

By Patrick Bourk and RJ Coar

The burgeoning scandal over the timing of stock option awards will, as a matter of course, prompt review of companies' Directors and Officers (D&O) liability coverage. Reuters reports that executives will be exposed to "a wave of fresh shareholder anger as the list of companies under government scrutiny grows."¹ But just what is being scrutinized and by whom?

Background

Stock options were once the darling of economists and compensation experts alike. During the 1980s, their rallying cry was the alignment of corporate leadership interests with those of shareholders in an effort to discourage the pursuit of executive personal enrichment to the detriment of the corporation. To achieve this, executive compensation structures were formed to tie company officers' rewards directly to the appreciation in their companies' share price. The virtuous presumption underlying this compensation scheme was that share prices could only increase if corporate chieftains behaved themselves, i.e., if they pursued strategies to build shareholder value and implemented those strategies successfully. Having done so, the investing community would presumably recognize the growing value of the firm and drive up demand for shares to the benefit of existing shareholders. Stock options therefore were intended to motivate company management to increase shareholder value and support good governance.

Perhaps the most prominent examples of stock-option-based compensation were among the Silicon Valley start-ups in the 1990s. As during the 1980s, stock options were once again front-and-center in their popularity. Not only could they motivate company management but they also could be used by venture-backed companies as a relatively inexpensive and cutting-edge way to attract skilled employees with future reward.

In practice, however, the use of options as a form of compensation has provided incentive for some to artificially inflate their company's financial strength and, consequently, its stock price in order to generate windfall gains for the executives upon exercise of the options. Others discovered the potential to backdate option grants to qualify them as "in the money" immediately without much, if any, risk to the officer.

Backdating Options

Typically, company-issued stock options give executives the right to buy shares in the future at a "strike price" equal to the closing price of the stock on the date the options were granted. If share prices subsequently rise and

¹ Anna Driver, "Investor Anger over Options Awards Mounting," *Reuters*, 24 May 2006.

the options have vested (i.e., can then be exercised), the executive may purchase the optioned shares at the strike price and sell the shares at the higher current price, to realize the gain of the option. "Backdating" involves manipulating the date—and strike price—of the options in a way that creates a larger windfall for those executives who hold the options.

It has been written that the current scrutiny of option issuance practices in the U.S. may be adopted by Canadian stock exchanges and securities regulators.² Given the almost daily updates in numbers of companies under review by the SEC, the volume of media attention the issue has attracted, and the number of dual-listed companies that transact business in the U.S. and Canada, such a scenario is not difficult to imagine. While the consequences of backdating are significant in both Canada and the U.S., the prescribed rules and allowances for backdating options may differ from jurisdiction to jurisdiction.

U.S. and Canadian Concerns

Broadly speaking, there are a number of issues, from corporate governance to financial accounting perspectives, surrounding the so-called option backdating scandal. Among issues of particular note in the U.S. and Canada:

Backdating as a prohibited practice

- Currently in the U.S., companies may report in their proxy statements that the strike prices for options are always equal to the market value on the date of a grant. The grant date generally coincides with the date on which the Board of Directors approves the award. Revising the date thereafter could constitute a securities-fraud violation for a misstatement of material fact in a company's disclosure. Indeed, the practice of backdating is not prohibited under Securities and Exchange Commission (SEC) regulation if properly disclosed. In Canada, the Toronto Stock Exchange (TSX) rules, by way of example, require that the exercise price for stock options cannot be lower than the market price of the stock at the time the option is granted³. This obligation would appear to, at the very least, severely restrict the ability to backdate stock options. However, the process by which options are granted, which is typically by way of the board of directors passing an approving resolution on the date that they are granted, may still be subject to scrutiny, particularly if it is not stringently followed. Furthermore, as recently stated by a TSX spokesperson, if one is

² "The U.S. Option Backdating Scandal: What It Means for Canadian Issuers and Their Executives," Torys LLP Client Memo, 10 July 2006, #CM2006-16.

³ "Changes in Capital Structure of Listed Issuers, Security Based Compensation Arrangements," *Toronto Stock Exchange Company Manual*, Part VI, sec. 613.

determined to manipulate exercise prices and timing issues, it would be difficult to detect⁴.

Involvement of Regulators and Stock Exchanges

- In what some are calling the biggest change governing executive compensation disclosure in almost 15 years, the SEC in the U.S. has recently proposed a plan whereby companies would be required, among several other things, to furnish tables in their annual filings that clearly show values of options on the date of the grant, and the closing market price on that day, if it is greater than the exercise price.⁵ The table will be designed to bring to light any attempts by companies to give executives options priced below the value on the date they were granted and any discrepancies will have to be explained. While most parts of the new rule were expected and had been proposed in early January, the sheer enormity and rapidly growing scope of the option backdating situation appears to have forced the SEC to act more quickly than anticipated and to set clear guidelines for companies and stakeholders alike. Indicative of the mounting pressures and alarm, on July 28, 2006, the U.S.-based Public Company Accounting Oversight Board issued its first ever "audit practice alert," warning auditors to be watchful of problems relating to the timing and accounting treatment of stock option grants.⁶
- Interestingly, on October 24, 2005 Canada's TSX issued a staff notice to applicants, listed issuers, securities lawyers and participating organizations reminding them of certain provisions in the TSX Company Manual relating to the granting of options under security based compensation arrangements.⁷ As the notice states, "Staff has become aware that listed issuers may not be adhering to the requirements of Section 613(j) of the Manual, particularly in the context of ongoing consideration or negotiation of strategic alternatives of the listed issuer." The notice specifically emphasizes the requirement that issuers may not set option exercise prices on the basis of market prices which do not reflect material information of which management is aware but which has not been disclosed to the public. Despite this issue being at the heart of the notice, the message of overall concern regarding stock option manipulation, and the associated serious consequences, is very clear.

⁴ Tara Perkins, "Options Could Face Greater Scrutiny" *Toronto Star News*, 19 July 2006.

⁵ Kara Scannell, Joann S. Lublin, "SEC Issues Rules On Executive Pay, Options Grants," *Wall Street Journal*, 27 July 2006, p. C1.

⁶ Judith Burns, "Accounting Board Issues Alert on Options," *Dow Jones Newswires*, 28 July 2006.

⁷ TSX Staff Notice to Applicants, Listed Issuers, Securities Lawyers and Participating Organizations, 24 October 2005, #2005-0003.

Under the Microscope

To date, the SEC, Department of Justice, United States Attorneys in New York and California, and the Internal Revenue Service have all taken action, in one form or another, as the backdating scandal has gained momentum. In June 2006, Integro Insurance Brokers reported to its clients that approximately 50 companies were either under investigation or embroiled in regulatory and legal scrutiny. As of early August, that number swelled to almost 80. In fact, the number of companies under SEC investigation or inquiry has nearly quadrupled from May 2006 to July 2006. Christopher Cox, SEC Chairman, has stated that "with more than 20,000 comments, and counting, it is now official that no issue in 72 years of the Commission's history has generated such interest."⁸

Insurance Implications

Given the momentum of this issue, it is critical to know whether and how your company's D&O insurance policy would respond should your firm become swept up in these issues. The following elements of a D&O policy contract are worth reviewing and considering:

- Are investigative costs covered? Numerous companies caught up in the backdating scandal have said publicly that they have initiated ongoing investigations headed up by a special committee of the board of directors supplemented by outside counsel and, in some circumstances, accounting specialists. Costs associated with these activities may or may not be covered. A review of the definition of "claim" and "loss" should be undertaken.
- Policy proceeds may not pay for disgorgement. Whether options-related windfalls are deemed ill-gotten gains should be monitored and may determine efficacy of coverage.
- Is backdating excluded? A policy's so-called conduct exclusions may bar coverage.
- Will these claims impact the indemnifiable or non-indemnifiable insuring clause of the D&O contract, or both? Will the limits of the total D&O program be sufficient in the event of multi-pronged litigation involving both criminal and civil allegations? Only exposure-based benchmarking of the D&O program can reasonably answer these questions.

⁸ "SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters," SEC News Release, 26 July 2006, #2006-123.

- If there is a restatement of the financials of the company as a result of the backdating issue, will the carrier rescind coverage? Is there any non-rescindable coverage available to the directors and officers within the program?

Conclusion

The options backdating issue, while still unfolding, is gaining steam within the regulatory and government communities as well as the plaintiffs' bar. Insurers and insureds alike will no doubt continue to monitor the evolution of the matter as it relates to management liability insurance. From an insured's perspective it will be critical to understand whether your company is properly covered in the event that it is investigated and/or sued so as to determine what steps can be taken to maximize the responsiveness of the current D&O program and improve upon it in the future.

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