

On Backdating Battles

Right from the start, remember to check insurance coverage.

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The recent wave of investigations and lawsuits involving the alleged backdating of stock options promises to become one of the most widespread corporate crises in recent years. As these allegations mount, targets of the investigations will look to their insurance companies to help pay their potentially substantial defense costs and any resulting liabilities.

At the same time, insurance companies will be looking for ways to minimize, or even evade entirely, their coverage obligations. As a result, targets of backdating investigations must move quickly to protect their insurance coverage.

As has been widely reported, more than 80 companies—including heavyweights such as Home Depot, Apple Computer, and Barnes & Noble—allegedly backdated stock options or otherwise manipulated options pricing. Although the practice of backdating stock options itself is not necessarily illegal, it may lead to a host of tax and regulatory liabilities. Some companies and their executives also have been sued in shareholder class actions based on the same allegations. Recent academic studies suggest many more companies have engaged in backdating stock options and therefore may be vulnerable to backdating-related allegations.

Defending these investigations and lawsuits will be costly, and any resulting liabilities threaten to be substantial. Fortunately, these companies and their executives may have millions of dollars of insurance that may cover these defense costs and liabilities. For many companies and executives, securing insurance proceeds will be an important step in surviving these potentially costly problems.

The principal type of insurance policies that may apply to backdating-related liabilities is Directors and Officers (D&O) liability policies. These policies generally insure against liabilities, including defense costs, resulting from “wrongful acts” allegedly committed by directors and officers. D&O policies typically cover the individual directors and officers as well as the company for any obligation to indemnify those directors and

officers. Many D&O policies also cover companies for their own liabilities that result from allegedly wrongful acts their directors and officers committed.

The insurance industry already has taken note that it soon may face numerous and expensive backdating-related claims. *The Wall Street Journal* reported in a recent article that insurance companies have identified backdating claims as a “major source of claims.” One insurance executive has gone so far as to call the backdating investigations a “mini-crisis” for the insurance industry. Some insurers have suggested they may attempt to exclude options-related claims from future insurance policies.

KEEP IN MIND

In this environment it is critical that targets of backdating investigations act quickly to protect their rights. Although the facts of every case will differ, targets of backdating investigations can maximize their insurance recoveries by keeping in mind four key points.

1. Insurance and defense strategies must work together.

For companies and executives who find themselves targeted by backdating allegations, there may be a temptation to focus first on the defense of those allegations and defer insurance issues for a later day. This can be a mistake.

Seemingly innocuous decisions made in the course of defending against backdating allegations can have a very significant effect on the amount of coverage ultimately available to pay for that defense. For example, in some instances certain insurer arguments may hinge on whether a backdating allegation is characterized as a single course of conduct or as numerous, discrete acts.

The reverse also is true: Insurance policy provisions may dramatically influence how a company or executive defends underlying backdating claims. For instance, insurance policies often pay for the costs of defending a claim or investigation, but many policies provide that every dollar paid for defense costs reduces the amount available to pay for any resulting liability. Similarly, certain insurer arguments do not apply when a policyholder settles the underlying claim without admitting guilt. These and

other provisions create incentives to settle any backdating claims or lawsuits as early as possible.

A company's business strategy also may interact with its insurance strategy. For example, companies may wish to minimize the publicity surrounding potentially sensitive securities allegations. Some companies also may have long-standing relationships with their insurance companies. Companies may accommodate these types of business concerns in their insurance strategy.

Targets of backdating investigations should not see their insurance issues as rote. Instead it is critical that they act quickly to develop an effective insurance strategy that works well with their unique defense strategies and other business goals.

2. Remember that early decisions can have critical consequences.

Early in an investigation, or even before an investigation begins, a company and its directors and officers immediately face a series of important decisions that may have critical insurance consequences.

In making these early decisions, insured companies and executives must keep a close eye on the specific requirements of the policy language. For instance, one of the most significant early decisions involves giving notice to the insurers. Most D&O policies are "claims-made" policies, which means a claim generally is covered only if it is made and reported to the insurer during the policy period.

Similarly, insurers often argue that their policies give them the power to participate directly in the defense or settlement of claims. Insurers also sometimes argue that the policies give the insurer the right to limit the insured company's choice of defense counsel. Understanding these and other potential insurer arguments can help targets of backdating allegations to navigate the crucial early days of an investigation.

3. Do not be discouraged by negative responses.

Insurance companies faced with potential backdating-related coverage claims typically will hunt for any way to justify their refusal to provide coverage. Fortunately, in many cases the insured company will have strong arguments to counter the insurance company's efforts.

For example, in past securities and corporate governance cases, insurers have sought to rescind insurance policies in their entirety by arguing that the same wrongful acts alleged in the investigation or lawsuit also prove a misrepresentation in the policy application. In the backdating context, insurers might argue that their policies incorporate the securities filings at issue into policy applications.

Rescission is a very severe remedy, potentially resulting in the voiding of all coverage under the policy. But insurers often face high hurdles in their rescission efforts. For instance, insurers generally must prove the insurer relied on the alleged misstatements in issuing the coverage and that these misrepresentations were made with an intent to deceive the insurer.

In addition, courts have limited the draconian consequences of rescission in two critical ways. First, some courts have required insurers to pay defense costs until there is an actual

adjudication that the policy should be rescinded. Second, even when courts find that rescission is justified, many courts have relied on standard policy language to decline to rescind the policy for any directors or officers who were not aware of, or responsible for, the alleged misrepresentations.

Insurers also might rely upon an array of policy terms to argue that coverage for backdating-related claims is excluded. For example, insurers might argue that policy language excluding coverage for fraud or intentional misconduct applies to backdating claims. Here too most companies and their executives have powerful counterarguments. Exclusions for intentional misconduct, for instance, often apply only when there has been a final adjudication establishing the intentional wrongdoing. As a result, despite these exclusions, insurers generally must pay to defend and, in many cases, settle the claims.

Even when insurer arguments initially appear intimidating, policyholders ought not be daunted. Many insurer arguments depend on legal positions that policyholders in other contexts already have litigated successfully.

4. Beware of conflicts among insured companies, directors, and officers.

A company and individual directors and officers may find themselves in conflict not only with their insurer but sometimes with one another, as well.

D&O policies commonly pay all policyholders out of a single pool of money, so that every dollar paid to one policyholder reduces the amount available for all others. D&O policies generally pay claims on a first-come, first-served basis. As a result, although companies and individual executives share the goal of minimizing their own liability, there may be competition among companies and their directors and officers when it comes to pursuing insurance.

This competition for coverage may have significant implications for each policyholder's insurance and defense strategies. Because the policy provides a limited asset pool, both the insured company and its individual executives may strive to be the first in line to call on the insurance company. That competition may be balanced by the policyholders' shared interest in cooperating to defend against backdating-related claims and to maximize available insurance coverage.

Because the interests of individual officers and directors may not be aligned, both companies and individual executives should consider choosing separate and independent insurance counsel.

In sum, companies and executives ensnared in backdating allegations must fight the temptation to focus solely on defending against those allegations. Instead they should immediately and proactively develop an effective insurance strategy. Failure to do so could be as devastating as the consequences of the backdating allegations themselves.

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