Businesses operating in the shadow of the Sarbanes-Oxley Act of 2002 and increased oversight of the Securities and Exchange Commission (SEC) are under the microscope to execute flawlessly when it comes to corporate governance – and the technology and life science industry is no exception.

The technology and life science industry is characterized by intense mergers and acquisitions (M&A) activity, rapid technological innovation and product obsolescence, highly complex accounting issues, and the frequent need to access capital markets. These characteristics increase the chances of running afoul of federal regulation – a possibility that firms can’t afford to ignore.

However, technology and life science firms of all sizes that embrace the new laws and the principles behind them are protecting themselves against possible litigation and enhancing their value to their investors, potential investors, acquirers, customers, and employees.

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was developed and passed in response to the spate of corporate accounting and governance scandals that rocked the U.S. earlier this decade. The Act is intended to protect investors by improving the accuracy and reliability of corporate disclosure made pursuant to SEC laws, and for other purposes. The Act provides the SEC with greater enforcement powers over the activities of public companies by requiring increased corporate responsibility and enhanced financial disclosures. It also imposes more stringent corporate and criminal fraud accountability standards and greater white-collar crime penalties than before. For more in-depth information about Sarbanes-Oxley, go to www.sec.gov and enter “Sarbanes-Oxley” in the search box in the upper right corner.

The Burden is on Business

These laws and regulations place the burden squarely on businesses to create a corporate culture that is focused on ethics and compliance. For technology and life science firms, this means increased scrutiny of company business practices. While it appears that Sarbanes-Oxley has done little to expand the rights of shareholders, it has helped to provide them with greater insight into the corporate governance and the adequacy of internal control structures of publicly traded companies, which could be used to support a civil action should shareholders choose to bring one.

In 2004, according to the PWC Securities Litigation study, the number of securities class action lawsuits was up 16%. This trend, coupled with a decline in the dismissal rates, is increasing defense costs for companies and their insurance carriers. As a result, the underwriters of Directors & Officers (D&O) liability insurance are
looking not only for adherence to the “letter of the law” but also the execution and enforcement of strong corporate governance policies and procedures that help to mitigate the risk of any negative surprises which can drive litigation or regulatory action.

**Sound Corporate Governance for All**

The benefits of sound corporate governance are not just for large firms. They hold true for companies trading on the over-the-counter market, on the pink sheets, and even those that are privately held. By embracing the principles of good corporate governance, companies become less risky to investors, potential investors, acquirers, customers, employees (and more attractive to D&O insurers).

For example, a young company that needs to raise capital to finance development or market a new product may secure a higher valuation from investors and creditors when there is less perceived risk in its underlying business – particularly with respect to the quality of the financial reports and projections that are analyzed in the due diligence process.

The accuracy of financial books and records is also critical for firms that are looking to be sold. In order for a public company to even consider buying them, there needs to be near certainty that no accounting errors will surface post transaction that could lead to a restatement. Senior executives of the acquiring public company will have to personally certify the accuracy of the combined financial statements on the next filing date. A restatement subsequent to that certification could jeopardize the careers and net worth of those individuals as well as cause reputational harm to the acquiring company.

**Benefits Accrue**

In addition to making companies better candidates to access the capital markets, sound corporate governance enhances their ability to attract talented and ethical employees and makes them less vulnerable to loss due to litigation, regulatory fines, and employee theft. Further, statistical studies, such as those conducted by Paul Gompers of Harvard and Andrew Metrick of the University of Pennsylvania’s Wharton School, and reported in their article, “Corporate Governance and Equity Prices” have found that “firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth.”

**Steps to Good Corporate Governance**

As there is no one perfect model of corporate governance, your company’s management and board of directors should seek the assistance of a law firm or an outside consultant to help design a system that is effective for your company based on its size and ownership structure.

Steps to good corporate governance may include:

- **A strong board of directors** - Build a board of directors with diverse backgrounds and areas of knowledge and independence.
- **Board of directors committees** - Form committees for audit, compensation and disclosure.
- **Compensation for directors and officers** - Align compensation with the long term interests of the company and its shareholders.
- **Codes of conduct** - Implement and enforce rigorous codes of conduct for all levels of employees.
- **Control policies and procedures** - Design control policies and procedures to ensure the accuracy and integrity of the company’s financial books and records.
- **Disclosure** - Ensure the timely and accurate disclosure of material matters to shareholders.
- **Checks and balances** - Build a system of checks and balances to avoid any misuse or misappropriation of company assets by employees or outsiders.
- **Review of contracts** - Ensure strong legal (in-house or outside counsel) review of all contracts.
- **Adequate insurance** - Make sure your business has insurance coverage including D&O, EPL (Employment Practices Liability), Fiduciary Liability, Miscellaneous Professional Liability, and Crime/Fidelity coverage to go along with traditional property and casualty coverages such as workers’ compensation, general liability, property, auto and umbrella.

Technology and life science firms of all sizes that embrace the new laws and the principles behind them are protecting themselves against possible litigation and enhancing their value to their investors, potential investors, acquirers, customers and employees.
DIRECTORS & OFFICERS INSURANCE - WHAT IS IT AND WHY IS IT IMPORTANT

Directors and Officers (D&O) liability insurance found its roots in the 1960s when several landmark cases that clearly established the personal liability of directors and officers and class action suits were authorized. At the time, there were essentially no laws addressing the permissibility of indemnification by companies. And, it was uncertain if such indemnification would be considered to be against public policy. While case law eventually established that in many instances indemnification was permissible, the need quickly arose for a new insurance product to address the personal liability of directors and officers.

The first policies contained two basic insuring agreements. One protected directors and officers in the event their corporation could not indemnify them due to legal limitations on indemnification or the firm’s financial insolvency. The other agreement protected the company from loss arising from its indemnification of directors and officers.

In 1995, the corporation was added as an insured “person” for claims by shareholders. This evolution in coverage was essential for publicly traded companies to address the problem of allocation of loss between the covered directors and officers and the uncovered corporation in shareholder litigation involving both parties. As a result of this entity coverage, the basic policy today contains a third insuring agreement that covers the corporation for claims by shareholders.

As coverage evolved for publicly traded companies, insurers also began to consider the needs of privately held companies. These companies saw less value in a D&O policy because the most significant exposure in D&O – shareholder suits – presented little or no threat. The largest threat to privately held firms – claims for wrongful employment practices – was usually addressed in a separate policy. Purchasing both policies was often too expensive for smaller companies. Today, insurers offer a combination D&O/Employment Practices Liability Insurance (EPLI) policy that addresses both exposures.

D&O is important because it provides balance sheet protection for your company should a claim be made, and protects the directors’ and officers’ personal assets should the corporate entity not be able to indemnify them. In addition, quality D&O coverage can help your corporation to attract and retain successful individuals to serve on your board of directors.

For More Information

For more information on how to manage risks for your business, contact your local Hartford agent, or visit www.thehartford.com.

Best Practices for Your Business

About The Hartford’s Technology Practice Group

For more than 25 years, The Hartford has insured technology and life science businesses of all sizes. Our products are flexible enough to grow with a business – from a startup or sole proprietorship to a large, publicly traded company. We also offer services that can help businesses lower their losses, like our series of Technology Best Practices.