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Improper Stock Option Grants: The Next Wave of D&O Claims?

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A new round of D&O claims may be imminent as allegations surface that a number of publicly traded companies backdated stock options awarded to executives in order to inflate substantially the value of those options. According to public reports, the U.S. Securities and Exchange Commission is currently investigating at least 20 companies.

Federal prosecutors in both the Southern and Eastern Districts of New York have also begun investigations at several companies over these practices, and directors and officers at a number of companies have resigned as a result of these investigations and stories in the press. Most significantly, from an insurer perspective, at least one shareholder suit has already been filed, and many more may be filed in the ensuing months. This update provides a brief overview of the alleged practices at issue and then discusses the potential implications for D&O carriers.

Overview of the Practices at Issue
Companies award stock options to officers, and sometimes to directors, in order to give the executives greater incentive to improve their company's share price. Generally, each option represents the chance to buy a share of company stock at a certain “strike price” on a future date. At some point in the future, assuming the stock price rises, the executive can exercise the option and benefit from the difference between the strike price and the price when he exercises the option. Typically, the board or compensation committee sets the strike price at the market price of the company on the day the options are awarded.

Since a company's stock price will fluctuate throughout the year, the decision as to the strike price may be significant. Suppose, for example, that a company's stock price fluctuates between $20 and $40 during the year the options are awarded; the company awards the CEO 100,000 options and the CEO exercises the options when the stock price reaches $60. If the strike price is $20, the options are worth $400,000 (($60-$20) x 100,000), but if the strike price is $40, then the options are worth only $200,000 (($60-$40) x 100,000).

For a number of years, corporate experts have noted that strike prices are often set quite low and suggested that executives engage in "opportunistic" behavior by trying to time the awarding of options for a date when they perceive the price to be artificially low. For example, the executive might seek an options award immediately prior to announcing higher than expected earnings or immediately after bad news artificially depresses the stock price.

Very recently, however, spurred by academic research by Erik Lie, a business professor at the University of Iowa, the press and government officials have suggested that an improper practice has resulted in a lower strike price. The new wave of investigations alleges that a number of companies backdated the strike price in order to increase the value of stock options. That is, the company treated options as if they were awarded on March 1 at a given price, even though the company did not award the options until November 23, when the stock was at a higher price, and even though the company stated that it would set a strike price based on the date of the options award. The investigations and litigation predominately involve the awarding of options prior to 2002, when Section 403 of the Sarbanes-Oxley Act imposed a requirement to disclose awards of option grants within two days of the award.

Professor Lie concluded that a number of companies likely engaged in the practice of backdating options after noting that these companies repeatedly awarded options to executives at the lowest price during the year. He noted the statistically remote possibility that a company would consistently award options at the lowest possible price absent backdating. For example, one company, Affiliated Computer Services, Inc., assertedly awarded options to its then-president during six different years, in each case on one of the four lowest trading days during the respective years. According to *The Wall Street Journal,* the statistical probability of that occurring without backdating is one in 300 billion.

The practice of backdating options raises a number of potential legal issues. Most significantly, although the decision to award options at a low strike price does not violate the law, the failure to accurately disclose how the options were awarded may be securities fraud. The practice also potentially raises accounting issues since the awarding of options at below-market price constitutes extra compensation that must be accounted for in a company's financial statements. For example, one company that has acknowledged it is under investigation, Brooks Automation, Inc., has also disclosed that it may need to restate seven years of earnings as a result of the practice. The backdating may also have tax implications for the executives.

Potential Implications for D&O Carriers

We expect that the alleged practice of backdating stock options may lead to a number of investor suits, particularly where the plaintiffs bar can piggyback on work by the government. In some cases, the options at issue are sufficiently large that plaintiffs will argue that they should be deemed material. For example, five

public pension funds have sued UnitedHealth Group CEO William W. McGuire, COO Stephen J. Hemsley and several board members to prevent them from exercising approximately $1.5 billion in allegedly backdated stock options.

Even where the amount of the options at issue is much smaller, the plaintiffs bar may still contend that the practice was harmful because it provided substantial compensation to the executives without properly linking the compensation to performance, as stock options are intended to do. To the extent that the company must restate its earnings, plaintiffs will contend that the argument is strengthened. We also expect plaintiffs to seek to merge these stock options issues with other allegations in an effort to use the issue of the strike price date to establish scienter and to add color to the case.

Lawsuits over the strike price for options grants will also raise a number of potentially significant coverage issues. To the extent that executives are required to disgorge income earned through excessive options, they arguably have not suffered a covered loss. However, if the executive lacks the financial means to repay the amount at issue, plaintiffs may seek recovery from other officers or directors who arguably are culpable for the practice. The lawsuits also will raise issues based on exclusions for fraud, intentional acts and profit or advantage. In fact, in some cases, these issues may even be adjudicated in advance of a resolution of any private litigation since the government investigations appear to be in front of the plaintiffs' bar at the moment. Finally, since the practice often dates back into the 1990s, D&O insurers may wish to consider exclusions based on prior knowledge or prior acts dates and to consider whether misrepresentations occurred in the application process.