

The impact of SOX on D&O

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SOX

The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002, and commonly called SOX or Sarbox, is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. These scandals resulted in a decline of public trust in corporate behavior, focused on the (un)believability and (in)accuracy of publicly available information. An inability to trust publicly available information, is likely to harm financial markets. Both to demonstrate their toughness in the face of corporate misdeeds and to restore investor faith in financial markets, Congress passed SOX. The legislation makes significant changes in management's responsibilities in financial reporting and enlarges the scope and nature of the auditor's and Board members' responsibilities. More specifically, the major provisions of SOX include, but are not limit to, the following:

- Creation of the Public Company Accounting Oversight Board (PCAOB)
- A requirement that public companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditors for such companies "attest" (i.e., agree, or qualify) to such disclosure
- Certification of financial reports by chief executive officers and chief financial officers
- Auditor independence, including outright bans on certain types of work for audit clients and pre-certification by the company's Audit Committee of all other non-audit work
- A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor

Cost of SOX compliance

Even before the legislation was passed, corporate executives knew that it would be expensive, both in direct and indirect costs. Direct costs include higher D&O insurance premium, expenses related to higher level internal controls, and higher director fees, while indirect costs include larger amount of time and resources devoted to corporate governance, higher level of anxiety of directors as a result of greater commitments and responsibilities and exposure to higher risks. Importantly, as a result of the increase in personal liability, companies may become more cautious and risk-averse in the post-SOX environment. Many corporate officers and directors might be too fearful of personal liability to take business actions with risks.

Under SOX, directors and officers in corporate America assume increased levels of responsibilities and accountabilities. Particularly CEOs, CFOs, and board directors are facing heightened liability risks due to new regulations brought by SOX. Thus companies have to pay higher compensation as well as provide greater benefits to lure executives into running a company under intense scrutiny. One of important benefits is D&O insurance coverage, which has become more difficult to obtain in the insurance market and thus more expensive. And D&O coverage becomes tricky in some situations. Directors often are asking: "If I get sued, will I be covered?"

D&O liability insurance

Although SOX includes some provisions that will certainly have impact on D&O insurance, it is not obvious what exact changes will result. For a publicly-traded company, some key personnel, including the CEO, CFO and directors in the Audit Committee, are particularly affected by SOX. However, none of those provisions discussed earlier directly changes the provisions of D&O insurance policies. Neither do they impose direct litigation issues on the existing D&O insurance policies. Nevertheless, companies may find their D&O insurance provider stands in a better position when disputes on coverage or claim denial occur. Some SOX provisions may give D&O insurance carriers more room defend themselves in such situation. A few examples are discussed below.

First, D&O insurance coverage generally protects against claims that arise from alleged wrongdoing by directors and officers in their corporate capacities during the policy period. Typically, such claims usually involve the officers' and directors' investment decisions, such as allegations that placement materials were misleading, that management failed to perform, acted in self interest or made decisions detrimental to the company. D&O claims may also involve decisions to raise capital, expenditure of such capital, and decisions to merge into or acquire other companies. Instead of listing specific types of covered claims, most policies cover "wrongdoing" which is a term that the policy may define broadly. Typically for coverage to be triggered, such wrongdoing must occur while directors and officers are performing their management roles of the company. SOX act, however, requires a corporation's CEO and CFO to certify financial statements of their company personally. This requirement may enable insurers to argue that the wrongdoing is a personal rather than an official act, hence denying D&O coverage for alleged certification violations.

Additionally, D&O insurance policies also narrow coverage by limitations and exclusions. Even if a SOX claim triggers a D&O insurance policy, the insurer may deny the claim using a policy exclusion clause. In the case of alleged internal trading claims, insurers can deny claims by quoting a personal profit exclusion clause, which states that claims are not covered under circumstances when directors or officers "in fact gained any personal profit, remuneration or advantage to which the insured was not legally entitled." Another example is the fraud exclusion. D&O policies usually have an exclusion for claims arising out of fraud. It is likely that the SOX will increase the number of potential claims that will be brought against directors and officers for fraud. The certification requirements provide insurers more opportunities, with regard to financial restatements and internal corporate controls, to allege that fraud has occurred and that coverage should therefore be denied. From the insured's perspective, it is important to note that this exclusion should only apply if fraud is found by the court in a final judgment. Moreover, it is crucial to make clear that the fraud of one officer or director is not imputed to anyone else.

Conclusion

Precipitated by a slew of corporate scandals, Sarbanes-Oxley was meant to address systemic flaws in the way corporations have been reporting their accounting numbers for decades. SOX compliance is focused on both corporate management and corporate Board behavior. As a result, Director's and Officer's liability insurance is affected. A number of questions exist regarding D&O insurance coverage, questions that likely will not be fully answered until courts address them; as a consequence, potential corporate Board members may be hesitant to serve. Organizations are encouraged to work with their insurers to specify intended coverage and to communicate such coverage effectively to their Board members.

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