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Is There Insurance Coverage for Backdating Stock Options?

By R. Mark Keenan and Craig M. Hirsch

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It's no fun getting caught up in the scandal "du jour." In the wake of a front-page, multi-part *Wall Street Journal* exposé, many companies will find themselves subject to regulatory scrutiny and litigation stemming from their alleged "backdating" or "spring-loading" of stock options granted to executives and other employees. The improper backdating of stock options is currently white-hot and on the lips of regulators and shareholders alike.

Corporations frequently award stock options to their officers to attract and retain top industry talent. For example, a corporation announces that an executive will be awarded 1 million stock options on August 1, 2006, when the value of each share of the corporation is $30. By October 1, 2006, the stock has increased in value and the executive exercises the option at $50 per share, thereby realizing a $20 million net gain.

However, backdating the stock option sweetens the pot. If the option is deemed awarded on May 1, 2006, when the per share value was $20, the executive garners a larger profit — $30 million versus $20 million when the exercise or "strike price" reflected the share value on the date of the award.

When corporations fail to make the proper disclosures about backdating to their shareholders and the board of directors; and public filings with various government agencies mischaracterize how the options' value will be calculated, allegations of fraud and securities violations start to arise. A recent cascade of civil claims and regulatory investigations have heightened the problem in the public eye. The key issues have become whether these strike prices were specifically connected to the date the options were awarded and did the shareholders and board of directors receive an honest disclosure of the award procedure through regulatory filings.

Misery may sometimes love company — but not when insurance companies are involved. When a new type of scandal suddenly engulfs an industry or businesses generally, insurance companies reflexively look for ways to deny coverage, generally reverting to a few tried-and-true defenses.

The application process presents the first opportunity for the insurance company to seek out a policyholder misstep. The knowledge of a director-insured that backdating is occurring without full disclosure to shareholders could undermine your corporation's insurance coverage. The insurance company will dub this a "material misstatement" on the application in an attempt to defeat coverage. Fortunately, many policies contain a severability clause to protect the insurance application process from a claim of rescission. With severability comes the comfort that the knowledge of a single insured will be cordoned off from the rest of the corporation when entity coverage is sought.

"Make sure you obtain the defense and indemnification you paid for."

Some courts specifically addressing rescission in the context of defense costs have held that an

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ANDERSON KILL
ANNUAL FINANCIAL INSTITUTIONS SEMINAR

Insurance for Financial Institutions: Easy to Buy, But Will It Pay Your Claim

DATE
JULY 13, 2006

TIME
3:00 P.M. - 6:00 P.M.
(2:30 P.M. Registration)

LOCATION
The Harvard Club
27 West 44th Street
New York, NY

TOPICS
- **Coverage for lawsuits, class actions**, regulatory investigations, employee defalcations and other nasty surprises.
- **Current Compliance Issues**
- **Marketplace Overview**
- **The Hidden Billion Dollar Exclusion**: Issues regarding "matters uninsurable under the law"
- **Coverage for Property Losses**
- **Captives—Write Your Own Insurance?**
- **The Art of War:** Persuading the insurance company to get your claim paid.

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This is a free program which qualifies for NY CLE.

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insurance company must first advance defense costs to its policyholder until a final adjudication of rescission is reached. *Wedtech Corp. v. Federal Ins. Co.*, 740 F. Supp. 214 (S.D.N.Y. 1990) (holding that where the insurance company sought rescission, it was still required to advance defense costs so long as the mere possibility of coverage remained).

In recent years, insurance carriers writing D&O coverage have been particularly fond of unilaterally rescinding policies on the grounds that the alleged misdeeds trigger exclusions. Based on past behavior, corporations accused of improperly backdating stock options, or spring-loading by granting options on the eve of positive corporate news, should be on guard against rescission attempts or coverage denials based on exclusions for intentional or dishonest acts, or for personal profit (the latter precludes recovery for any personal profit or remuneration the executive was not legally entitled to).

"Bad acts" exclusions, allowing the insurance company to deny coverage if a proscribed action occurs (i.e., intentional violation of law, gaining an illegal profit, wrongful conduct as a fiduciary, etc.), are a common feature of standard D&O and professional liability coverage programs. Yet most policies contain broad severability language such as "with respect to the exclusions of this Policy, no fact pertaining to or knowledge possessed by any Insured Person shall be imputed to any other Insured Person to determine if coverage is available." This language eliminates the possibility of vicarious liability between directors and officers under the policy when the insurance company issues its coverage analysis. As a result, the unwitting director who negligently approved the stock option relying on flawed information will not lose coverage as a result of those insiders with firsthand knowledge of the improper backdating with severability language in play.

These exclusions may preclude coverage in some cases. However, they generally cannot be invoked until there is a determination of fault, since most policies require a "final adjudication" or an "in fact" determination that the executive's stock award was an illegal personal profit before denying coverage. Courts have ruled that coverage is required until "an actual adjudication or determination of fact [before the] application of the profit or advantage exclusion." *PMI Mortg. Ins. Co. v. American Intern. Specialty Lines Ins. Co.*, No. C 02-1774 PJH, 2006 WL 825266, at *5 (N.D. Cal. Mar. 29, 2006).

If your corporation settles the claim before a final adjudication without admitting liability, your insurance coverage will be viable, as most policies require an in fact determination that the executive received an illegal personal profit. *Federal Ins. Co. v. Cintas Corp.*, No. 1:04-CV-00697, 2006 WL 1476206, at *6-*7 (S.D. Ohio May 25, 2006); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 378 (D. Del. 2002) (holding profit or advantage exclusion applies only if proof exists that such illegal profit or advantage actually occurred).

Defense and investigation costs incurred in defending your

corporation against regulatory or civil claims should be reimbursed and advanced by your insurer before a determination of ultimate liability. *Federal Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397, 404 (App. Div. 2005). Also keep in mind that board members charged with negligent oversight in approving the award of stock options based on faulty information will not trigger policy exclusions precluding coverage for intentional, dishonest or fraudulent acts. *In re Donald Sheldon & Co., Inc.*, 186 B.R. 364, 369-70 (S.D.N.Y. 1995) (stating the dishonesty exclusion is not triggered by self-dealing and exercise of business judgment without a final adjudication of deliberate dishonesty).

There is something inherently paradoxical, not to say dysfunctional, in selling insurance that purports to provide defense against allegations of wrongdoing — and then rescinding those same policies on the grounds that wrongdoing was alleged. Don't let your insurance company get away with it. Make sure you obtain the defense and indemnification you paid for.

R. Mark Keenan is a senior shareholder in the New York office of Anderson Kill & Olick, P.C. and chair of the firm's Financial Institutions Group. Mr. Keenan is a leading lawyer in the fields of insurance coverage, securities law and litigation. Mr. Keenan regularly represents policyholders in insurance coverage disputes involving broker/dealers, hedge funds, investment advisors and other financial institutions. Mr. Keenan can be reached at mkeenan@andersonkill.com or (212) 278-1888.

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9TH ANNUAL POLICYHOLDER ADVISOR CONFERENCE

Maximizing Your Insurance Recovery

DATE
SEPTEMBER 15, 2006

TIME
9:00 A.M. - 4:00 P.M.
(8:30 A.M. Registration/ Continental Breakfast)

4:00 P.M. - 5:30 P.M.
Cocktail Reception

LOCATION
The Westin Philadelphia
99 South 17th Street
Philadelphia, PA

TOPICS
- Key Issues Affecting D&O/ E&O Insurance
- Current Trends in Insurance Coverage for Real Estate and Construction Exposures
- Issues with Insolvencies and Schemes of Arrangements
- First Party Property/ Business Interruption in the wake of Katrina/Rita/Wilma
- Ethics of Claim Submissions and Claims Handling

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