and Nasdaq to propose new listing standards. While the SEC has yet to approve the changes, the new standards are expected to be in place before 2003, with some phased in over time. The changes include revised qualification criteria for "independent" directors, a mandate that listed companies have a majority of independent directors on their boards with fully independent compensation and nominating committees and a number of additional obligations for audit committees. Both the NYSE and Nasdaq proposals exempt "controlled companies" – where more than 50 per cent of the voting power is held by an individual, group or another company – from the majority-of-independents and certain other requirements. The NYSE, Nasdaq and SEC may also relax the requirements facing non-US companies qualifying as "foreign private issuers," >>

though perhaps only where they conflict with home country requirements.

While many of its precise ramifications remain undetermined, Sarbanes-Oxley and its regulatory progeny are likely to affect the private equity industry in several ways, three of which are examined in this article. First, private equity-style investors will have a host of new considerations to take into account as they participate in the corporate governance of portfolio companies. Second, a different mix of factors may come into play for public companies sponsoring and investing in private equity funds and similar vehicles. And third, industry participants may confront enhanced accounting, auditing, fiduciary and compliance standards.

1. Participating in corporate governance

Sarbanes-Oxley and the NYSE and Nasdaq reforms strike a new balance between corporate management and the board of directors. All directors, especially independent directors, will have to play a more active role. For private equity firms, Sarbanes-Oxley ups the price of seeking influence over portfolio investments.

Governance risks. Director candidates and their shareholders should ascertain the risks associated with board membership not only by analysing the fiduciary duties they owe to the company and its shareholders, but also by asking the following kinds of questions. What steps has the company taken in response to Sarbanes-Oxley: has it set up nominating, compensation and disclosure review committees, banned personal loans to executive officers, etc.? Will the CEO and CFO be able to provide the certifications in the next quarterly or annual report? Has the company adopted a code of conduct for all officers? Where the answers to such questions are unsatisfactory but the investment is still worth the trouble, observer status may be preferable to board membership.

D&O indemnification and insurance. Careful study of indemnification provisions and insurance policies has become an absolute necessity. Directors and their shareholders (and counsel) should understand the scope and other terms of the indemnification in the company's charter documents or other agreements and of the company's D&O and E&O insurance. What items do the indemnity and insurance cover (e.g., mistakes in SEC filings)? What carve-outs and exclusions exist? Have any claims been made? What type of backstop coverage does the private equity firm's own insurance policy provide? Have companies and firms updated their policies to reflect the legal risks associated with Sarbanes-Oxley?

And how much will additional insurance cost if purchased at the firm or company level?

Counting "independents." Boards are to be more "independent" so as to better scrutinise conflicts and questionable uses of power on the part of corporate managers. An NYSE-qualified independent director will have no material relationship directly or indirectly with the company (e.g., whether commercial, industrial, banking, consulting, legal, accounting, charitable or familial in nature). Qualifying directors of Nasdaq companies will not be officers or employees or otherwise have relationships that would interfere with their ability to make unbiased, non-conflicted decisions regarding the company. Ex-company employees or company auditor employees will need to wait - three years for Nasdaq, five years for the NYSE - before they can be considered independent.

Neither the NYSE nor Nasdaq has established per se rules precluding directors affiliated with large shareholders from qualifying as independent. Perhaps such persons should qualify - particularly where they are appointed by private equity investors whose return-oriented interests seem well-aligned with those of other shareholders seeking checks on management. In any case, the "controlled company" exception eliminates the majority-of-independents requirement in perhaps the most crucial case for private equity investors. But the new independence rules leave open several questions. For example, it remains to be seen whether investors will more often opt to acquire control (individually or as a group) or elect to reconfigure the composition (who's on and who's off) or size (bigger or smaller) of corporate boards.

2. Private equity sponsorship and investment by public companies

A substantial percentage of public companies, including not only banks and brokerage firms but also diversified conglomerates, meaningfully participate as sponsors and investors in today's private equity market. Though unlikely to alter the basic investment thesis - return on capital and, for fund sponsors, participation in carried interests and management fees - Sarbanes-Oxley may complicate the path of private equity sponsorship and investment by public companies.

Going off balance sheet. Many public companies have structured captive and third-party funds as off-balance sheet entities or special purpose vehicles. Grappling with the consolidation rules to account for such investment vehicles has involved fact-intensive analysis with respect to ownership and control (including, for instance, evaluation of the rights of LPs to remove GPs). Depending on the circumstances, companies could transfer assets

Beefing up the audit committee. The need for “monitoring the monitors” stands out as a central theme of Sarbanes-Oxley, as is clear in the case of audit committees. Under Sarbanes-Oxley, audit committees will now be “directly responsible for the appointment, compensation and oversight” of the company’s accounting firm, and the accounting firm must, in turn, “report directly to the audit committee.” The audit committee must establish procedures for receipt and handling of complaints, and confidential and anonymous submission by “whistle-blowing” employees, regarding accounting or auditing matters. Companies must give audit committees the authority and funding to retain independent counsel and other outside advisors. At least one member of the audit committee will need to meet the soon-to-be-issued criteria of a “financial expert” (e.g., having an understanding of GAAP and its application in accounting for estimates, accruals and reserves).

Higher fiduciary standards. Although Sarbanes-Oxley does not expressly do so, its application may begin to raise the bar on fiduciary duties. Private equity firm-appointed directors must remain particularly sensitive because of the tension between their fiduciary obligations to all shareholders (not merely the ones that appointed them) and their own funds’ interests (including fiduciary duties to fund investors). Investment managers generally owe investors a fiduciary duty coupled with affirmative duties of the utmost good faith, and complete disclosure of material facts. Where a fund partnership agreement is silent or ambiguous on these matters, courts look for guidance to traditional notions of fiduciary duties, notions Sarbanes-Oxley may adjust. One precautionary step funds can take is to ensure that their LP advisory committees are being presented with all conflict of interest situations and difficult valuation decisions.

Certifying errors. Irregularities and misstatements uncovered after certification will require special care. Of course, where mistakes are made, none of the choices will be appealing. Arguing that a fact is not “material” may be one possibility. Indeed, for a fund invested in one public company and sponsored by another, it may even be possible to concede a fact is material at the portfolio company level without foreclosing an argument about its materiality at the level of the parent. But the strength of such an argument will depend on the size and significance of the investment, and one never knows which investment will stand out as the elusive “home-run” and which the dreaded “dog.” If materiality simply cannot be debated, audit committees may need to step in, possibly hiring special counsel and accountants to conduct internal investigations and, depending on the results, evaluating whether restatements are necessary.

Reporting trades. As a result of Sarbanes-Oxley, private equity funds owning more than 10 per cent of a public company’s shares (and possibly less if they have appointed directors) will need to file Section 16 – Form 4 reports within two business days of a change in ownership. Private equity firms should work with portfolio companies to ensure that stock and option grants to their directors are reported. Oftentimes directors go unaware of such grants and do not instruct compliance officers to file the necessary Form 4s. Perhaps the best way to proceed going forward – in order to avoid inadvertently missing the deadline – will involve asking portfolio companies to file for both inside and outside directors. Fortunately, “foreign private issuers” will remain exempt from Section 16 requirements.

Exit

The private equity industry seems overall to have avoided the harsher effects of the treatment administered by Sarbanes-Oxley to public companies and their boards, management and accountants. But private equity managers must now more carefully evaluate how much influence over portfolio companies to pursue and how to exercise the influence they have. Another key message is the call for better accounting and tighter compliance. Less obvious, but still decipherable, is the meaning for institutional private equity practices, which may change over time. Sarbanes-Oxley’s potential reach may serve as yet another reason in today’s bear market to ask when the IPO can again become a preferred method of exit. This obviously depends on the returns that listing a business can generate. Once public markets recover, offering better multiples for private equity backed-companies seeking a listing, the hard-to-swallow aspects of Sarbanes-Oxley should go down more easily.

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