



Backdated Stock Options, Derivative Actions and D&O Insurance

David K. Bradford, Editor-in-Chief, Advisen Ltd.

June 2007

The U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice (DOJ) are investigating companies who allegedly backdated stock option grants, enabling executives to benefit from advantageous movements in share price. According to the Wall Street Journal, Dow Jones and Advisen research, nearly 200 companies since July 2006 have disclosed government probes, or have voluntarily acknowledged misdated options. At least seven executives have been charged with criminal offenses.

Although investigations into backdated stock options have led to delayed filing of financial reports and earnings restatements, the impact on shareholders has largely been negligible, and there have been comparatively few securities class action suits filed. However, in about three-quarters of the cases, shareholders have filed derivative actions, based on OakBridge Insurance Services ("D&O Diary," Kevin LaCroix) and Advisen research. Shareholder derivative suits only rarely result in large monetary settlements, but they can be very expensive to defend, and settlements generally require the defendant to pay the plaintiffs' legal costs.

Shareholders file derivative suits on behalf of a company, alleging that the company's directors or officers violated certain fiduciary duties. Plaintiffs usually don't seek to extract monetary damages, but rather to protect their long-term interest in the company through improved corporate governance and management changes. If there is a monetary recovery, it runs to the corporation, not to the individual plaintiff shareholders. Shareholder derivative suits are usually filed in state courts, whereas securities class action suits are almost always tried in federal courts.

Many of the backdating derivative suits allege that directors and officers breached their fiduciary duties by (i) either approving backdated option grants or reaping financial benefits as recipients of backdated options, (ii) permitting the grants to be improperly recorded and accounted for on the company's records, and (iii) disseminating false financial statements. The suits frequently contend that defendants were unjustly enriched, and seek to recover "illegal profits."

A number of the backdated stock option shareholder derivative suits already have been dismissed. In some

Continued on back

cases, these were suits filed while an investigation was underway that failed to uncover any activities requiring enforcement action. In a suit filed against Novellus Systems Inc., for example, an internal audit concluded that there had been no wrongdoing, and the SEC chose not to investigate the company. The original complaint was dismissed, but the judge gave the plaintiffs the opportunity to amend it; they chose instead to walk away.

In order to bring a derivative claim, a plaintiff must show that he has either made a demand on the corporation's board of directors that has been wrongfully refused, or that he can prove that such a demand would be futile. Two recent district court cases in California alleging backdating of stock options were dismissed because the courts concluded that plaintiffs had not proved that it would have been futile to make a demand of the board of directors. The plaintiffs argued that a demand would have been futile since there was a substantial likelihood that most board members would themselves be liable. Some legal analysts believe that these cases will provide persuasive authority in arguing for dismissal of many other pending backdating derivative suits.

"We have a substantial number of (backdated stock option) investigations under way (including) cases that are maturing to the point of potential commission action," said SEC Chairman Christopher Cox in a recent speech. As the investigations continue, there undoubtedly will be more suits filed. The good news for defendants and their D&O insurers is that emerging trends in backdated stock option litigation suggest that a significant percentage of those suits will be tossed out. For suits that are settled, large monetary settlements are unlikely. All the same, D&O underwriters remained concerned about these suits and continue to monitor developments closely. Though the probability of paying a large monetary settlement is low, monetary settlements are becoming more common in derivative actions in general. In addition, corporations and their insurers may still incur substantial defense costs, and defendants usually are required to pay the plaintiffs' attorney fees in settlements. For defendants, these suits, at the very least, are a distraction to executives and a drain on corporate resources.

This briefing was written by Dave Bradford, Editor-in-Chief, Advisen Ltd. 212.897.4776 (dbradford@advisen.com).

