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# On the Job: Legal Manager/Corporate Governance

# Taking Stock

*Catherine J. Serafin and Andrew M. Reidy*

As of September more than 105 companies have disclosed that they are the subject of internal or SEC investigations, or that they are defendants in lawsuits alleging improper stock option dating practices. Existing directors and officers insurance policies may provide a source of funding for the defense and settlement of these claims, but companies need to examine their policies and take the steps necessary to secure coverage as soon as possible.

The scandal shows no signs of abating, and indeed has expanded in scope. A May 2005 study by Erik Lie of the University of Iowa concluded that, in the aggregate, the dates of nearly 6,000 CEO stock option grants showed evidence of manipulation. A March 18, 2006, article in The Wall Street Journal regarding the manipulation of executive stock options sparked widespread publicity of this issue. In June the Council of Institutional Investors, an association of corporate, union, and public pension plans, sent a public letter to the Securities and Exchange Commission requesting additional investigation and enforcement in this area. In July The New York Times reported that more than 2,000 companies may have backdated stock options. Further, on July 26, the SEC unanimously adopted new rules regarding disclosure of stock option practices.

But companies facing claims related to stock option dating practices may find a bright spot in an otherwise ominous vista. In-house counsel should immediately examine their directors and officers liability insurance policies. They may be surprised to discover that they are covered for backdating and spring-loading stock options, among other allegations. Given recent developments, however, it is critical that in-house counsel understand the policies and promptly take steps to preserve their coverage.

*Granting stock options* became common during the 1990s technology boom, especially at start-ups. Stock options became one way to reward key employees based on performance of the company, as reflected by the stock price.

The key question, however, was how much the recipient must pay to exercise the options. Pegging the options to the value of the company's stock on a given day sets a strike price to exercise the options. Two types of alleged wrongdoing involve setting the strike price so as to backdate or spring-load the options. In both cases, if the strike price is low, and the current market value of the stock is high, the options can be valuable. Conversely, when the strike price is high, but the market value of the stock lower, the options are worth less.

Backdating options involves picking a date in the past for the strike price. Provided proper disclosures are made and proper record-keeping procedures are followed, it is not necessarily improper to peg the strike price of options to a date in the past when the stock price was low. When inadequate disclosures or accounting are involved, however, backdating stock options may cause errors in earnings reports and underpayment of taxes.

Additional problems can arise when the options are spring-loaded. This involves pegging the strike price to the current market value of the stock, but in circumstances in which insiders are aware of material information that, upon public disclosure, is likely to cause the stock price to increase. Spring-loading stock options can lead to charges of insider trading and breach of fiduciary duty, among others.

Information about public companies' stock option practices is readily available. The plaintiffs bar can easily analyze a public company's filings with the SEC and obtain records of fluctuations in the stock price, and then allege backdating and spring-loading.

It is no surprise, given this climate, that insurance companies have developed questionnaires on stock option practices, and that they are starting to ask new and renewing policyholders to certify that options have not been backdated or spring-loaded. Policyholders with stock option practices issues need to take steps now to preserve existing coverage. Here are some of the key terms and issues.

*Wrongful acts*: D&O insurance policies typically provide coverage for liability arising from a Wrongful Act. Policies differ as to the definition of Wrongful Act. A common definition is any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, omission or act . . .

An insurer's obligation to pay a lawyer to defend an insured entity is triggered when an underlying claim contains any allegations that could be construed as falling within the definition of Wrongful Act. Many policies extend coverage to SEC investigations. Criminal complaints also may give rise to an insurer's defense obligation. In fact, given the recent increase in claims alleging corporate malfeasance, many D&O policies expressly provide coverage for criminal proceedings commenced by the return of an indictment. If a policy contains such coverage, then triggering the defense obligation for a criminal complaint involving improper stock option practices should be fairly straightforward.

Even if the policy does not contain such express language, however, an insurer might still have to pay for a lawyer to defend policyholders against criminal charges. This is because in many criminal cases the allegations also allege that corporate directors or officers made misstatements or misleading statements or breached duties, and those allegations fall within the definition of a Wrongful Act.

*Notice*: D&O policies usually are written on a claims-made basis, which means that a policyholder's obligation to give notice of a claim arises either when the claim is asserted or when there are circumstances likely to give rise to a claim. Complying with notice provisions in policies is important, because in some states coverage is forfeited unless there is strict compliance with notice obligations. Some policies have a fixed deadline for giving notice, such as 30 or 60 days after the receipt of a claim. Other policies require notice as soon as practicable and no later than the end of the policy period. Companies should carefully review all policies for notice requirements. Otherwise, this may be an additional basis for an insurer to deny coverage.

*Personal conduct exclusions*: Insurance companies historically have raised several policy exclusions to avoid coverage for cases alleging corporate misdeeds, and there is no reason to believe they will not raise these same exclusions in an attempt to bar coverage for claims alleging improper stock option practices. For example, most policies contain exclusions for fraud, dishonesty, or illegal profit similar to the following:

The insurer shall not be liable to make any payment for Loss in connection with a Claim made against an Insured:

arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which an Insured was not legally entitled;

arising out of, based upon or attributable to: (1) profits in fact made from the purchase or sale by an Insured of securities of the Company within the meaning of Section 16(b) of the Securities Exchange Act of 1934 and amendments thereto or similar provisions of any state statutory law; or (2) payments to an Insured of any remuneration without the previous approval of the stockholders of the Company, which payment without such previous approval shall be held to have been illegal;

arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraudulent act.

Allegations that bring the claim within the scope of these exclusions should not, however, affect the insurer's obligation to pay for the defense of the policyholder because most policies provide that the insurer cannot rely on the personal conduct exclusions unless and until there is a final adjudication of fraud or dishonesty. In recent cases, several courts have held that an insurer is required to defend its insured until there is a final adjudication on the merits of criminal actions.

*Severability provisions*: To prevent the loss of coverage as to all insureds for the conduct of one or a few, many policies include severability clauses that prohibit imputing knowledge or bad acts to all those who are insured. For instance, one typical severability provision says:

For the purpose of determining the applicability of the foregoing Exclusions . . .

(1) the facts pertaining to and knowledge possessed by any Insured shall not be imputed to any other Insured Person; and (2) only facts pertaining to and knowledge possessed by any past, present or future [officer or director] . . . shall be imputed to [the] Organization.

Under such a provision, innocent directors and officers are not charged with the knowledge or conduct of bad actors, and the burden is on the insurer to prove that a particular insured's conduct falls within the exclusion.

*Rescission*: The allegations about stock options often involve senior management and conduct that took place years ago. Insurers may assert a rescission defense, arguing that the D&O insurance was obtained based on material misrepresentations or omissions in the application for insurance. The law of rescission is governed by statute in many states. Importantly, the simple assertion of a rescission defense does not excuse the insurer from its defense obligation.

*Dispute resolution*: Insurance companies have taken different positions on stock option claims. Some have agreed to pay defense costs and reserved rights. Others have denied coverage. An individual or company that is working with a D&O insurer on these issues should be aware that insurance law varies from state to state. Some insurance companies have been aggressive recently in filing lawsuits to secure forums favorable for the insurer. In-house counsel need to be aware of the risk of an insurer filing an action to secure a favorable forum, and must consider all options in dealing with insurers on these claims.

Companies faced with allegations of improper stock option practices need to examine their insurance policies quickly and provide prompt notice to carriers of claims. Although the initial response of the insurer may be to raise exclusions and other defenses to coverage, there is a good chance that the insurer's defense obligation, at a minimum, may be triggered. Moreover, insurance may pay all or a portion of any settlement or judgment relating to stock option claims.

*Catherine J. Serafin and Andrew M. Reidy are partners in the insurance recovery group of Howrey.*