



Defending Against Backdating Suits

Lawsuits related to options backdating are on the rise, and directors and officers should consider both defense and insurance strategies as investigations turn into restatements.

[Marie Leone](#), CFO.com

August 16, 2006

Some shareholder lawsuits linked to backdating stock option grants are more straightforward than others. Consider the headline-grabbing case of Kobi Alexander, the former Converse Technology CEO. The *Wall Street Journal* reported that Alexander allegedly fled the country to avoid a backdating investigation involving \$57 million in purportedly ill-gotten gains, and subsequently became a fugitive from the FBI.

Not all backdating cases offer that level of drama, but they may be equally difficult to sort out. That's because the economic effects of backdating won't be clear for another year, reckons Patrick Conroy, a vice president with NERA Economic Consulting. Indeed, the retroactive nature of the backdating may make linking economic losses to the practice difficult, which in turn, may make plaintiff's arguments more difficult to craft, Conroy says.

Backdating involves using hindsight to assign a stock-option contract an earlier date than its actual grant date. By pushing the date into the past, to a time when the underlying stock traded at a lower price than it did the day the grant was issued, the option holder is, in effect, being given the promise of cash, or what is called an "in-the-money" options grant. Such grants need to be expensed. Some companies, however, accounted for them as at-the-money grants, which under old accounting rules, did not need to be expensed. (Under FAS 123R, all options need to be expensed.)

At last count, about 100 companies have announced that they are involved in a backdating investigation. The probes include internal reviews, Securities and Exchange Commission scrutiny, and in rare cases, Department of Justice investigations. Most associated announcements suggest the possibility of restatement.

Conroy says companies will have to make improvements in their internal control procedures to deal with sloppy recordkeeping, poor controls, and improper options practices to satisfy shareholders. However, Conroy points out that, except in cases where there appears to have been deliberate manipulation, there is generally little significant price reaction to corporate backdating announcements.

That's because backdating does not directly affect future cash flow, a metric that investors value greatly, contends Conroy. And while backdating may produce a risk to a company's reputation, as shareholders don't usually like to see restatements, the economic effect remains in the past.

Nevertheless, restatements related to backdating have led to 11 shareholder class action suits and 40 derivative actions, according to the *Wall Street Journal*. That seems par for the course, says Geoffrey Fallon, a managing director at insurance broker Marsh. Fallon explains that if a company announcement results in a stock price drop of 10 percent or more, on heavy trading volume, a class action suit is generally filed within 24 to 48 hours of the announcement.

Similarly, big regulatory fines spark derivative suits as shareholders charge directors and officers with mismanaging the company. Yet, despite the current furor over backdating, the Securities and Exchange Commission has yet to charge or fine a company for its practices, according to SEC spokesman John Nestor. (Several individuals, including executives at Brocade and Comverse, have been charged.)

Derivative lawsuits, however, shine a spotlight on directors and officers (D&O) insurance, which is used to protect individuals from, among other things, suits arising from restatements. As backdating investigations — and attendant lawsuits — increase, policyholders should be aware of how their D&O policy handles certain issues, says attorney Jonathan Cohen of Gilbert Heintz and Randolph.

Cohen, who represents clients against insurers, emphasizes one overarching concept — that insurance and defense strategies should complement each other to achieve the best results. That includes bringing an insurance company into the lawsuit defense or settlement process early as a way to ensure maximum coverage. Some policies don't leave the choice up to defendants. In such cases, insurance companies retain the right not only to be involved in defense strategy planning, but to provide a defense attorney to represent the policyholder, says the attorney.

Cohen also counsels potential defendants to be aware that D&O policies are often set up as a single pool of money, which is accessed through the claims process by directors and officers, as well as the company. If a policy is not set up correctly, payments will be made on a first-come, first-serve basis, says Cohen. That is, payments will be made in the order that claims are filed. As a result, a company that files first, and agrees to a large settlement, would leave little money to support the claims of officers and directors.

Cohen suggests checking to make sure policies carry priority of payments endorsements, which states that directors and officers' claims get paid before company claims.

Still, Fallon says the "real worry" for directors and officers is that the DOJ is involved in some probes, which can mean more criminal charges — beyond Kobi Alexander and other execs at Comverse and Brocade — may be on deck. The good news is that D&O insurance usually covers criminal defense costs. The only problem, says Fallon, is that the insurance doesn't kick in until after an indictment is brought.