

RISK FROM GOVERNMENT INVESTIGATIONS:

Securities and Exchange Commission and Department of Justice investigations into alleged securities violations such as the backdating of stock option grants—and the class actions or derivative actions that invariably follow them—are proliferating as investors, the government, and members of the plaintiffs' bar continue to scour corporations' financial disclosures and records for accounting irregularities. These investigations and lawsuits can exact enormous costs on the corporations facing them—including large settlements, fines, and penalties; costs associated with restating financial statements; and costs to directors and officers who may be forced to pay a portion of settlement dollars or give up their stock options. However, directors should know that insurance coverage for these costs is available and that corporate policyholders who take proactive measures to minimize potential coverage issues stand a better chance of recouping their defense and settlement costs.

CASE IN POINT: OPTIONS BACKDATING INVESTIGATIONS AND LAWSUITS

The recent spate of government investigations into alleged stock options backdating offers a good example of the risks companies face in association with alleged securities law violations. In July 2008, for example, UnitedHealth Group announced an \$895 million preliminary settlement of a securities class-action lawsuit pending against it in Minnesota. Originally filed in 2006, the case stemmed from allegations that UnitedHealth misrepresented and omitted material facts regarding its stock options backdating practices. On May 5, 2010, in the country's third-largest options-backdating securities class-action lawsuit settlement, Maxim Integrated Products announced that it agreed to settle options-related securities claims pending against the company for \$173 million. According to the company's press release, the after-tax cost from the settlement would be \$110 million. And in October 2010, after four years of litigation, Apple Inc. agreed to pay \$16.5

million to settle a class-action suit by the New York City Employees' Retirement System, which had alleged that the company improperly backdated stock options between 2001 and 2006. These and other settlement costs are in addition to the millions of dollars spent investigating and defending against alleged securities law violations.

As these examples demonstrate, although examples of options backdating are being exposed today, the scrutinized practices may well have occurred several years ago and under different management. As a result, present management, which may have had no involvement in the backdating, is now being expected to answer for the practices. Further, derivative suits related to backdating—which frequently follow on the heels of a government investigation—often allege breach of fiduciary duties by current directors and officers. Shareholder plaintiffs have alleged, for example, that directors and officers have liability if they approved backdated option grants, benefitted financially from the receipt of backdated options, permitted grants to be improperly accounted for on the company's records, or disseminated or approved financial statements that were false or misleading as a result of options backdating.

THE SCOPE OF D&O COVERAGE VARIES

When alleged misconduct or accounting irregularities surface, a company's response is necessarily immediate—and often expensive. Typically, multiple law firms are retained to handle the government investigations, private litigation, and internal investigations that follow, and to defend implicated directors and officers.

Most corporations carry directors and officers liability insurance policies, which they believe will respond to these sorts of investigations and lawsuits. However, not all D&O policies have the same terms or provide the same scope of coverage. As the backdating investigations, lawsuits, and settlements have accumulated, so too have the number of coverage issues raised by insurers seeking to escape

A hand holding a magnifying glass over the text "ARE YOU COVERED?". The magnifying glass is held by a hand from the right side of the frame, and the lens is focused on the text. The background is a light, neutral color.

ARE YOU COVERED?

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liability. For example, when confronted with a policyholder's efforts to obtain coverage for costs incurred in connection with backdating-related allegations, insurers frequently take a narrow position on what constitutes a "claim" under their policies. Insurers may contend, for example, that costs incurred in connection with government investigations and subpoenas are not incurred in connection with a "claim." Insurers may also argue that internal investigation costs—such as those that come about via a special committee created to investigate alleged wrongdoing—are not covered because such costs supposedly are unrelated to the defense of a "claim."

A related argument is that costs incurred in defending against a derivative action are not covered because such actions are brought on behalf of the corporation as a nominal defendant and thus present no "claim" against the corporation to trigger coverage. Additionally, insurers often argue that coverage for a derivative action is excluded where the action alleges that the policyholder was unjustly enriched, engaged in fraud, or gained "illegal profits." Thus, how a policy defines key terms such as "claim" and the scope of exclusions may be critical to determining the bounds of coverage.

Many policyholders and defense counsel agree that insurers' coverage arguments are overly formalistic and are often divorced from the business realities of these situations. A December 2009 decision from the Southern District of New York, *MBIA Inc. v. Federal Insurance*, represents a welcome, common-sense judicial approach to some of these issues and has positive future implications for policyholders. The insurance companies in *MBIA* argued that costs incurred by a special litigation committee in hiring outside counsel were not covered under a D&O policy because the committee exercised "independent decision making." The D&O policy at issue covered the corporation itself but did not explicitly include the committee as an "insured." Ultimately, the *MBIA* court found that costs billed by the committee's outside counsel were covered. And while the opinion

does not explicitly address this issue, by finding coverage for the internal investigation fees related to the derivative suits, the *MBIA* court implicitly recognized that the fees were incurred in connection with a "claim." Policyholders have good cause to feel emboldened by *MBIA*; the opinion may very well signal a trend in favor of D&O coverage for costs related to internal investigations.

PROACTIVE MEASURES ARE BEST

If corporations are aware of these important coverage issues, they can proactively take steps when purchasing new or renewal policies to ensure coverage for future government investigations and lawsuits arising out of alleged securities law violations. For example, insurance coverage is available in the marketplace that expressly defines "claim" to include government investigations, among other favorable terms.

Moreover, if a corporation learns that it has potential liability for securities law violations such as stock options backdating, the immediate steps it takes can have a major impact on whether coverage is ultimately provided. Claims arising out of securities violations are often complex and raise a number of coverage issues. It is critical, therefore, that the facts of the claim be presented to the insurer in a manner that anticipates potential coverage issues. A corporation's notice of potential liability to its insurer will set the tone for all future dealings.

Policyholders should assume that their D&O insurers will dispute the availability of coverage for government investigations and related lawsuits. In anticipation of this, policyholders should be prepared to provide a carefully detailed articulation of the facts underlying a particular investigation or lawsuit and should be mindful that the way in which facts are presented from the outset can influence whether coverage is ultimately available for the costs incurred. 🌐

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