What Every Private Equity Professional Must Know About Sarbanes-Oxley Reforms

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On 7/30/02 President Bush signed into law the Sarbanes-Oxley Act of 2002 ("SO"), overwhelmingly approved by Congress five days earlier by a House vote of 423 to 3 and a Senate vote of 99 to 0, reflecting the intense political pressure on both Republicans and Democrats to respond to the corporate and accounting scandals roiling public markets. SO represents Congress's and the Administration's effort to restore investor confidence in public markets through sweeping disclosure, accounting, and corporate governance reforms. Partially on their own initiative and partially in response to SO, the NYSE and Nasdaq have also proposed rules to enhance board and audit committee independence and impose other corporate governance reforms.

This article focuses on the key issues of particular concern to private equity ("PE") funds and their portfolio companies arising out of SO and the NYSE/Nasdaq proposed rules, including:

- Under what circumstances is a PE-financed portfolio company covered by SO, including the absolute prohibition on loans to executive officers and directors?
- When does SO's absolute loan prohibition prevent a portfolio company from selling stock to an executive in exchange for a note?
- Under what circumstances do SO and the NYSE/Nasdaq proposed director independence rules prevent a PE fund principal from serving on a portfolio company's board of directors or audit committee?
- How will a PE fund (or its principal) which is a §16 insider to a portfolio company comply with §16's new 2-day accelerated filing requirement for beneficial ownership changes?

A. §402 Executive Loan Prohibition

Frequently a PE fund's portfolio company sells stock to one or more of the portfolio company's key executives,

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who pay for the stock in whole or in part with a note. However, SO §402 prohibits a company covered by SO's "issuer" definition (generally a company with publicly-issued or publicly-traded securities, as described in more detail below) from:

> *"directly or indirectly, including through any subsidiary, ... extend[ing] or maintain[ing] credit, ... arrang[ing] for the extension of credit, or renew[ing] an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof)...."* [1]

***Application of §402 to Stock Sale for a Note*.** Where a company falling within SO's "issuer" definition sells stock to an executive officer (or director) for a note (or partially for cash and partially for a note), the note likely constitutes an extension of credit in the form of a personal loan and hence falls within SO §402's loan prohibition. This is because (absent favorable, and unlikely, SEC interpretation) the note issued to the company by the executive in exchange for the company's stock (like a personal borrowing of cash) is an obligation of the executive to pay money at maturity, generally with interest.

***Application of §402 to PE-Financed Portfolio Company*.** SO defines "issuer" (i.e., a company subject to SO §402's loan prohibition) as:

(1) a company with a class of debt or equity securities traded on a national securities exchange (a 1934 Act §12(b) company), or

(2) a company with (a) a class of equity securities (or warrants or options) held by 500 or more holders of record and (b) consolidated gross assets of $10 million or more (based on its balance sheet prepared in accordance with GAAP) (a 1934 Act §12(g) company), or

(3) a company which has sold debt or equity securities pursuant to a registration statement under the Securities Act of 1933 (the "1933 Act") and hence is "required to file [Forms 10-K, 10-Q, and other] reports [with SEC] under [1934 Act] section 15(d)" (a 1934 Act §15(d) company), except that such a company's status as a §15(d) company (and thus as an "issuer") is automatically suspended for each fiscal year (subsequent to the fiscal year in which the 1933 Act registration becomes effective) when the company has (on the first day of any such subsequent fiscal year) fewer than 300 record holders of such 1933 Act registered security, or

(4) a company which has filed with SEC a 1933 Act registration statement covering debt or equity securities that has not yet become effective but has not yet been withdrawn.

If a company falls within any one of these four "issuer" definitions, the company is prohibited from making a loan to an executive officer (or director) or continuing a loan previously outstanding (except for such a loan outstanding before SO's 7/30/02 enactment which is not thereafter materially modified or renewed). As discussed above, this prohibition likely includes (absent favorable, and unlikely, SEC interpretation) executive's note for the purchase of company stock.

There are several circumstances where a company might become a covered "issuer" (subject to SO §402's loan prohibition) even though the company has no publicly traded equity securities:

(a) Under (2) above, a company with 500 or more record holders of a class of equity securities and $10 million or more of assets is an "issuer" even if there is no public trading in the company's stock.

(b) Under (4) above, a company which files a 1933 Act registration statement with SEC to sell debt or equity securities (even though the registration statement has never become effective) immediately becomes an "issuer" at the time of filing with SEC, unless or until the 1933 Act registration becomes effective (in which case the company becomes an "issuer" under (3) above) or the company takes affirmative steps to withdraw the not-yet-effective 1933 Act registration statement (so that a company whose 1933 Act registration is on hold should generally withdraw the registration statement if the company desires to avoid SO §402's loan prohibition).

For example, a company filing a 1933 Act registration statement for (i) an equity IPO or (ii) a high-yield bond issuance — either for cash in the public market or in an A/B exchange for bonds previously issued in a private placement or offshore transaction — is immediately covered at the time of its 1933 Act SEC filing.

(c) Under (3) above, where a company's 1933 Act registration statement for debt or equity securities (including high-yield bonds) actually becomes effective and the securities are sold, the company is thereafter required to file 1934 Act §15(d) periodic SEC reports and is therefore an "issuer." However, such a §15(d) company — which has not become a §12(b) company (listed on a national securities exchange) or a §12(g) company (with 500 or more record holders of a class of equity securities and $10 million or more of assets) — ceases to be required to file SEC reports under §15(d), and hence ceases to be covered by SO §402, with respect to any fiscal year subsequent to the fiscal year its 1933 Act registration became effective if, on the first day of such subsequent fiscal year, the class of registered securities is held by fewer than 300 record holders.

Example 1

On 6/1 year 1 PE fund forms Newco (which adopts a calendar year) to acquire TargetCo in an LBO. Two months later on 8/1 year 1 Newco sells 80% of its stock to PE fund and 20% to Executive (who becomes Newco's CEO) in exchange for a note (or partly for a note) and then acquires TargetCo in an LBO financed in part by high-yield bonds privately-placed with 20 institutional buyers.

One month later on 9/1 year 1 Newco files with SEC a 1933 Act registration statement to exchange the privately-placed bonds for registered bonds with equivalent terms in an A/B exchange. Three months later on 12/1 year 1 the registration statement becomes effective and Newco promptly completes the bond exchange with the 20 institutional bondholders.

Newco has no securities listed on a national securities exchange and no class of equity securities held of record by 500 or more persons.

On 9/1 year 1 when Newco filed the 1933 Act registration statement, Newco became an "issuer" covered by SO §402 under (4) above, so that unless Executive paid the note no later than 8/31 year 1 SO §402 would be violated. On 12/1 year 1 when Newco's 1933 Act bond registration became effective, Newco remained an "issuer" under (3) above and hence continued to be covered by SO §402.

Example 2

On 1/1 year 2 (i.e., the first day of Newco's fiscal year subsequent to the fiscal year in which the 1933 Act registration statement became effective) there are fewer than 300 record holders of Newco's bonds.

On that date Newco automatically ceases to be covered by 1934 Act §15(d) with respect to fiscal years subsequent to year 1 (although SEC requests, but does not require, that Newco file a Form 15 notifying SEC that Newco has ceased to be a §15(d) company).

Notwithstanding this cessation: (1) Newco is still required to file its Form 10-K for year 1 with SEC (typically in March of year 2) and (2) if Newco's registered bonds are ever held by 300 or more record holders in the future, Newco would again be covered by 1934 Act §15(d) and would again be an "issuer".

It is, however, unclear whether Newco's "issuer" status terminated on 1/1 year 2 or continued until Newco filed its Form 10-K report for year 1, the last fiscal year in which Newco was subject to §15(d). Arguably Newco ceased to be an "issuer" under (3) above — i.e., a company "required to file reports under section 15(d)" — on 1/1 year 2, since Newco then had only one report (year 1's 10-K) to file with SEC and was no longer required to file "reports" generally.

However, SEC has not yet indicated its view on this timing issue and hence there is risk SEC may take the position that Newco's obligation to file a last 10-K for year 1 (in March of year 2) means that Newco is required to file "reports" until that final 10-K is actually filed.

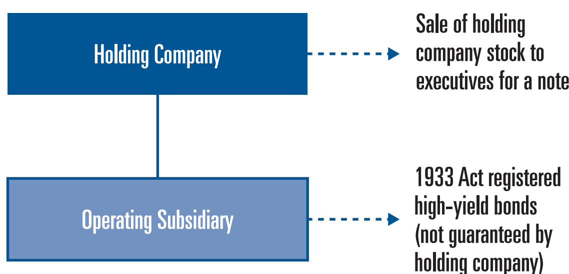
Most high-yield indentures for 1933 Act registered bonds require a portfolio company (even after dropping below 300 record holders and thus ceasing to be required by the 1934 Act to file periodic SEC reports) to continue filing with SEC the 1934 Act §15(d) reports which the company would have been required to file with SEC if the company still had 300 or more holders of such bonds. This raises

the question whether such a "voluntary filer" (i.e., a company required to file 1934 Act reports with SEC by indenture but not by law) is — by virtue of filing SEC reports not required by law — nevertheless an "issuer" under (3) above (i.e., a company "required to file reports under section 15(d)"). On 11/8/02 SEC answered this question by announcing that "required to file" means required by law, not by contract, so that a voluntary filer is not an "issuer."

***Avoiding §402's Loan Prohibition*.** Where a PE-financed portfolio company proposes to issue high-yield bonds to finance an LBO, the portfolio company may adopt three alternative courses of action to avoid SO §402's loan prohibition:

First, the company can issue the bonds in the private Rule 144A market (rather than in a 1933 Act registered public offering) without any agreement to effect a subsequent registered A/B exchange of the private bonds for similar SEC registered bonds.

Second, the company can adopt a two-tier holding company/operating company structure — with 1933 Act registered high-yield bonds issued by operating subsidiary — so that parent holding company, which sells holding company stock to executives, never becomes an SO §402 covered "issuer" at all. Under this approach, holding company must not guarantee operating subsidiary's bonds, because the guarantee is itself a security that must be registered, which would cause holding company to become an "issuer."



This approach should not violate the spirit of SO §402's loan prohibition, which is designed to prevent a covered "issuer" from risking assets belonging in part to the issuer's public holders by making risky loans to the issuer's executives. Where only operating subsidiary has public securityholders (the high-yield bondholders), parent holding company's loan to an executive does not put at risk any of operating subsidiary's assets (just as a loan from holding company's PE fund investor to a holding company executive — not guaranteed by operating company — would not put at risk any of operating company's assets).

Because SO §402 also prohibits an "issuer" from "arranging" a loan to an executive officer (or director) of the "issuer," operating subsidiary (which is an "issuer") should not "arrange" for executive's loan from holding company (or from holding company's PE fund investor). Because holding company and operating subsidiary likely have many overlapping employees, there may be uncertainty on this "arranging" issue where one or more persons who are employees of both companies are involved in "arranging" holding company's sale of stock to a person who is an executive of both.

However, it would clearly be helpful on the "arranging" issue if (a) the borrowing executive — although also an operating company executive — has some duties to holding company which make it rational for holding company to extend credit (i.e., to engage in a stock sale for a note) to such executive and (b) the holding company officials who approve and document the stock sale for a note are not operating company employees (e.g., the holding company directors who vote for the stock sale and receive the executive's note in exchange are not operating company employees, although they could be PE fund employees serving as part-time holding company officials).

Third, the company's PE fund investor or some other third party can lend money to the executive (so that the executive can purchase the company's stock for cash, rather than for a note), with the company subsequently lending money to executive (so executive can pay off the PE fund or third party loan) once the company ceases to be an "issuer" "required to file" 1934 Act §15(d) reports (because in a subsequent fiscal year the bonds are held by fewer than 300 record holders).

***Persons Covered by §402*.** §402's loan prohibition applies only to issuer's directors and executive officers. An executive officer covered by SO §402's loan prohibition (under 1934 Act Rule 3b-7) is:

- issuer's president,
- each of issuer's vice presidents in charge of a principal business unit, division, or function (such as sales, administration, or finance),
- each of issuer's officers performing policy-making functions for issuer, and
- each executive officer of a subsidiary of issuer performing policy-making functions for issuer.

Application of §402 Where Portfolio Company Goes Public or Promotes Executive. SO §402 grandfathers (i.e., allows an "issuer" to leave outstanding) a pre-7/30/02 loan to an executive officer (or director) so long as that loan is not thereafter materially modified or renewed. However, this grandfather clause does not cover a post-7/29/02 loan which was legal when made but later becomes a §402 violation because of subsequent events.

For example, where PE-financed portfolio company is not an "issuer" at the time of the company's post-7/29/02 stock sale to an executive officer for a note, but subsequently becomes an "issuer" (e.g., because the company subsequently files a 1933 Act registration statement), the loan becomes a §402 violation as soon as the company becomes an issuer. Similarly, where the company is an "issuer" at the time of its post-7/29/02 stock sale for a note to a lower level employee (i.e., not an executive officer) but the lower level employee is subsequently promoted to executive-officer level, the loan becomes a §402 violation as soon as the executive is promoted.

Hence any loan documents should require payment of the note immediately before any event that would make the loan illegal under SO §402.

Issuance of Stock Without Payment. SO Act §402 does not appear to cover an issuance of stock to an executive simply because the stock is subject to vesting (e.g., the executive must return the stock to the company if the executive quits prior to a specified date). For example, if a PE-financed portfolio company issues shares ("free shares") to an executive without payment (or issues shares to an executive in exchange for a cash payment), the executive's conditional vesting obligation to return the shares to the company does not appear to create a "personal loan" since there is no interest, no obligation to pay money, and no fixed maturity.

However, where an executive receives free shares (subject to vesting) worth (e.g.) $100,000 and makes a Code §83(b) election to start his or her long-term capital gain period, the executive suffers $100,000 of immediate taxable ordinary income, i.e., an amount equal to the shares' value. On the other hand, if the executive issues a note (or pays cash) equal to the stock's value, (a) the executive suffers no such ordinary income and (b) the company ultimately receives an amount equal to the stock's value, although (c) such a sale for a note invokes the §402 loan prohibition.

B. Board of Directors and Board Committees

SO imposes new independence requirements for public company audit committee members (as described below), but does not impose any independence requirement for members of the board or any other board committee. The NYSE/Nasdaq proposed rules, however, will (when adopted) impose a number of new and more stringent independence requirements for members of both the board and various board committees (including but not limited to the audit committee) of a public company listed on the NYSE or on Nasdaq ("a listed company").[2]

These proposed rules are currently in flux and will likely remain in flux until SEC publishes for comment (likely first quarter 2003) the proposed rules with any amendments adopted by SEC.

SO and the proposed rules (when adopted) are likely to have a profound impact on the composition of the board of directors and board committees of a listed PE-financed portfolio company, on whether a PE fund principal is eligible to serve, and on the amount of time that a PE fund principal, when eligible, must devote to such service.

Majority of Independent Directors. The NYSE/Nasdaq proposed rules require that a majority of a listed company's directors be "independent" and tighten the independence definition. In many cases PE fund principals will not meet the tougher independence standards, so that a listed PE-financed portfolio company may be required to (1) reduce the number of affiliated (e.g., PE

fund) directors or (2) add more directors who are not affiliates of the company or PE fund.

Under the *NYSE proposed rules,* a director qualifies as "independent" if (1) the director is not, and was not at any time within the past 5 years, an employee of the company or its auditor, (2) the director has no immediate family member who was a company officer or an auditor employee at any time within the past 5 years, and (3) the company's board determines that the director has no other material relationship (e.g., commercial, industrial, banking, consulting, legal, accounting, charitable, or financial) with the listed company, either directly or as a partner, shareholder, or officer of an entity with such a relationship. The NYSE commentary states, however, that "as the concern is independence from management, the [NYSE] does not view ownership of even a significant amount of [the company's] stock, by itself, as a bar to … independence…."

Under the *Nasdaq proposed rules* a director qualifies as "independent" if (1) the director is not a company or subsidiary officer or employee, (2) the director was not a company, parent, or subsidiary employee at any time within the past 3 years, (3) the director has no family member who was a company, parent, or subsidiary executive officer at any time within the past 3 years, (4) the director was not a partner or employee of the company's auditor who worked on the company's audit at any time within the past 3 years, (5) the director is not a partner, control shareholder, or executive officer of an entity which made payments to, or received payments from, the company (other than those arising out of the entity's investment in the company's securities) exceeding 5% of recipient's consolidated gross revenue (or $200,000 if greater) during the current or any of the prior 3 years, (6) the director has not received (or had a family member who received) payments from the company or any of its "affiliates" exceeding $60,000 during the current or past 3 years, and (7) the company's board determines that the director has no other relationship which would interfere with his or her independent judgment.

These complex proposals contain numerous rules under which a PE fund principal might be disqualified from serving as an independent portfolio company director, including:

First, while the *Nasdaq proposed rules* apparently assume (as the *NYSE proposed rules* explicitly state) that stock ownership alone does not destroy independence, the *Nasdaq proposed rules* also appear to assume that a 20% or greater shareholder of the company (e.g., a PE fund) is a company "affiliate," so that a PE fund principal who receives more than $60,000 of payments from the PE fund (which owns 20% or more of the listed company) apparently can not be an independent director of that company (under Nasdaq (6) above).

Second, where a PE fund's management company receives a management fee from a portfolio company, can a principal of the PE fund serve as an independent director of the company? Under the *Nasdaq proposed rules,* if the PE fund principal is a partner, control shareholder, or executive officer of the PE fund and the management fee exceeded 5% of the management company's gross revenue (and also exceeded $200,000) for any of the current or past 3 years, the director is disqualified (under Nasdaq (5) above).

The *NYSE proposed rules*, on the other hand, do not contain such a numerical test, so that disqualification could arise (if at all) only from a board determination that the director has a "commercial" or "consulting" "material relationship" with the company (under NYSE (3) above). NYSE officials have informally indicated their belief that a management fee would indeed disqualify such a director.

For *both the NYSE and the Nasdaq proposed rules*, there is an exception to the majority-independent-director requirement for a "controlled company," i.e., a company in which more than 50% of the voting power is held by an individual, a group, or another company (such as a PE fund). In the case of such a "controlled company," there is no independent-director requirement at all. Thus, where PE fund owns less than 50% of portfolio company's voting power (or will own less than 50% after the company's IPO), the company may consider issuing high-vote stock to PE fund prior to its IPO. While such a high-vote/low-vote capital structure may adversely impact IPO marketability, such a structure would allow the company to be "controlled" by PE fund post-IPO (for purposes of this exception) even though PE fund's post-IPO economic interest is below 50%.

Compensation and Nominating/Governance Committees. Except in the case of a "controlled company" (as defined above), the *NYSE proposed rules* require every listed company to have (1) a compensation committee and (2) a nominating/governance committee, each comprised entirely of independent directors, with the former setting the CEO's compensation and performing certain other executive compensation duties and the latter selecting (or recommending to the board) director nominees and recommending to the board corporate governance principles.

Except in the case of a "controlled company," the *Nasdaq proposed rules* generally require that (1) director nominations be approved either by a majority of independent directors or by an independent nominating committee consisting entirely of independent directors, except that the committee can have one non-independent member serving under "exceptional and limited circumstances," (2) CEO compensation be approved either by a majority of the independent directors meeting in executive session or by an independent compensation committee which can include one non-independent member (not an officer of the company) serving under "exceptional and limited circumstances" for not more than two years, and (3) other executive officers' compensation be set in a similar fashion (although the CEO may be present).

Under *both the NYSE and Nasdaq proposed rules,* if an investor (such as a PE fund) has a contractual right to nominate a director, such director's selection and nomination need not be subject to the independent nomination process described above.

Audit Committee. SO §301 prohibits an audit committee member from (1) receiving any "consulting, advisory, or other compensatory fee from the issuer" or (2) being an "affiliated person" of the company or any subsidiary.

Both of these SO audit committee disqualifications can impact the ability of a PE fund's principal to serve on a portfolio company's audit committee. The first statutory disqualification (receipt of fees from the issuer) may well apply where the PE fund receives (e.g.) management fees from the portfolio company and the PE fund principal who serves on the company's audit committee shares in these management fees. Indeed, the commentary to the *proposed NYSE rules* states that "compensation paid to . . . a director's firm for . . . consulting or advisory services [disqualifies the audit committee member] even if the director is not the actual service provider."

The second statutory disqualification (company or subsidiary "affiliated person") can be read as disqualifying the PE fund principal, because long-standing 1934 Act §3(a)(19) defines the term "affiliated person" by incorporating the "affiliated person" definition in the Investment Company Act of 1940, which includes a person with 5% or more stock ownership. Pending SEC interpretation, it is not entirely clear whether (1) Congress in enacting SO §301 meant to utilize §3(a)(19)'s 5% standard in determining whether PE fund is an affiliate of its portfolio company or (2) a PE fund principal would be tainted by the PE fund's (rather than the principal's) 5% or more ownership of company stock.

The *Nasdaq proposed rules* make clear that the audit committee member may "not own or control 20% or more of the [company's] voting securities, or such lower measurement as may be established by the SEC." This is good and bad — good because it adopts a 20% (not 5%) ownership standard for affiliation pending further SEC rulemaking; bad because it imposes a stock ownership bar in the first place, although it does not make clear whether a PE fund principal is disqualified when the PE fund (rather than the principal) owns 20% or more of the company.

It is particularly unfortunate that SO and the proposed NYSE and Nasdaq rules will frequently preclude a PE fund principal from serving on a company's audit committee. The principals of a PE fund are generally very experienced in financial matters, very interested in the company's success, and wholly independent of the portfolio company's management, i.e., exactly the type of person who should serve on the audit committee. Whether the public or organizations (such as Institutional Shareholder Services) that "rate" the independence of public company boards share this view remains to be seen. Several such organizations apply different standards in determining director and audit committee independence and may pressure the board to eliminate or reduce the number of PE fund directors, even when those directors otherwise meet SO and proposed NYSE/Nasdaq requirements.

One additional issue: SO §301 does not clearly state that its audit committee provisions apply only to a company

with a listed security. While SO §301's first subsection (new 1934 Act §10A(m)(1)) states that SEC shall require national securities exchanges and associations (such as NYSE and Nasdaq) to adopt the audit committee rules set forth in (m)(2) through (6) (including the audit committee independence requirements described above) for *listed companies*, thus indicating by implication that these audit committee rules apply only to listed companies, the subsequent subsections — (m)(2) through (6) — if read alone, could be viewed as applying more broadly to any "issuer" (as defined in A. above) because not explicitly limited only to listed companies. However, we anticipate that SEC will not seek to read (m)(2) through (m)(6) alone in order to apply these audit committee rules to non-listed issuers.

***Audit Committee Financial Expert*.** As required by SO §407, SEC proposed rules on 10/22/02 requiring companies (including "voluntary filers" as described in A. above) to disclose in their periodic reports whether at least one audit committee member is a "financial expert" and if not, why not. Under SEC's proposed definition, a "financial expert" must have: (1) an understanding of generally accepted accounting principles and financial statements, (2) experience in the preparation or auditing of financial statements and the application of accounting principles in connection with accounting for estimates, accruals, and reserves, (3) experience with internal accounting controls, and (4) an understanding of audit committee functions.

The SEC's proposed rules contemplate that this experience would be acquired through education and experience as a public accountant or auditor or as a principal financial officer, comptroller or principal accounting officer of a *public* company, or the equivalent. Thus, a PE fund principal eligible to serve on the audit committee may not qualify as a "financial expert" under SEC's proposed rules, despite his or her often considerable financial expertise gained from investing experience.

C. Accelerated Reporting Requirements for Insider Transactions

On 8/29/02 SEC adopted rules implementing SO's requirement that every §16 insider (i.e., a public company director or executive officer as well as a more than 10% holder of a class of equity securities registered under 1934 Act §12) must generally report a change in beneficial ownership (on Form 4) by 5:30 PM Washington, D.C. time on the second business day following the day on which the transaction took place.

In the past, §16 insiders have generally been required to report changes in beneficial ownership by the tenth calendar day of the month following the month in which the transaction took place (or by the 45th day of the following fiscal year for most stock option grants and a few other specialized transactions). Under the new rules, most transactions (including many transactions previously reportable by the 45th day of the following fiscal year) are subject to the 2-day filing deadline, including:

- a purchase or sale of stock,
- an option grant or exercise, and
- a restricted stock grant.

Where a PE fund (or a PE fund principal serving as a director) which is a §16 insider by virtue of more than 10% ownership (or by virtue of serving as a director) buys or sells portfolio company stock (or receives a director stock option grant or exercises any such option), the PE fund (or its principal) must be prepared to file in Washington, D.C. a Form 4 (reporting the beneficial ownership change) no later than 5:30 PM Washington, D.C. time on the second business day following the ownership change. The Form 4 (1) can be filed electronically via EDGAR or (2) can be filed manually with SEC in Washington, D.C., typically by hand delivery, Federal Express, UPS, or the like, but (3) may not be faxed to SEC. If the Form 4 filed with SEC does not contain an original signature, a copy of the Form 4 must be manually signed by the §16 insider before filing and retained for 5 years.

Obviously, in light of the significantly shortened deadline, a PE fund insider must make arrangements in advance (including applying for EDGAR codes if filing electronically) to ensure that all mechanics are in place before buying or selling stock (or receiving or exercising an option).

D. D&O Insurance

A PE fund generally requires each public portfolio company on whose board a PE fund principal serves to provide D&O insurance for its directors. SO's enactment (imposing

new and enhanced director duties) and the corporate and accounting scandals which gave rise to SO (creating a significantly higher volume of D&O claims) have resulted in several adverse D&O insurance developments.

First, D&O insurance premiums are rising dramatically, often 50% to 500%, while deductibles are rising even more dramatically, often 200% to 1,000%. *Second*, additional policy exclusions are becoming increasingly common. For example, D&O carriers are frequently seeking to limit coverage for claims based upon (1) a lack of adequate insurance for other business risks or (2) an assertion that the company's financial statements were inaccurate when the D&O policy was issued. *Third*, the financial viability of several D&O insurance carriers has declined, which may ultimately reduce the availability (and coverage amounts) of D&O insurance for portfolio company directors.

Loss or reduction of D&O insurance is particularly threatening to a PE fund (and its principal serving as a director) in these turbulent economic times, when portfolio companies are often at greater risk of bankruptcy, since bankruptcy renders worthless the portfolio company's contractual agreement to indemnify its directors.

E. No Bankruptcy Discharge for Certain Director Liabilities

SO §803 amends the Bankruptcy Code so that any judgment, settlement, or court or administrative order awarding damages or fines for any federal or state securities law violation or for fraud in connection with the purchase or sale of any security is no longer dischargeable in personal bankruptcy.

Thus, a PE fund principal serving as a director of a portfolio company runs a new risk: if the company goes bankrupt and the director is ultimately liable for securities law claims (including via a settlement) which are not covered by D&O insurance (e.g., because of D&O policy exclusions or because the D&O policy's coverage has been exhausted), the director can no longer obtain discharge of these claims in personal bankruptcy. ◎

Footnotes

[1] SO §402 adds this loan prohibition as §13(k) of the Securities Exchange Act of 1934 (the "1934 Act").

[2] As discussed below, there is some slight statutory ambiguity as to whether SEC might seek to impose some of the audit committee requirements on an "issuer" which is not a listed company.