

Stock Option Backdating Claims: *Are They Covered?*



*David E. Wood, Principal
Timothy S. Plum, Associate
Jeffrey A. Kiburtz, Of Counsel
Wood & Bender LLP*

(This article is condensed from a white paper on gaining insurance coverage for employee stock option backdating claims, which is available from Wood & Bender LLP upon request.)

Since late 2005, the practice of backdating employee stock options (“ESO’s”) has resulted in thousands of government investigations and lawsuits, criminal proceedings, and private lawsuits brought by shareholders and corporate employees.

The SEC and Justice Department have initiated informal or formal investigations into alleged ESO backdating at a substantial number of companies. Some of these investigations have culminated in the filing of civil lawsuits against corporations, and the directors, officers and other employees (collectively, the “D&O’s”) alleged to have participated or been complicit in the ESO backdating. In rarer instances, criminal proceedings have been initiated against a limited number of D&O’s alleged to have engaged in criminal conduct related to ESO backdating.

As should be expected, plaintiffs’ attorneys have filed “piggyback” suits against the targets of government investigations. Most of these suits have been brought as derivative actions, in which the D&O’s’ purported ESO backdating is alleged to have caused harm to the corporate entity. Also relatively common are shareholder suits brought against the corporate entity and individual D&O’s, in which plaintiffs seek redress for a loss in the value of their holdings. A third variety of suits allege violations of employee benefits law, such as the Employee Retirement Income Security Act.

Irrespective of the specific claims, counts or causes of action asserted, plaintiffs in these suits

typically seek monetary and equitable relief under a variety of theories. Plaintiffs argue that liability should be imposed on the D&O’s based on their alleged direct involvement in the backdating of ESO’s, their alleged actual or constructive knowledge of this practice, or their alleged participation in “insider trading.” These suits often assert that even those D&O’s who did not personally backdate or receive backdated ESO’s are liable on account of being complicit with those who personally participated in the alleged misconduct.

OVERVIEW OF INSURANCE COVERAGE ISSUES

Most corporations carry insurance that should cover most of the losses incurred as a result of alleged ESO backdating. Directors’ and officers’ liability policies (“DOLP’s”) and fiduciary liability policies (“FLP’s”) are the policies most likely to afford coverage for ESO backdating matters. Expenses associated with claims of ESO backdating can quickly exceed \$10 million, with the total potential exposure far exceeding that amount. As a result, insurers can be expected to try to limit their exposure to these losses, and to aggressively pursue all available means of achieving this goal. The specific manner in which insurers will attempt to limit their exposure to ESO backdating will depend, as always, on the nature and facts of the underlying ESO matters and the language of the implicated policy.

Insurers appear to be adopting common claim strategies and tactics in ESO backdating matters, as follows:

Internal Investigation Expenses

Insurers have reflexively declined coverage for costs incurred in connection with internal investigations most corporations have undertaken. In doing so, insurers fail to take into account the overlap between work performed in connection with the internal investigation and work performed, or would otherwise need to be performed, in connection with government investigations and securities suits. The facts supporting this argument vary from case-to-case, and developing these facts often requires close work between and among the various firms working for the impacted company.

Government Investigation Expenses

As respects defense costs incurred in connection with government investigations, insurers have been declining coverage on grounds that the investigations do not “target” “Insured Persons,” or that there is no evidence the investigation is “formal,” as is required by many DOLP’s. Insurers advancing these arguments often turn a blind-eye to the fact that most government investigations are conducted under a near absolute veil of secrecy.

Shareholder Litigation

In coverage disputes related to private suits, insurers have been taking a fairly hard line stance on claims they regard as “restitutionary in nature,” which are not insurable in most states. Similarly, insurers are commonly taking the position that claims involving allegations of intentional or fraudulent conduct are not covered either. Insurers taking these positions are attempting to capitalize on the intimidation tactics and vitriol employed by plaintiffs’ attorneys – which are often



manifest in claims of fraud and disgorgement – accompanying many of the ESO backdating matters.

Notably, a common tactic employed by insurers is to take the position that claims for restitutionary relief or intentional conduct do not fall within the DOLP’s definition of “Loss.” Insurers do this to circumvent exclusions for restitutionary relief or intentional conduct, which often require an “actual adjudication” or finding “in fact” of an improper benefit or fraud, and in an attempt to shift the burden of proof to the insured. Yielding to an insurer on this position, which in most cases is unsupportable, can result in the loss of a significant portion of the coverage provided by a DOLP.

The insurer’s ability to successfully advance these contentions depends, in part, on the specific language of the implicated policy. Definitions of terms such as “Claim,” “Loss,” and “Wrongful Act,” as well as the specific exclusions issued in a policy, may contain language that includes or excludes coverage for the types of relief sought in ESO backdating proceedings, the types of claims advanced in those proceedings, and may otherwise impact the existence of coverage. Thus the importance of reading and understanding the specific provisions of the insurance policy in question cannot be over-emphasized.

Rescission

An insurer may rescind an insurance policy (i.e., return the premium, and behave as if the policy had never been written at all) where the insured makes a material misrepresentation in obtaining the coverage, on which the insurer relies in issuing the policy. In many states, the misstatement can be a simple mistake: as long as it is material to the underwriting decision, and the insurer relies on the misstatement, the remedy of rescission is available. However, “severability” provisions can, in many cases, limit the insurer’s ability to rescind or void the policy only as to those insureds with knowledge of the misrepresentation, as opposed to all insureds.

In investigating claims, insurers will closely monitor allegations made and facts developed for anything which may support a rescission claim. This is especially true where an insured restates a prior-year financial statement submitted with an application. In these situations, insurers often contend that the mere act of restatement is an admission of a material misrepresentation in an application. However, insurers may also attempt to use alleged misrepresentations in financial statements as a basis for rescission, even in the absence of a restatement. In the context of an ESO backdating claim, the most significant rescission risk often comes from historical financial statements incorporated into the applications for D&O Policies and Fiduciary Policies which might need to be restated.

A potential loss of insurance coverage cannot serve as a reason not to restate financial statements, but it is one additional factor to bear in mind when investigating allegations of backdated ESO’s, and the accounting for them. Care should be taken to ask whether a restatement is necessary to correct a past material misstatement of a company’s financial condition. If so, this could serve as a basis for rescission of any coverage purchased via application to which the pre-restatement financial statements were attached. Conversely, if a restatement seeks to make the company’s financial condition more transparent, this is not necessarily an admission that the financial statements to be restated materially misrepresented the corporation’s financial condition in the first place. There are many reasons to restate financials that are not reflective of material misrepresentations in the original ones.

WHAT CORPORATIONS CAN DO TO PROTECT AND ENHANCE COVERAGE

The corporate policyholder can also be proactive and take steps to avoid or mitigate the insurer’s ability to limit or deny coverage. First, before such a claim ever arises, the corporation should be sure when purchasing or renewing coverage that the form of policy under consideration has favorable provisions. For example, “final adjudication” or “in fact” language in the exclusionary provisions related to improper benefits or intentional conduct, discussed above, is important. As are “severability” provisions which actually prevent imputation of knowledge of misrepresentations from one insured to another. Another key provision for public companies is the definition of “claim,” which should include government investigations. However, it should be kept in mind that very slight differences in policy language can mean the difference between coverage and no coverage, and all provisions in proposed or specimen policies should be examined very closely in the context of the insured’s business risks.

After a claim arises, the corporation must be prepared to deal with its insurers, and must create and employ a strategy that proactively minimizes or eliminates potential coverage issues. To maximize its effectiveness, that strategy should be put into practice as soon as the corporation learns of an existing or potential lawsuit or investigation, and before it notifies its insurer of that lawsuit or investigation. This notice will set the tone for all future dealings between the corporation and its insurer, and it is therefore imperative that this notice contain a description of the underlying facts that is accurate and complete as may be allowed by the knowledge then available to the corporation.

In complex claims that raise a host of complex loss definition and coverage issues (like ESO backdating claims), it is critical that the facts of the claim be presented to the insurer in a manner that “heads off” coverage issues wherever possible. For instance, where a derivative suit demands on behalf of the corporation restitution from senior management of undisclosed, backdated option grants, report this to the insurer while pointing out that no evidence suggests that the recipients reasonably believed the options were improper, which would foreclose any claim for equitable disgorgement of the ESO’s to the corporation. Call to the insurer’s attention that if there were any exposure arising from this claim (which presumably the insured officers deny), it would be for damages based on breach of fiduciary duty or some other claim at law – not an equitable claim arguably excluded from the definition of “loss” under the policy.

The corporation should assume that each of its insurers will disagree with that conclusion and will provide written notice that it is denying coverage or reserving its right to do so. In anticipation of this, the corporation should be prepared to provide an immediate response to some or all of its insurers, and should include in that response a more detailed discussion of the issues raised in the insurer’s letter. In any event, presenting the facts of the claim in a manner most conducive to coverage from the outset can have an anchoring effect, allowing the insurer to establish the parameters of a coverage dialogue going forward.

Finally, the corporation should perform, early and often, a “risk vs. benefit” analysis of the potential settlement of any ESO backdating lawsuits. That analysis should take into account, among other factors, (1) the monetary amount, if any, the corporation may be called upon to contribute toward that settlement; (2) the fact that settlement would preclude any judicial determination of fact or law upon which an insurer might be entitled to rely to deny coverage and seek reimbursement of defense costs; (3) the fact that settlement would deprive the corporation of the opportunity to vindicate itself; (4) whether a settlement can be structured to also resolve any disputes

between the corporation and its insurer(s); and (5) whether it is then in the corporation’s best interest to resolve any disputes between it and its insurer(s). Defense counsel should be involved in this analysis only if the corporation has exercised its right to assume its own defense.

CONCLUSION

As of this writing, SEC investigations into alleged ESO backdating continue to gain momentum. In the renewal process, insurers are becoming sensitive to the potential for litigation and claims arising from these investigations. They are asking direct questions about ESO programs and grants, and comparing them to public disclosures. ESO backdating issues are on underwriters’ “radar screens.” Policies are being written with this exposure in mind, even though the vast majority of claims based on allegations of ESO backdating have yet to be resolved. In short, insurers are positioning themselves to avoid catastrophic insured losses arising from ESO backdating claims, by beginning to define the boundaries of coverage they feel is warranted.

Very recent experience teaches that the scope of coverage these insurers think is appropriate for such claims is significantly narrower than the scope of coverage that corporate policyholders and their advocates believe is correct. Thoughtful planning and careful execution are a must if the insured is to shape the coverage landscape to its advantage, and weather the storm caused by the advent of this kind of liability claim.



Settle for Everything.™