

Top of Mind: Backdating Suits Seek More Than Reforms

by John Cummings

Created 05/01/2007 - 01:00

While the staggering settlements in securities class action suits have grabbed the headlines in recent years, D&O underwriters are keeping a close watch on a similar but less prominent variety of legal action: the shareholder derivative suit. More than 140 such suits related to the stock option backdating scandal have been filed in U.S. courts to date.

Shareholder derivative lawsuits are actions brought by the shareholders of a company on behalf of the company itself against a third party, usually the corporation's directors and officers. The plaintiffs may allege, for example, breaches of fiduciary duty, negligence, mismanagement or self-dealing. Most derivative suits aim at bringing about corporate governance changes, but monetary damages may be awarded. Any such recovery is paid to the company itself, and so may benefit shareholders indirectly.

Monetary settlements are not common, but they're on the rise, according to David Bradford, executive vice president of Advisen Ltd. "Not a lot of them settle for large amounts, but increasingly more suits are settling for substantial awards," he reports. Bill Lerach, partner with Lerach Coughlin Stoia Geller Rudman Robbins LLP, has seen the same trend. "In derivative actions, the amounts recovered have increased, though they have not increased to the same eye-popping levels that the class actions have," he notes.

Lerach's firm has filed a large proportion of the stock-options-related derivative suits currently working their way through the courts. He sees a wide scope for governance changes arising from these cases, for example "by having additional enhanced internal controls for stock option and executive compensation programs."

The D&O market for renewal and for new coverage so far has not been impacted substantially by the rash of options backdating suits, according to Jonathan M. Cohen, partner with Gilbert Randolph LLP in Washington, D.C., but he notes that "insurance companies, when they're underwriting, have been asking a lot more questions about stock option practices, as you'd anticipate they would.

"Some of the insurers have promulgated draft exclusionary language that they would propose to put into renewed D&O policies that pertains to stock options grants," adds Cohen. "Policy holders trying to renew their coverage ought to be quite concerned about those exclusions and quite skeptical of them, because the insurers will likely try to construe them as broadly as possible -- and that could create new issues for future insurance fights."

CFOs should take a hard look at their D&O coverage. "Virtually all of the time, in my experience, these policies have limits of liability," says Cohen. "And what that often can mean is there's a single limit applicable to all of the different people and entities that may have coverage under that policy. And that translates to a competition for insurance assets that may create tensions among people who otherwise may have quite aligned interests. It may be important for a CFO or director to recognize the differences ..."

Top 5 Shareholder Derivative Settlements*

Company	Year of Settlement	Amount	Company	Year of Settlement	Amount
Time Warner Inc.	2006	\$200 million	HealthSouth	2006	\$100 million
<p>Plaintiffs alleged that the defendants breached their fiduciary duties of care, good faith and loyalty to the company by, among other things, failing to take appropriate corrective action and/or ignoring repeated warnings that should have alerted them to alleged longstanding systemic governance and compliance breakdowns in connection with America Online Inc. The Stipulation of Settlement specifies that the \$200 million also be applied to other Time Warner actions including the securities class action suits, ERISA litigation, and DOJ and SEC investigations.</p>			<p>Derivative complaints filed in the Circuit Court of Jefferson County, Ala., were consolidated into one action, captioned Tucker v. Scrushy. The parties to the Tucker action reached a preliminary agreement in principle to settle claims against former directors and officers for \$100 million in cash. The settlement amount is to be paid by insurance carriers, and is included in the aggregate cash payment of \$230 million that is part of the proposed settlement of the related consolidated securities action.</p>		
Company	Year of Settlement	Amount	Company	Year of Settlement	Amount
Cendant	2002	\$54 million	Hollinger International (Sun-Times Media Group)	2005	\$50 million
<p>The plaintiffs alleged that certain directors and officers breached their fiduciary duties in connection with the Cendant merger and artificially inflated earnings, fabricated revenues and engaged in other accounting irregularities. While a large settlement, it is significantly smaller than the securities class action settlement of \$2.85 billion.</p>			<p>2003 lawsuit brought by Cardinal Value Equity Partners against Henry Kissinger, former Illinois governor James Thompson and other independent directors of the publishing company, accusing the directors of breaching their fiduciary duties by doing nothing while former chairman Conrad Black and other key executives allegedly plundered the company through improper fees, contracts, and other fraudulent methods.</p>		
Company	Year of Settlement	Amount	<p>*Note: Derivative suits often settle in conjunction with a securities action settlement. It often is difficult, if not impossible, to determine how the combined settlement was allocated (if at all) to the derivative suit.</p> <p style="text-align: right;"><small>SOURCE: ADVISOR LTD.</small></p>		
Bank of New York	2003	\$26.5 million			
<p>Plaintiffs alleged that the defendants breached their fiduciary duties of due care and loyalty by (i) aggressively pursuing business with Russian banks and other business entities without implementing sufficient safeguards and (ii) failing to supervise properly those responsible for that business.</p>					

Source URL: <http://businessfinancemag.com/article/top-mind-backdating-suits-seek-more-reforms-0501>