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Insurance Coverage for Claims Related to Investigations and Lawsuits Concerning Stock Option Grants

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TABLE OF CONTENTS

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I. INTRODUCTION

The Securities and Exchange Commission ("SEC") and federal law enforcement authorities are currently investigating historical stock option grant practices at more than 100 public companies. Shareholder class action lawsuits and derivative lawsuits have been filed against the companies and their executive officers and directors. The claims asserted in such lawsuits include securities fraud and manipulation, common law fraud, breach of fiduciary duty, breach of duty of loyalty and waste of corporate assets.

The basis for the SEC's investigations is described in a March 2006 *Wall Street Journal* article that examined executive stock option grants at a half-dozen public companies. It noted that many of the options appeared to have been granted on the date on which the company's stock had traded at or near its lowest price in several months or more, thereby greatly increasing the profitability of the options for the executives who received them. *See* Charles Forelle & James Bandler, *The Perfect Payday–Some CEOs Reap Millions By Landing Stock Options When They Are Most Valuable; Luck–Or Something Else?*, Wall St. J., Mar. 18, 2006, at A1. The article, like the academic research that had preceded it, questioned whether executive stock option grant dates were being set retrospectively—a practice that has come to be known as "backdating." Stock options, which are a highly significant component of executive compensation, give the option recipient the right to buy the company's stock at a certain "exercise" or "strike" price on the date of the option grant. Many companies' stock option plans provide that the options' exercise price will be set by reference to the trading price of the stock on the grant date, thereby providing option recipients with the incentive to cause the company's stock price to rise in the future so that they will realize profits upon the exercise of their options.

Among other things, the practice of backdating raises issues with respect to the incentive aspect of options—since the recipient gets an option with a "built-in" profit, he or she may have a reduced incentive to work toward increasing the company's future stock price. The taxability of the options with built-in profits and the accuracy of corporate financial reports and proxy statements that contained option grant information that failed to reflect or disclose backdating may also be a concern. Corporate executives who authorize and/or receive options with knowledge that they were backdated face potential liability. Directors, who are members of the committees that approve the grant of backdated options, may also face liability depending upon the extent of their knowledge or participation in the backdating.

Many of the companies under investigation by authorities have voluntarily undertaken internal investigations and are cooperating with the authorities. Some of these companies also have announced that they will restate their financial statements going back to the 1990s. Insurance carriers are taking notice and reportedly already are seeking to limit their exposure

Because of the many variations in policy language, this white paper does not address all of the issues. It also does not replace, and should not be relied on instead of, legal advice based on the specific policy language involved and an insured's particular situation. However, it does provide a starting point and is intended to be an aid in considering what sometimes is a maze of factual and legal issues regarding insurance. This white paper may be considered advertising in some states.

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under directors and officers ("D&O") insurance policies by relying upon various policy exclusions and/or by claiming the right to rescind their policies altogether. They also may attempt to raise premiums and set more restrictive terms in new policies. Despite such arguments, however, there may be insurance coverage for investigations and lawsuits relating to allegedly improper option grant practices. We highlight some of the bases on which insurance carriers may try to limit or deny coverage below, and discuss why these arguments may not succeed.

II. INSURANCE COVERAGE FOR INVESTIGATIONS BY THE SEC AND OTHER GOVERNMENTAL AGENCIES

Many companies purchase D&O insurance to protect company executives against claims that they acted inappropriately in their corporate capacities. These same policies often also cover the company for amounts expended to indemnify the directors and officers against any such suits or claims. In either circumstance, the coverage applies to claims of "wrongful acts" by corporate executives. These policies usually provide coverage for a "Wrongful Act," which is defined as "any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, omission or act . . . ." committed by a director or officer in his or her capacity as such. *See, e.g.*, AIG American International Companies, Executive and Organization Liability Insurance Policy Form 75010 (2/00) [hereinafter "Form 75010"], 2. Definitions (aa); *see also Lime Tree Vill. Cmty. Club Ass'n v. State Farm Gen. Ins. Co.*, 980 F.2d 1402, 1404 (11th Cir. 1993) (D&O policy provided coverage for any negligent acts, any errors, any omissions, or any breaches of duty); *Seidel v. Houston Cas. Co.*, 375 F. Supp. 2d 211, 223 (S.D.N.Y. 2005) (carrier had duty to defend officers under D&O liability policy where underlying allegations were based on the officers' improper decision making).

In at least certain policy forms, "Claim" often is defined to include: (1) "administrative or regulatory investigation[s]" targeting insureds against whom "civil, criminal, administrative, [or] regulatory" proceedings may be commenced; or (2) "in the case of an investigation by the SEC . . . after the service of a subpoena upon" an insured. Form 75010, 2. Definitions (b)(3). These policies also typically cover "Defense Costs," which often are defined as "reasonable and necessary fees, costs and expenses . . . resulting . . . from the investigation, . . . defense, and/or appeal of a 'Claim' against an insured[.]" *See, e.g., id.* at 2. Definitions (f). Thus, depending upon the language at issue, a D&O policy may obligate an insurance carrier to defend against governmental investigations.

Even in the absence of specific language providing coverage for investigations, courts have found that insurance carriers are obligated to provide a defense against such governmental investigations where the policy provides for coverage for claims seeking non-pecuniary relief. *See, e.g., Bodell v. Walbrook Ins. Co.*, 119 F.3d 1411, 1418 (9th Cir. 1997) (under a policy providing coverage for "any act, error or omission" in rendering services, insurance carrier was

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obligated to provide defense upon notification that the insured was the target of an investigation by the U.S. Postal Inspection Service for mail fraud where non-pecuniary relief was sought). Therefore, even if a company and its directors and officers are merely the target of a governmental investigation, and no litigation has yet ensued, coverage may well be available for the cost of defending against that investigation.

III. INSURANCE COVERAGE EVEN IF A CARRIER CLAIMS THE RIGHT TO RESCIND ITS INSURANCE POLICY

The very allegations as to improper option grant practices and concealment of such practices from shareholders that give rise to the claims discussed above might also be cited by an insurance carrier as grounds to "rescind" its policy. For example, a carrier may claim that when a corporation applied for coverage, it failed to disclose (or concealed) its allegedly improper option grant practices and related accounting practices, and that had the carrier known of such conduct, it would not have issued the coverage, or would have done so at an increased premium. Carriers, thus, may claim the right to rescind their policies and deny any coverage obligation, leaving their insureds to foot the expense of defending against the underlying litigation or investigation.

However, carriers may not raise coverage defenses and then sit back and wait for their insureds to sue for coverage. In fact, doing so is a clear breach of their broad defense obligations. Instead, upon tender of a claim, insurance carriers typically have an immediate duty to pay for their insureds' defense expenditures, and must continue to pay until they can prove the absence of coverage. Long-standing case law and recent decisions in the context of insurer rescission efforts provide clear support for this position.

An insurance carrier's defense duty is extremely important and broad. The California Supreme Court has held:

> The defense duty is a continuing one, arising on tender of defense and lasting until the underlying lawsuit is concluded or until it has been shown that there is *no* potential for coverage . . . . Imposition of an immediate duty to defend is necessary to afford the insured what it is entitled to: the full protection of a defense on its behalf.
>
> The insured's desire to secure the right to call on the insurer's superior resources for the defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability. As a consequence, California courts have been consistently solicitous of insureds' expectations on this score.

Montrose Chem. Corp. v. Superior Court, 6 Cal. 4th 287, 295-96, 861 P.2d 1153, 24 Cal. Rptr. 2d 467 (1993).

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Thus, unless the policy at issue contains language limiting its defense obligation, a D&O carrier's defense obligation is triggered by notice of a claim potentially within its coverage. *See Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 276-77, 419 P.2d 168, 54 Cal. Rptr. 104 (1966) ("An insurer, therefore, bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy."); *Olympic Club v. Those Interested Underwriters at Lloyd's London*, 991 F.2d 497, 503 (9th Cir. 1993) (D&O insurer has defense duty if complaint against insured "*potentially* seeks damages within the coverage of the policy."). Once the duty is triggered, an insurer cannot simply walk away from the defense should it unilaterally decide that the claim should not be covered. *Montrose*, 6 Cal. 4th at 299 ("[O]nce the insured has established potential liability . . . the insurer must assume its duty to defend unless and until it can *conclusively refute* that potential." (emphasis added)); *see also Villa Charlotte Bronte, Inc. v. Commercial Union Ins. Co.*, 476 N.E.2d 640, 641 (N.Y. 1985) (carrier has duty to defend claim against its insured unless it can establish "as a matter of law, that there is no possible factual or legal basis on which the insurer might eventually be obligated to indemnify [the insured] under any provision contained in the policy").

The same "potential for coverage" standard applies to D&O policies that provide for a duty to pay an insured's defense costs as well. *See, e.g., In re Worldcom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 464 (S.D.N.Y. 2005) ("The duty to pay defense costs 'exists whenever a complaint against the insured alleges claims that may be covered under the insurer's policy.' . . . [T]he duty to pay defense costs is 'construed liberally and any doubts about coverage are resolved in the insured's favor.'" (citation omitted)); *Fed. Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397, 402 (App. Div. 2005) ("The same allegations that trigger a duty to defend trigger an obligation to pay defense costs. Both 'an insurer's duty to defend and to pay defense costs under liability insurance policies must be construed broadly in favor of the policyholder.'" (citations omitted)); *Nat'l Union Fire Ins. Co. v. Guam Hous. & Urban Renewal Auth.*, 2003 Guam 19, *22 ("This inquiry [in determining whether National Union was required to pay defense costs under a professional liability policy] is similar to the inquiry made in determining whether the duty to defend is triggered, and cases discussing the duty to defend are therefore instructive."); *Cheek v. Williams-McWilliams Co.*, 697 F.2d 649, 654 (5th Cir. 1983) (insurer's "duty to reimburse [the insured] for the costs of its defense arises if [the insured's] potential liability to [the claimant] would have been covered by the policy").

As long as an underlying action or investigation constitutes a "claim" seeking damages for "wrongful acts" as those terms are defined within the D&O policy at issue, it is, at a minimum, potentially covered. Unless and until a carrier can conclusively prove, in the context of a judicial proceeding, that its purported rescission or other coverage defenses are proper, its defense obligation continues. A number of authorities across the country support this position. For example, in *Maryland Casualty Co. v. National American Insurance Co.*, 48 Cal. App. 4th 1822, 56 Cal. Rptr. 2d 498 (1996), the carrier argued that it had no duty to defend a construction defect

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lawsuit because its insured had concealed preexisting damage, thereby voiding coverage. The court noted that if the carrier successfully proved its concealment theory, it "would eliminate . . . its duty to defend." *Id*. at 1833. However, the court held that "until such time [as] the insurer prevails, its duty to defend continues." *Id*.; *see also Anthem Elecs., Inc. v. Pac. Employers Ins. Co.*, 302 F.3d 1049, 1060 (9th Cir. 2002) ("[T]he insurers' attempt to raise questions of fact about the ultimate issue of coverage (such as, e.g., whether [the insured] knew that its [products] were defective when it shipped them) cannot defeat summary judgment for [the insured] on the duty to defend. The insurers may do so only if they 'produce[] undisputed evidence of [knowledge] negating coverage potential as a matter of law.'" (citation omitted)); *Perini Corp. v. Orion Ins. Co.*, 331 F. Supp. 453, 457 (E.D. Cal. 1971) (policy terms still applied even when carrier claimed unilateral rescission).

More recently, in *Kozlowski*, 792 N.Y.S.2d at 402, a New York appellate court held that until an insurer's rescission claims are adjudicated and its policies are declared void *ab initio* by a court, the policies remain in effect and binding on the parties such that the carrier's claimed rescission does not affect the carrier's present obligation to defend its insured. According to the court:

> [A] rescission by notice cannot, without legal sanction, have retroactive effect and serve to suspend, even temporarily, obligations that—absent a basis for rescission—have accrued under the policy.

Id.; *see also Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 382 F. Supp. 2d 685, 690-92 (E.D. Pa. 2004) (insurance carrier obligated to advance defense costs despite claim that it unilaterally rescinded policy).

In light of this authority, D&O insureds should not allow their carriers to be the sole arbiters of the carriers' duties. If a potential for coverage is triggered, insureds should demand that their insurers pay for defense expenditures that are incurred, until a court says that they need not. Insurance carriers may not simply ignore their duties while leaving their insureds to fend for themselves.

IV. INSURANCE COVERAGE EVEN IF THE CARRIER RELIES ON THE FRAUD EXCLUSION

Insurance carriers also may seek to limit their coverage obligations based upon an exclusion for claims alleging "fraudulent" acts. Indeed, investigations or suits against the directors and officers may be based upon allegations that financial statements contained fraudulent representations concerning stock option grants. A D&O policy typically excludes coverage for "claims" "arising out of, based upon or attributable to the committing in fact of any deliberate criminal or deliberate fraudulent act . . . if a judgment or final adjudication . . . establishes that such . . . act was committed . . . ." Form 75010, 4. Exclusions (c), as modified by Final Determination Wording Endorsement. The insurance carriers may assert that such an allegation bars coverage. However, fraud exclusions often require a judgment or final adjudication

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establishing that the insured's conduct was deliberately criminal or deliberately fraudulent. Absent such a finding, the fraud exclusion should not apply. *See Nat'l Union Fire Ins. Co. v. Brown*, 787 F. Supp. 1424, 1429 (D. Fla. 1991) (noting that exclusion for losses arising out of claims made against insureds for fraud, dishonesty, or criminal acts did not apply until final adjudication established that insureds engaged in fraud, dishonesty, or criminal acts), *aff'd*, 963 F. 2d 385 (11th Cir. 1992).

Furthermore, as long as the claim involves other potentially covered matters, the insurance carrier should be obligated to provide a defense. As the California Supreme Court held:

> We look not to whether noncovered acts predominate in the third party's action, but rather to whether there is *any* potential for liability under the policy. Since an insurer has a duty to defend the entire third party action if any claim encompassed within it potentially may be covered . . . , the mere fact that [the insurer] could not indemnify [the insured] for [one claim] did not eliminate its duty to defend other, possibly covered claims.

Horace Mann Ins. Co. v. Barbara B., 4 Cal. 4th 1076, 1084, 846 P.2d 792, 17 Cal. Rptr. 2d 210 (1993) (citations omitted).

V. INSURANCE COVERAGE EVEN IF THE CARRIER RELIES ON THE PROFIT EXCLUSION

Insurance carriers also may seek to disclaim coverage based upon their profit exclusions. Like the fraud exclusion, a profit exclusion may provide that there is no coverage for "claims" "arising out of, based upon or attributable to the gaining of any profit or advantage to which a judgment or final adjudication . . . establishes that the Insured was not legally entitled . . . ." Form 75010, 4. Exclusions (a), as modified by Final Determination Wording Endorsement. As discussed above, one of the premises of the claims being made in the shareholder lawsuits is that directors and officers who are the recipients of the stock option grants received illegal profits resulting from improperly-determined grant and exercise dates of stock options. The insurance carriers may assert that such an allegation, like a fraud allegation, is also a bar to coverage. However, profit exclusions also usually require a final judgment or adjudication finding that the profit was gained illegally. Until such a finding, the insurance carrier is obligated to provide a complete defense for the entire lawsuit if the policy otherwise provides coverage. *Id.; see, e.g., PMI Mortgage Ins. Co. v. Am. Int'l Specialty Lines Ins. Co.*, No. C 02-1774 PJH, 2006 U.S. Dist. LEXIS 24853, at *13 (N.D. Cal. Mar. 29, 2006) (profit exclusion did not apply because "adjudication is necessary to determine whether there was, in fact, any illegal profit or gain").

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VI. “SEVERABILITY” PROVISIONS MAY PROTECT “INNOCENT” DIRECTORS AND OFFICERS

The threat of rescission of an insurance policy or denial of coverage based on an exclusion may be tempered by policy benefits that protect “innocent” directors and officers. When insurance carriers claim the right to rescind, they often will seek to do so as to *all* insureds, regardless of whether they were involved in the wrongful conduct, leaving their “innocent” insureds without protection. Similarly, an insurance carrier may also rely on the fraud and profit exclusions to deny coverage for all insureds.

A number of courts have recognized that D&O carriers can rescind their policies in appropriate circumstances. *See, e.g., TIG Ins. Co. v. Homestore, Inc.*, 137 Cal. App. 4th 749, 40 Cal. Rptr. 3d 528 (2006); *Mitchell v. United Nat’l Ins. Co.*, 127 Cal. App. 4th 457, 25 Cal. Rptr. 3d 627 (2005). But, broad “severability” provisions in D&O policies can protect “innocent” officers and directors. These provisions typically limit imputation of knowledge possessed by one insured to other insureds. The protection afforded by these provisions, however, will depend on the specific “severability” language found in the policy.

For example, certain provisions may be argued to protect innocent insureds, unless the “bad actor” was a high-level executive or signed the policy application. While such a provision appears to provide broad protection, it arguably may not address the primary concern of protecting innocent insureds. Binding all insureds to information possessed by any one insured arguably defeats the very purpose of D&O insurance: to protect corporate board members, should they be sued for non-fraudulent conduct in their corporate capacities. Allowing an insurance carrier to impute the fraud of one insured to another could render that coverage illusory.

Other policy language might be argued to protect “natural person” insureds (such as executives), but not the company that has agreed to indemnify them. Under this approach, statements in the application could affect coverage for the company itself, but should not affect coverage for any other individual insured. This language, however, again may not comport with the purpose of D&O insurance and severability provisions: to pay for amounts incurred by innocent insureds. It thus should not matter who ultimately makes the payments, the executives themselves or their company. Arguably, this severability provision then should apply only to amounts paid by the company to reimburse “guilty” insureds.

A severability clause also can prevent the application of the fraud and profit exclusions to “innocent” insureds. For example, many D&O policy forms provide that, “For purposes of determining the applicability of the [fraud and profit exclusions] the facts pertaining to and knowledge possessed by an Insured shall not be imputed to any other Insured . . . .” *See, e.g.*, Form 75010, 4. Exclusions. Thus, even if the fraud and profit exclusions bar coverage for some insureds, assuming there are requisite judicial findings, “innocent” insureds still may be entitled to full coverage under the policy.

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