

The Options Scandal and the D&O Insurance Response

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The director and officer liability insurance industry was as surprised as everyone else by the recent options backdating scandal. D&O carriers had never previously considered improper option accounting, and therefore few, if any, D&O policies contained explicit provisions addressing options backdating. Since the scandal first hit, however, D&O insurance carriers have had a chance to assess their exposure, consider their coverage position under the language of existing policies, and determine how they will treat improper option accounting issues going forward. In general, most D&O insurance carriers have been reasonable and evenhanded in their response.

Moreover, this response has been instructive in revealing how D&O insurance carriers view the scope of coverage. By understanding the position of D&O insurance carriers, companies can provide the best possible insurance protection for their directors and officers.

SOURCES OF EXPOSURE: WHO IS LIKELY TO BRING A CLAIM?

There are two primary groups that have, or may, seek redress of option abuses: the government and shareholders². The risk posed by each group varies in its nature, scope and probability. Understanding the nature of the potential claims that may be brought by each of these two groups is the first step in determining when and whether a D&O policy will respond to a particular claim.

Government

On behalf of the government, both the Securities and Exchange Commission and the Department of Justice have been active in policing option abuses. As of December 31, 2006, the SEC and DOJ have collectively targeted for investigation more than 100 public companies. In some cases, the SEC and DOJ have initiated formal investigations or other formal legal proceedings, but in many other instances these inquiries have been informal. In response to these informal inquiries, companies have undertaken internal investigations of their own past option granting practices. In many cases, directors and officers have been asked or forced to resign. Even with this high level of activity, however, as of the end of 2006, there have been only 5 criminal indictments for activities related to the abuse of stock options.³

Shareholders

Shareholders have initiated both securities class action suits and shareholder derivative suits. Securities class action suits have been brought on behalf of the class of shareholders who bought shares that were allegedly over-priced as a result of a company's alleged failure to disclose its options practices. Unless covered by a D&O policy, damages in a securities class action suit are typically paid by the company to the plaintiff shareholders. In contrast, a derivative suit is brought on behalf of the company by shareholders to force the company to take action against directors or officers for

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² It has been suggested that there may also be a rash of employee suits brought against directors and officers of public companies as a result of stock option mishandling. Although feared employee actions have yet to materialize, there is always the possibility that when options are mishandled, employees may look for ways to redress their grievances and target those perceived to have deep pockets. Directors and officers of a company might be considered a natural target for an employee who is told that his or her options were mishandled and, as a consequence, he or she owes past due taxes, including fines and penalties. Because we have yet to see an employee action, the exact legal basis for these types of claims remains unclear, and therefore the likelihood of insurance coverage cannot yet be assessed.

³ Woodruff-Sawyer & Co. Proprietary D&O Litigation Database.

breaches of their fiduciary duties. In the absence of D&O policy coverage, damages in a derivative suit are paid to the shareholders by the officers and directors of the company.

With respect to both types of suits, the news so far has not been good for companies. In 2006, shareholders collectively filed 22 securities class action suits related to option grants, constituting 20% of the securities class action cases brought in that year. In addition, more than 120 derivative suits related to stock option backdating were filed in 2006. Perhaps equally worrisome, more suits may follow, pending the results of a number of ongoing internal investigations. In addition, there have been several suits brought under Section 16 of the federal Securities and Exchange Act against directors and officers. These suits seek the disgorgement of short-term profits from those director and officers who profited from trading shares acquired through improperly granted options.

SCOPE OF COVERAGE: IS THERE A "CLAIM"? OR AN "EXCLUSION"?

Option backdating cases raise several issues regarding coverage and the extent to which a D&O policy will pay for damages paid in these cases. For a D&O insurance policy to respond in any given situation, there first needs to be a "claim" as defined by the applicable policy. If this definitional hurdle is met, the next test that must be addressed is whether the specific type of claim at issue triggers an "exclusion" from coverage. In other words, even if a plaintiff brings an action that falls within the definition of a claim, payment of the claim could be denied if the type of claim is excluded by the policy. In light of the scope and breadth of the options scandal, companies should examine these two questions carefully to maximize the likelihood that current losses will be covered by existing policies and to ensure that future losses will be covered. At stake is not only the ultimate determination of coverage for losses, but also the advancement of defense costs.

Is there a "claim" as defined by the D&O policy?

The likelihood of an options backdating loss falling within

the definition of a claim depends on the facts and circumstances surrounding the potential claim. To uncover the thinking of D&O insurance carriers on this issue and provide general guidance to companies, we have reviewed numerous carrier-issued "Reservation of Rights Letters" that embody the initial response of carriers to losses related to improper option accounting.⁴ Based on this research, several broad themes can be identified.

First, directors and officers who are sued either in securities class action or derivative suits have the easiest case to make with respect to insurance coverage. A suit brought by a shareholder will usually fall within the four corners of a D&O policy's definition of a "claim."

Second, directors and officers faced with an SEC or DOJ investigation are in a trickier situation with respect to D&O insurance coverage. On the one hand, some policies define claims expansively to include formal investigations by the SEC or other governmental authorities. Under such policies, there would likely be coverage. On the other hand, some policies do not include governmental investigations within the definition of a claim.

Furthermore, many investigations by the SEC or the DOJ are "informal," in which case coverage under the D&O policy is even less likely to be found. This is despite the fact that the implicit threat behind an informal investigation is that if a company does not cooperate, the government will make the investigation both formal and more onerous. As a result, informal government investigations or even mere requests for information usually result in a company's launching an expensive internal investigation.

Likely as a result of expressed frustrations by insureds over having to bear large costs for internal investigations without the benefit of any insurance coverage, several carriers in today's market have responded with changes in their policy language. Some carriers will now cover the cost of informal investigations in the future, provided that these investigations later mature into formal investigations or suits that otherwise meet the policy's definition of claim. This recent development, however, will not help the companies already faced with this problem. Under the earlier

⁴ When an insured company submits a claim to its D&O insurance carrier, the carrier as a matter of course responds with a "Reservation of Rights Letter" that sets forth its initial coverage opinion. The purpose of the Reservation of Rights letter is to put the insured on notice that the alleged claim may not be covered under the contractual terms of the insurance policy, and the letter thereby protects the insurance carrier's right to subsequently deny coverage. The insurance carrier also has the ability to later assert reasons for not covering a claim that are not addressed in the Reservation of Rights letter, but in general insurance carriers try to give their insureds as much information as possible as soon as possible about the various reasons for denial that the insurance carrier may be considering.

policies, even if a claim is later brought concerning the same set of facts underlying an informal investigation, the insurance carrier may not be contractually responsible for any costs that were incurred by the insured before the actual event that meets the definition of claim under the policy.

Lastly, it is ironic that the companies in the worst shape from a coverage perspective are possibly the best actors: companies that took the conservative route of launching their own internal investigation simply out of an abundance of caution. These investigations have been expensive, and there is no coverage under most D&O insurance policies because of the self-initiated nature of the investigations.

Is there an exclusion under the D&O policy?

For situations that satisfy the definition of claim, there is still the issue of whether there are exclusions in the policy that would prevent a carrier from covering a claim. There are four different types of exclusions that are implicated by the option backdating cases.

The first category of exclusions relate to public policy.

- **Fines and Penalties** - Fines and penalties resulting from governmental actions will usually be excluded from coverage, whether they are levied against a company or its directors and officers. Even if the policy itself does not exclude fines and penalties, governmental authorities almost always prohibit the use of insurance proceeds to pay fines and penalties.
- **Fraud or Intentional Wrongdoing** - All D&O insurance policies contain an exclusion for any intentional wrongdoing committed either by directors and officers or by the company through its directors or officers. This exclusion exists to avoid creating a moral hazard problem in the same way that a homeowner's insurance policy will not cover fire damage for a fire intentionally started by the homeowner.
- **Illegal Profit or Remuneration Exclusions/ Section 16** - Section 16 cases are usually

specifically excluded from D&O insurance policies. Even if Section 16 cases were not specifically excluded, Section 16 cases may be excluded under a policy's illegal profit or remuneration exclusion. A carrier's argument would be that the backdated options received by an optionee were compensation to which the holder was not entitled, and hence constitute illegal remuneration.

The second category of exclusions relate to explicit definitions within the D&O policy.

- **Definition of Loss** - A carrier is only responsible for paying a "Loss" as defined in the policy. The definition of loss invariably excludes matters that are uninsurable as a matter of law.⁵ Some carriers may take the position that the gravamen of an options-related claim relates to the disgorgement of ill-gotten gains and is therefore not a loss as defined by the policy. Although not dispositive, there are some cases that hold that disgorgement is uninsurable as a matter of law where a company raised capital through an improper offering of its securities. These courts have held that the company must disgorge the proceeds of such offerings because the company was not entitled to these proceeds. Drawing on this case law as an analogy, it may be argued that claims related to improper option accounting are claims that are really about disgorgement and therefore are not covered by the D&O policy. The argument would be that the recipients of backdated options received the benefit of a lower exercise price and that this benefit should be disgorged because it was a benefit to which they were not entitled.
- **Insured Capacity** - A carrier is only responsible for claims that relate to an insured's capacity as a director or officer of the insured company. Wrongdoing associated with an options abuse may be deemed to be action taken outside the scope of an executive's duties and therefore excluded from coverage. To support this position, a carrier would have to assert that the facts at hand describe activities that are unrelated to any activity that a director or officer would take in his or her capacity

⁵ This exclusion could arguably be treated as a public policy exclusion, but is being treated here as a definitional exclusion because the definition of loss is such a robust, highly-articulated part of the D&O policy. Also, the scope of what is uninsurable as a matter of law is highly controversial in this context.

as a director or officer of the company.

- **Insured versus Insured** - A carrier is only responsible for third party claims. To the extent that an insured party is participating in bringing a claim against the other insureds or is actively cooperating with the plaintiffs, the “insured-versus-insured” exclusion may lead to a denial of coverage. For example, the insured-versus-insured exclusion may be implicated where an insured party, such as a company officer implicated in an options scandal, is cooperating with the government or other plaintiffs in an action or investigation against another insured, such as the company itself or the other directors and officers. Another example is the situation that may arise if a company ratifies or otherwise cooperates with a derivative suit.⁶

The next category of exclusions relates to timing and the “claims-made” nature of the D&O policy. As a claims-made policy, the D&O policy that responds to a given claim is the policy in effect at the time the claim comes into existence.⁷ Since D&O policies typically renew on an annual basis, the applicable D&O policy is therefore not necessarily the policy in effect when the activities giving rise to the claim took place. Indeed, this division is most likely in situations like the options scandal where claims have come into being years after the underlying activity of improper option grants. In some circumstances, carriers will insert exclusions in a policy that relate to knowledge held on a certain date or acts that took place prior to a certain date. Exclusions related to timing include the following.

- **Prior Knowledge** - A carrier is only responsible for claims that were not known—and generally were not knowable—at the time the D&O policy was put into place. When D&O insurance is first put in place, the company and key executives are often asked to warrant that they know of no facts that are reasonably likely to give rise to a claim. This type of warranty is usually not required

subsequently if a company stays with its same D&O carrier year after year. In some circumstances, however, a warranty statement may be required; for example if the company decides to buy an additional layer of insurance. Because most of the backdating allegations relate to activities that took place prior to 2003, some officers had warranted on behalf of their companies that they knew of nothing that could give rise to a claim. Improper option accounting could thus be excluded by the “prior knowledge” exclusion because of information held by the company or its key officers.

- **Past Acts** - A carrier is only responsible for claims that arise out of actions that took place during the time period that the carrier agrees to cover. Improper option accounting could fall under the “past acts” exclusion if option backdating activities took place during a time period that is not covered by the D&O policy in place at the time the claim is brought.

The last type of exclusion from coverage centers on the question of whether there is a valid insurance contract that can be asked to respond to a given options backdating claim.

- **Rescission**⁸ - Option abuses have brought into question the public disclosure of some public companies with respect to their options granting practices. Since a company’s public filings are generally incorporated into the insurance policy application, carriers could attempt to rescind coverage based on alleged misrepresentations in the application. An insurance company is particularly likely to rely on rescission if the insured company had to restate its financial statements. The carrier could take the position that the restatement is essentially an acknowledgement that the company’s previously filed financial statements were materially incorrect. To the extent that a policy was well-brokered and contains

⁶ Typically companies do not cooperate with shareholders when they bring derivative suits. However, a company might choose to do so if the circumstances are such that the company does not want to defend the actions of the alleged wrong doers. In 2006 it was widely reported that the board of directors of Mercury Interactive Corporation made such a decision.

⁷ In contrast to a claims-made policy, consider an “occurrence-based” policy. Under an occurrence policy, the policy that would respond is the policy that was in place at the time the alleged wrongful act took place.

⁸ To be sure, rescission of the D&O policy is not technically an exclusion; it is an action that an insurance carrier can pursue if there were misrepresentations in the application for insurance. However, for a given claim, the effect of a successful action on the part of a D&O carrier to rescind a policy and the effect of an exclusion is the same: no payment under the D&O policy.

language that causes the policy to sever out the bad actors from insurance coverage while maintaining the policy for innocent parties—referred to as “severability” language in the insurance contract—innocent actors are in a much better position to receive the benefits of the insurance contract than if there is no such well-drafted severability language in the D&O policy.

Whether a particular claim falls under one of these exclusions depends largely on the facts and circumstances presented in each case. This determination also depends on whether the D&O policy in question was drafted in a way that lends itself to an expansive reading of the exclusions.

There is also the question of when the exclusion may be triggered. For any event that satisfies the definition of a claim, the insured will look to its insurance carrier to advance defense costs. On this count, some policies provide greater coverage than others. An expansive, or pro-insured, policy will generally advance the cost of defense until there is a “final adjudication” of fraud or some other policy exclusion that allows the insurance carrier to stop covering the claim (at which time the previously advanced monies must be repaid to the carrier). A narrower policy will only advance the cost of defense until a policy exclusion, such as the fraud exclusion, is triggered “in fact”—a term of art that allows the insurance carrier to stop paying defense costs well before the final adjudication of the claim.

GOING FORWARD: WHAT ARE INSURANCE CARRIERS DOING ON RENEWALS?

A few insurance carriers have attempted to write D&O policies that exclude from future coverage stock option practices completely, even in the absence of any known facts that are likely to give rise to a claim. This practice, however, is not standard in the marketplace; many high quality insurance carriers do not preemptively exclude claims related to stock option grants. Consequently there is no reason for companies to accept this condition.

In the context of the D&O policy renewal process, insurance carriers now focus intently on each insured’s equity granting procedures. Requests to complete stock option granting

practices questionnaires have become routine. Some carriers have gone further and have sought to obtain warranty statements from their clients about the integrity of their options granting practices.

Insurance carriers of course have every right to ask questions about an insured’s options-granting practices. Yet there is a difference between seeking information in an underwriting meeting and asking an insured to sign a warranty statement with respect to an insured’s practices. The latter can lead to denial of insurance coverage in the case of an inadvertent breach of the warranty—a risk that is heightened if the language of the warranty is very broad and general. Moreover, under current market conditions, most companies can still obtain high quality insurance without executing a warranty letter on the point of stock option granting practices.

Another tactic that carriers may use to shield themselves from future claims is the aggressive employment of Past Acts⁹ exclusions discussed above. For example, consider the predicament faced by a company that must renew its D&O policy in the midst of a yet-to-be-concluded investigation into its options practices. Because the company must disclose the ongoing investigation to the carrier, the carrier may add exclusions on the new policy for any prior acts that may be revealed by the ongoing investigation. But once this new policy comes into effect, the old policy will expire, leaving the company without coverage under either the old or new policy.

Faced with this dilemma, how can an insured that has an ongoing investigation avoid a gap in coverage? One solution—a very expensive solution—involves invoking the “discovery” period on the expiring claim. This measure usually involves paying between 100% and 200% of the expiring policy’s premium in exchange for the right to continue to report to the expired policy claims that relate to actions that took place before the policy expired.

A much less expensive solution is for the insured to provide a “notice of circumstance.” Noticing the circumstance refers to the right of the insured in any well-written D&O policy to tell the carrier of circumstances that are reasonably likely to give rise to a claim. Successfully noticing a circumstance allows an insured to preserve whatever coverage might be

⁹ Sometimes the exclusion will be styled as excluding any claims related to acts that took place prior to a specified point in time. In other instances, the exclusion will be a “specific matter exclusion,” and will carve back from coverage any claims that arise from a described set of acts.

available to it from the old, expiring policy if a claim later arises in the future from the set of facts described in the notice of circumstances. Furthermore, noticing a circumstance has the effect of putting claims related to the circumstance on the expiring policy. Therefore, noticing the circumstance on the expiring policy also means that the renewal policy about to be put in place will have its full limits available for other, future problems that may arise. Whether a carrier will accept this type of notice of circumstance will depend on two factors: the facts at hand and whether an insured's broker had negotiated policy language favorable to the insured on this point at the time the expiring policy was put in place.

CONCLUSIONS: WHAT DOES THE OPTIONS SCANDAL MEAN TO ME IF I DON'T HAVE ANY OPTIONS PROBLEMS MYSELF?

The options scandal has been difficult for the companies, individuals, and shareholders that have had to endure the ongoing investigations. For everyone else, the options scandal has been enormously instructive on the point of how to best grant stock options. Beyond that, the options scandal has tested, and continues to test, D&O insurance policies to their limits, often in novel ways. A company undertaking an annual renewal of its D&O policy should learn from these gaps in past coverage. The company can, and should, work with its insurance broker to fill in these coverage gaps. Although no one can predict exactly what coverage will be needed, companies can better protect their directors and officers in the future by at the very least closing the coverage gaps that the options backdating scandal has uncovered.

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