THE PRACTICE OF BACKDATING STOCK options has drawn a great deal of attention from state and federal regulators and from the plaintiffs class action bar. Stock options typically give the recipient the right to purchase stock at a "strike price" set on the date the option is granted. If the stock price subsequently rises, the holder may exercise the options and profit from the increase. "Backdating" refers to a practice by which the grant date and strike price are set after the fact, based on the lowest recent stock price, thereby increasing the potential gain.

The Securities and Exchange Commission is currently investigating more than 100 companies for backdating, and as many as 2,000 companies may have engaged in this practice. The SEC has also brought criminal charges against several executives, and dozens of securities lawsuits and derivative suits have been filed by class action plaintiffs firms.

A backdating controversy may cost a company millions of dollars in defense costs alone, to say nothing of the potential liability.

EXECUTIVE SUMMARY

Although the practice of backdating is not illegal per se, it may require disclosure and tax treatment that the company has not yet acknowledged. This may lead to governmental investigations and private securities litigation. Insurance should be an important part of a company's strategy in responding to such allegations.
for such claims. Insurance coverage should play a central role in a company’s strategy in responding to these claims. Insurers are well aware of the scope of this problem and can be expected to take a very aggressive approach to claims. An equally focused approach is required by insureds to ensure they obtain the full benefits of their insurance.

**BACKDATING CLAIMS**

There is nothing illegal about selecting a lower strike price for the option grant after the fact, though it does raise accounting and tax issues.

Ordinary compensation must be expensed by a company, but stock options need not be expensed if they are issued at fair market prices. However, backdated options may not qualify for this treatment. A number of companies have reviewed their option-granting practices and have restated their earnings for the past several years. This has led to SEC and IRS investigations and private litigation. Backdating can expose a company and its executives to potential tax liability, tax penalties, SEC fines, potential criminal liability, and civil liability in class actions and derivative suits.

**D&O COVERAGE**

Directors and officers insurance (D&O) generally provides coverage for “wrongful acts” by directors and officers of a company in managing the company, subject to a number of exclusions. D&O policies may provide several different types of coverage, including direct coverage for the personal exposure of the directors themselves (often called Side A coverage), and coverage for the company, to cover its obligation to indemnify the directors and officers (Side B coverage). In addition, many policies provide coverage for certain types of claims against the company itself, such as open-market securities claims (Side C or “entity” coverage).

D&O policies are typically “claims-made,” meaning that coverage applies only if the claim is made during the policy period and notice is given to the carrier within the policy period (or a short grace period thereafter). These policies typically pay for losses consisting of both defense costs and eventual settlement payments. Unlike under some other policies, payment of defense costs is charged against the policy limits; thus, D&O policies are often referred to as “wasting.” Terms differ from policy to policy in ways that significantly affect the scope of coverage.

**TYPES OF CLAIMS COVERED**

D&O policies typically provide coverage for loss on account of any claim. The definition of “claim” is critical to the scope of the company’s protection. Some policies define claims to be limited to demands for monetary relief, whereas broader policies give coverage for the defense of governmental investigations, and some include coverage for criminal matters as well. These broader coverages may not apply until the insured is identified as a target.

**FINES AND PENALTIES**

Policies typically exclude from the definition of covered loss fines, penalties, and the multiple portions of treble damages. Some policies expressly list “taxes” as excluded; others do not, which may provide insureds with an argument for coverage, though all other requirements would need to be satisfied.

**RESCission RISK**

Despite the fact that D&O policies are purchased largely to protect the insureds from claims of misrepresentation, carriers frequently assert the right to rescind the policy if the application has incorporated financial

**EXPERT ADVICE**

Here are a few things to keep in mind:

- Insurers can be expected to take a hard line on coverage for backdating claims.
- If the backdating leads to a financial restatement, insurers may seek to rescind the policy, claiming misrepresentation. Such adjustments, however, are unlikely to be “material” from the underwriting standpoint.
- Carriers may assert the “personal profit” exclusion, but it may not apply, depending on whether the claim is against the individual who received the grant, the individuals who approved it, or the company itself.
- Backdating is not an improper “personal profit” to which the recipient is not entitled. Rather, liability is based on the failure to disclose the practice.
- Some policies cover only civil lawsuits, others extend to governmental investigations or criminal proceedings. But even broader policies may not apply unless and until the insured is identified as a target.
- Even if there is no claim to report, insureds should evaluate whether to report backdating as a “circumstance” under its expiring policy to avoid potential problems under a renewal policy.
restatements, amended public filings, or any false statements. Insurers often contend that a restatement is a concession of a material misrepresentation, but that argument is superficial. The issue is not materiality from an accounting standpoint, but from an underwriting standpoint. It may be difficult for the carrier to show it would have declined to issue a policy if the option costs had been properly expensed, because lower reported net income would seem irrelevant to the underwriting analysis.

Moreover, many policies have severability clauses. Terms vary, but these clauses typically provide that the policy may be rescinded only regarding those insureds who made the misrepresentation or who knew of the misrepresentation. This may severely limit which insureds are subject to having their coverage rescinded. Allocation rules also vary according to policy terms and state law, but a common rule is that a loss is deemed covered in its entirety despite the presence of uninsured defendants if the defense costs and liability would be the same with or without the uncovered defendants. If all defendants are equally liable for the loss, the company and its directors should still have full coverage for the loss even though the policy may be subject to rescission as to some insureds.

In addition, a carrier generally has an obligation to contemporaneously advance defense costs to its insured during the course of litigation, even if it has asserted rescission. It must prove the rescission claim before it can terminate its obligations. However, because the issues in the rescission case overlap with the issues in the underlying claims against the insured, the insured has a good argument that pursuing the rescission claim is prejudicial to the insured's defense and should be stayed until the lawsuits are over.

PERSONAL PROFIT

Generally, policies exclude coverage if the insured received any personal profit, payment, or advantage to which that person was not legally entitled. This exclusion applies only if there is an actual adjudication that the insured obtained a personal profit. In addition, policies usually have a severability provision, so that the exclusion excludes only the culpable insured.

Perhaps most important, the exclusion applies only to compensation the insured is not “legally entitled” to receive. Executives, however, are legally entitled to the full amount of their stock option compensation. The issue with backdating is not whether it was improper for the executive to receive it, but how it was reported by the company for income statement and tax purposes.

NOTICE ISSUES

To avoid a notice defense, the company should report the claim promptly to the insurance company, both to trigger the policy to ensure that it applies to the loss and to avoid arguments that costs were incurred without approval of the insurer.

Policies also permit notice of a “circumstance”—meaning an event that could later give rise to a claim—even if there has not yet been a claim. If the insured is aware of a circumstance, then the insured is permitted to give notice of it during the policy period. Any claim made later will be attributed to the policy period in which notice of the circumstance was given.

If the company has not yet received a claim, careful consideration should be given to notifying the carrier of a circumstance before a policy currently in force expires. This may be advisable for several reasons. First, carriers may be attaching backdating exclusions to future policies. Triggering the current policy avoids that problem. Second, carriers may ask for additional information on renewals, or even warranties or certifications with respect to option practices. Notice of a circumstance places the loss in the current policy year and avoids any issues regarding the adequacy of the renewal application.

Insurance is an important part of any company's response to a backdating controversy, and careful attention should be given to this issue in developing and implementing a company's strategy to maximize the value of this asset.

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