

InSights

The Options Backdating Scandal and the D&O Insurance Marketplace

Just as the Enron criminal trial ended and the clamor over corporate scandals seemed as if it might finally start to die down, an increasing number of companies are now finding themselves ensnared in a new scandal involving the backdating of stock option grants. The “options backdating” story first attracted widespread attention in March 2006 when the *Wall Street Journal* reported an apparent (but statistically unlikely) pattern at several companies of options grants to senior executives dated just before a sharp rise in the share price, and at or near the bottom of a steep drop. The issue gained momentum in recent weeks as the SEC, the Department of Justice, the Internal Revenue Service and several United States Attorneys’ and states’ Attorneys General’s offices have initiated investigations into the stock options practices of certain companies. Other companies have announced their own internal investigations of their option grants. So far, over 40 companies have been connected to the options backdating investigations, with more companies becoming involved on almost a daily basis.

This article provides background on options backdating, and discusses the kinds of problems companies involved in the investigations are facing. The article also touches on the emerging response to the unfolding story in the D&O insurance marketplace, and suggests practical steps for companies to take in connection with their purchase of D&O insurance under the current circumstances. The article concludes with information on how to stay current on the options backdating story as it develops in the months ahead.

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Contact:

Lisa McNamara Hughes
 Phone: 860-906-0103
 lhughes@oakbridgeins.com
 www.oakbridgeins.com

What is Options Backdating?

Stock options are intended to give executives an incentive to improve their company’s share price so that investors’ and executives’ financial interests are aligned. Generally, each option represents the chance to buy a share of company stock at a certain “strike” price on a future date. The strike price is usually the share price on the date the option is granted. Thus, a recipient stands to gain only if the share price has risen between the grant date and the date the option is exercised. Options backdating involves changing a grant date to an earlier time, usually when the share price was lower. (A variant of this is “options spring-loading,” where the options date is set anticipating the future release of favorable news known only to the options recipients that is likely to cause share prices to rise when disclosed.) The lower the share price

on the grant date, the greater the options holder's profit will be when he or she exercises the options and sells the underlying shares.

There is not necessarily anything wrong with options backdating, if the backdated grant has Board approval, is fully disclosed, and the accounting and tax issues are handled properly. Indeed, some of the companies whose names have been mentioned in the media coverage surrounding the options backdating story have announced that they investigated their options practices and found nothing wrong. Of course, if an executive's stock options are awarded in a way that guarantees that the executive will profit (by the grant of so-called "in the money" options), the hoped-for alignment between investors' and the executive's financial interests is eliminated.

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Many of the options backdating allegations raised so far have involved options grants made during the 1990s and up to 2002, when the passage of the Sarbanes-Oxley Act made backdating more difficult. Under Section 403 of the Act (made effective August 29, 2002), options grants and options exercises must now be reported within two business days following the transaction. These more timely reporting requirements seem to have discouraged options backdating practices. But even though the practice may have been largely eliminated several years ago, the news of the investigations comes when corporate governance issues are very high profile and executive compensation issues are particularly hot topics.

What kinds of problems are companies facing from the Options Backdating Investigations?

If a company's backdated options grant was not approved, fully disclosed or appropriately booked, the company could face several serious problems:

- 🍷 **Accounting:** Several companies that have admitted backdating options have accompanied those admissions with financial restatements impacting both their balance sheets and income statements, in order to accurately reflect their true compensation costs. One company involved in the options backdating investigations (Brooks Automation) has announced that it will have to restate seven years' of financial statements.
- 🍷 **Tax/Cash:** The revelation of options backdating could require some companies to restate prior years' tax reporting, which could create an unpaid tax liability.

- **Regulatory/Legal:** The SEC and the Department of Justice have begun investigations of several companies' options practices, and several United States Attorneys' and states' Attorneys General's offices have also subpoenaed records from some companies.
- **Management:** A number of companies have announced executives' resignations as a result of questions raised during options backdating investigations. All of the companies whose names have become associated with the options investigations have been the subject of intense media scrutiny, which has created distractions and share price pressures.

More generally, backdating raises questions related to corporate governance, the alignment of management with shareholders' interests, and adequacy of internal controls. The potential ethical implications of options backdating could cast a shadow over the integrity of a company's executives and raise questions about the company's culture and the level of its board oversight.

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What has been the Litigation Response to the Options Backdating Investigations?

Perhaps inevitably as a result of the media attention, plaintiffs' lawyers have seized on options backdating as a new source of inventory and are piggybacking on the *Wall Street Journal's* work and the governments' investigations to initiate various lawsuits:

- **Securities Class Action lawsuits:** Since the March 2006 *Wall Street Journal* article appeared, four companies (United Health Group, Vitesse Semiconductor, Comverse Technology, and American Tower) have been named as defendants in purported shareholder class action lawsuits alleging options backdating. (In addition, a plaintiffs' firm best known for its attorneys' involvement in tobacco litigation has announced the formation of an "Options Pricing Investigations Division" to examine options practices at U.S. corporations; the law firm's press release encourages shareholders to contact the firm to "discuss your legal rights.") The lawsuits filed so far allege that the defendant companies' disclosure was inadequate or misleading because the backdated options grants were dated earlier than disclosed in SEC filings. Plaintiffs further allege that the companies' prior accounting or tax disclosures were materially misleading.

- Stockholders' derivative actions:** In addition, a number of companies' boards have also been named in shareholders' derivative actions. These actions allege that the boards breached their fiduciary duties and committed waste by allowing executives to backdate their options grants (or by failing to adequately monitor options grants).
- ERISA actions:** United Health Group and its board have been sued in a separate purported class action on behalf of the company's employees in connection with their 401(k) plans, which include company stock as a plan option.

How Have D & O Insurers Responded?

D & O insurers, concerned about the lawsuits that have already been filed and troubled by the possibility of an unknown number of additional new lawsuits, have begun to respond. At least so far, and with respect to companies whose names have not yet been associated with options backdating investigations, the carriers' response has been limited to additional underwriting. Carriers are starting to ask questions to determine whether applicant companies are exposed to an options backdating investigation. D & O carriers undoubtedly would also like to raise rates and tighten terms across the board to protect themselves against companies whose exposure to options backdating problems have not yet emerged, but in the current competitive marketplace the carriers' flexibility to restrict terms or raise rates is limited.

Companies whose names have surfaced in connection with the options backdating scandal will find their D & O insurance placement process highly challenging. These companies will likely find it difficult to obtain renewal terms at palatable rates and may be forced to accept potentially restrictive terms. They will also face a number of difficult choices under their expiring programs, such as whether or not to provide a notice of potential claim to their current carrier and whether or not to exercise their right to discovery under the expiring policy. (These circumstances are not unlike what any company announcing a material financial restatement would face.)

Even for companies not presently involved in options backdating investigations, the possibility they might become involved raises a number of important considerations in connection with their D & O program.

There are several key policy provisions that will become particularly important in the event of a claim involving an options backdating investigation. These terms include, among others, the conduct exclusions (including in particular the personal profit and dishonesty exclusions); key policy definitions (including "Loss" and "Claim") and notice provisions; and the severability provisions and other terms that

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would affect rescission issues. The policy definition of “Loss” could prove to be particularly significant in cases in which claimants seek to compel executives to return options trading profits, as carriers may contend that executives who are required to disgorge income earned through excessive options have not suffered a covered loss. In addition, because the allegations could reach back into the 1990s, policy provisions relating to prior acts and retroactive dates could also potentially be critical.

Practical Steps for Companies to Take In Connection With the D & O Insurance Transaction

In this changing environment, there are a variety of practical steps for companies to consider in connection with the companies’ purchase of D & O insurance:

Companies should anticipate the underwriters’ questions and be prepared to provide cogent answers. Insureds will likely be called upon to provide extensive information about options granting and accounting, and about any external or internal inquiries or investigations the company has received or conducted with respect to options practices.

Although most underwriters’ stock option questions have arisen in underwriting meetings or calls, some carriers have attempted to introduce written questionnaires concerning stock options practices. We have found some of these questionnaires burdensome to insureds, with open ended or Imprecise questions, and in one case, a requirement for a warranty statement. Because the carriers’ use of the questionnaires is not indispensable to their obtaining the needed information, the carriers may be persuaded to accept verbal responses and to waive the questionnaires.

As noted above, key policy terms could potentially have a significant impact on subsequent claims involving options trading practices. It will be very important for companies to have their D&O policy wordings reviewed by a knowledgeable insurance professional to ensure that their policy provides the best available coverage.

Companies whose names have surfaced in connection with the options backdating investigation but who have not yet been the subject of a claim will want to carefully consider providing notice of a potential claim under their expiring programs, particularly if confronted with renewal terms including a “stock options activity exclusion” or other restrictive provisions. These companies will also want to consider their alternatives under the expiring policy’s discovery provisions.

In the current circumstances, insureds will find it more important than ever to

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involve knowledgeable insurance professionals in their D&O insurance transaction. It is particularly important to work with an insurance professional that understands both the issues arising from the options backdating investigations and all of the potential insurance consequences. It will also be important to work with a broker that has claims personnel sufficiently skilled to be able to advocate effectively on behalf of policyholders' interests in the event of a claim.

Future Developments in the Evolving Options Backdating Investigations

Most people will recall how long it took for the Enron scandal to unfold. The options backdating story has only just arisen. It will continue to evolve and there undoubtedly will be numerous important developments in the months and even in the years ahead.

In order to provide continuing updates as the options backdating story unfolds, periodic reports will be posted on the author's Internet weblog, the *D & O Diary* which can be accessed via the OakBridge website: www.oakbridgeins.com or directly at <http://dandodiary.blogspot.com>. The *D & O Diary* is a periodic journal that contains occasional items of interest from the world of directors and officers liability, including occasional commentary. There have already been numerous *D & O Diary* posts relating to the options backdating investigations. Those who want to continue to follow the options backdating story as it develops will want to visit the *D & O Diary* regularly, or better yet, subscribe to the *D & O Diary* using the "Subscribe Me" dialog box on the right-hand side of the *D & O Diary* home page.

About the Author

This article was prepared by Kevin M. LaCroix, Esq. of OakBridge Insurance Services. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 25 years. Prior to joining OakBridge, Kevin was President of Genesis Professional Liability Managers, a D & O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell. Kevin is based in OakBridge's Beachwood, Ohio office. Kevin's direct dial phone number is (216) 378-7817, and his email address is klacroix@oakbridgeins.com.

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