

Backdating of Stock Options

The Effect on Directors' and Officers' Liability



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As allegations continue to evolve around the practice of backdating stock options by publicly traded corporations, we may be witnessing the next wave of claims against directors and officers. Many investigations have been launched into several companies' practice of backdating stock options. As a result of these probes, directors and officers have resigned from their Board seats and management positions. Additionally, the U.S. Securities and Exchange Commission has publicly disclosed investigations into companies in various business segments for the same practices. The recent scrutiny of the practice of backdating stock options has raised significant concerns for corporations and is generating serious apprehension among boards of directors, officers, audit committees, compensation committees and in-house lawyers. Many companies are initiating voluntary internal reviews into their past and present options programs/procedures in anticipation of future government inquiries.

William Gallagher Associates, a leading provider of insurance brokerage, risk management and employee benefits services to firms with complex risks, within industries that include high technology, life sciences, financial risks, healthcare services, energy, and environmental services. WGA has offices in Boston, MA; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris France.

Shareholder suits have already been filed against corporations and their directors and officers as a result of corporate restatements that were prompted by their alleged failure to account for the appropriate expenses that resulted from granting the under-priced options to certain executives. We expect that courts across the country will have an increase in the number of securities claims filed due to the pending investigations and the resulting financial implications such as tax and restatement risk.

This update provides a brief overview of the alleged backdating stock option practices and the potential implications for Directors' and Officers' Liability insurance.

THE PRACTICE OF BACKDATING STOCK OPTIONS:

When did the backdating of stock options take place?

The investigations appear to involve options granted between the mid-90's and August of 2002. In 2002, the passage of the Sarbanes-Oxley Act ("SOX") imposed a specific provision (Section 403) requiring the disclosure of the option grant within two days of the award. The significance of the mid to late 1990's relates to the wild growth of the technology, semiconductor and a few other specific industry sectors - a time when offering significant stock options as incentives to entice employees to leave larger, stable companies to join more volatile start-up organizations. Of course, it comes as no surprise that many of the companies now being investigated fall into these industry sectors.

What does the practice of backdating stock options entail?

The practice of backdating stock options occurs when an individual selects a date that has already passed to seek an options award, typically a date when the valuation of the company's shares is at a low point. The selection of the earlier date creates a potential opportunity to inure a significant advantageous personal financial gain - assuming the stock price has risen between the date of the options award and the date when the options are exercised. As an example, an executive with options to be awarded may select, and backdate to, an award date which immediately followed an announcement of bad news which drove the stock price down.

Who has the ability to grant stock options within organizations?

Usually in most corporations, stock options are granted by the board of directors or by the compensation committee. The actual practice of backdating the option, however, may very well be within the purview of a CFO, CEO, or member(s) of the finance or human resources departments.

What are the legal implications of backdating stock option?

Historically, backdating of stock option grants were considered acceptable if the following practices were followed:

1. Disclosure to shareholders of the backdating practices and procedures;
2. Correct accounting of the taxes for the compensation; and
3. Correct accounting for the backdating in the corporate earnings.

Since the decision to award options at a low strike price does not appear to violate any specific law, the real concern appears to be the lack of transparency regarding how those options were distributed and accounted for which may be considered fraudulent and violative of securities laws. In that vein, the legal implications could include complaints brought by shareholders directly or derivatively against the Board of Directors, Executive Officers and the Company to remedy alleged breaches of fiduciary duties and other violations of the law. One such derivative case already filed against the company nominally, the Board and certain executives include formal cause of action for: violations of Section 14(a) of the Exchange Act; disgorgement under SOX; breach of fiduciary duty; gross mismanagement; and corporate waste.

To date, no criminal charges have been filed in connection with backdated options, but this may change in the months ahead as these investigations progress. Additionally, there may be an increase in restatements by companies since the backdating practices raise potential accounting issues regarding the awarding of options at under-valued prices equating to additional compensation that must be accounted for (or previously accounted for) in a company's public financial statements. Finally, backdating may also impact income taxes filed in prior years.

How are D&O underwriters reacting to these investigations and claims?

Executive compensation has been a significant focus in D&O underwriting due diligence for the past two years and now stock option practices will be at the forefront of an underwriter's risk evaluation. D&O insurers are concerned about the risks and claims that may arise from backdating of stock options and have begun to look closely at their policyholders' past and present option granting practices. One leading D&O insurer has developed a questionnaire that is required to be completed as part of the application process. In the alternative, several other insurance companies are mandating discussions with senior management to address this specific issue. That being said, at this time, based on various financial tracking models, it does not appear that an excessive number of companies have suspiciously timed grants. Therefore, the expectation is that while the underwriter inquiries will certainly involve an even deeper probing into a company's financial accounting and corporate governance practice, the majority of companies should not have their D&O program impacted by the evaluation.

Will heightened regulatory attention over the backdating of stock options have an adverse effect on the D&O marketplace?

At this point, we do not expect the issue of stock option practices to have a significant effect on the pricing, retentions, and terms being offered to the majority of companies. Insureds that; are being investigated, have reported claims, or have risks associated with backdating stock options will likely see potential policy changes upon renewal. D&O insurers may seek to apply exclusionary wording based on prior knowledge and/or prior acts and will carefully consider whether misrepresentations occurred in the application process.

What are the potential coverage implications within a D&O contract for claims involving backdating stock options?

Companies and executives involved in backdating stock options are at risk for disclosure and securities-fraud related liabilities. The D&O coverage implications are still unclear as the SEC continues to expand the scope of its probe. The potential need for companies to restate financial results will likely generate shareholder claims which will, in turn, likely spawn “*tag along*” derivative actions. Companies could also face significant IRS bills (including fines and penalties) for past income taxes since options found to have been backdated will not qualify for compensation-related tax deductions that may have already been taken.

Claims that arise from the backdating of stock options could potentially trigger a number of the Personal Conduct exclusions in the D&O policy including; Fraud, Personal Profit, Insider Trading, and Disgorgement once these “*wrongful acts*” are proven at the applicable threshold of either “*in fact*” or “*final adjudication*”. Another potential coverage concern arises if it is proven that directors or officers knowingly violated the law in committing these acts. Insurers might also undertake rescission actions should they deem that a company has intentionally failed to disclose (to underwriters) certain past or present option practices.

Due to the scope of these investigations, we are also monitoring the effect stock options backdating will have on other executive risk policies such as Employed Lawyers, Professional Liability, and Fiduciary Liability.

What can companies do if they have an upcoming D&O renewal?

In preparation for an upcoming renewal, companies should be prepared to discuss past and present stock option practices with underwriters. Companies aware of any “material knowledge” as it relates to the granting of stock options either through an internal investigation or a regulatory probe should fully discuss these issues promptly with your attorney, broker and insurers. Also, it is strongly recommend that executives charged with the responsibility of the D&O placement and renewal closely review the applications, questionnaires and any warranty requests relating to stock option practices. It is vital that companies are aware of the implications prior to completing or signing the documents as they may contain express or implied representations and warranties that could potentially impact the extent of coverage.

