

Stock option backdating

Directors' and officers' liability issues to consider **Interviewed by Denise Ward**

For the past several months, the issue of stock-option backdating among public companies has become the subject of substantial media attention. In May 2006, the *Wall Street Journal* published articles that exposed the fact that executive stock options at numerous companies had been backdated or timed to coincide with their lowest annual share price. In some cases, it was estimated the odds that the grants were not manipulated were one in 300 billion.

Smart Business spoke to Jim Lopiccolo, vice president of executive liability and financial products for DLD Insurance Brokers Inc., about backdating.

Explain stock option backdating.

Stock option backdating involves the practice of selecting a date prior to the actual grant date of an option, so that the option exercise price is less than the fair market value on the date the grant actually occurred — the goal being to issue 'in-the-money' options that can be exercised for financial gain.

While the practice itself is not illegal, certain conditions must be met:

- Documents cannot have been forged.
- The effect of the backdating must be properly reflected in earnings reports.
- The effect of the backdating must be properly recorded for tax purposes — both in terms of the company's compensation expense and the capital gain for the individual option recipient.
- Shareholders must be clearly notified of the backdating practice.

What are spring loading and bullet dodging?

Spring loading and bullet dodging refers to a more controversial practice whereby option grants are timed to take place before expected good news or after expected bad news, respectively — to take advantage of the resulting effect on the stock price. Other questionable practices include: granting blan-



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ket board approval to set option dates for a specified period, providing special agreements to executives versus regular employees, and manipulating new hire start dates.

Will director and officers liability insurance (D&O) coverage respond to claims involving stock-option backdating?

Generally, with the exception of a few cases where criminal charges were filed, most of the claims we've seen thus far involve traditional securities class-action lawsuits alleging fraud or breach of fiduciary duty, or derivative suits brought by shareholders on behalf of the company. D&O policies are designed to cover defense costs and any resulting judgment or settlement amounts against the individuals, as well as the company for securities claims.

There are a number of policy provisions that could affect the availability of coverage. These include, but are not limited to:

Definition of Claim - Most policies will respond in the event a civil, criminal, arbitration, administrative or regulatory proceeding is filed against the individual directors and officers. Formal investigations will often trigger a defense obligation as well, but informal investigations simply requesting documents typically would not.

The directors, officers and the company would be on their own for these costs.

Personal Conduct Exclusions - The fraud, dishonesty and personal profit/advantage exclusions could come into play as well, depending on the nature of the allegations and the exact policy wording. In some instances, an 'in-fact' finding of fraud or personal profit would be sufficient to trigger the exclusion, whereas in better policies, the exclusions are only triggered if fraud or dishonesty is proven at a final adjudication.

Severability of the Application and Exclusions - Severability deals with the ability of the carrier to impute knowledge or facts pertaining to one insured person to another insured person to determine whether coverage applies. Policy applications now include not only the carrier's written application, but also all public disclosures and SEC filings. Since stock option backdating investigations often lead to financial restatements, carriers can point to potential fraud in the application to deny or limit coverage. Good severability language can offer significant protection to those insured persons (such as outside directors) who had no knowledge of a misrepresentation in the application, or were not involved in fraudulent conduct.

What should a company do if a fact or circumstance is found that could lead to a claim during the renewal process?

Most carriers do not require a mainform application be completed for a renewal of a policy that is already in place. Mainform applications are more troublesome than renewal applications, since they contain a warranty statement that specifically requires the insured to disclose whether they are aware of any facts or circumstances which could give rise to a claim. Nonetheless, full disclosure is best, since a claim filed shortly after a renewal can give the appearance that the insured intentionally failed to disclose information that would affect the underwriter's evaluation of the risk.

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