

# Executive Risks

Willis

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The liability landscape for executives is changing rapidly – for good or for ill depends on your perspective – and all signs indicate that 2007 is going to be a watershed year. It's only March, and already some pivotal legal decisions have been handed down. Tighten your seat belts and be prepared for a bumpy ride as we highlight three hot topics.

- Recent stock options backdating cases
- Wal-Mart's EPL glass-ceiling case
- EPL class action waivers

### Stock Options Backdating Cases

The backdating of stock options has swept to the forefront of Directors & Officers (D&O) litigation in the last year; and last month, the closely watched Delaware Court of Chancery issued two rulings that may reverberate in corporate board rooms and provide some insight into future stock option litigation.

### The Dating Game

Many publicly traded companies grant stock options to their senior officers and managers as part of a competitive compensation package. Stock options give the holder the right, but not the obligation, to exercise the options at their discretion for a specified number of shares of common stock. When the price of the stock is higher than that of the option at the time of exercise, it is said to be *in-the-money* and the holder has a financial gain. To *backdate* a stock option, the grantor allows the receiver, or a member of management, to choose an advantageous date on which the option will be valued. Generally, the grant will reflect a date on which the stock price

was at its lowest point during the previous 90 to 180 days, thus increasing the likelihood that an option is in-the-money. The backdating of stock options is not in itself illegal (though its ethics have clearly been challenged), as long as the proper protocols are followed. If the grantor of the option properly discloses the backdating at the time of the grant, no fraud has taken place. However, failing to properly disclose this information can reduce corporate expenses and serve to artificially inflate earnings – a practice which has given rise to allegations of fraud or mis-management against approximately 140 companies to date. In some egregious cases, additional steps were allegedly taken to hide or affirmatively misrepresent the practice.



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The Toronto Stock Exchange has established controls to prevent abuse of option grants: the issuer cannot set option exercise prices on the basis of market prices that do not reflect material information that management is aware of but has not disclosed. Further, it is not deemed appropriate to grant options if there is material undisclosed information at the organization. Finally, the exercise price cannot be lower than market price at the time of grant.

## Raising the Stakes on Disclosure

With the passing of the Sarbanes-Oxley Act in 2002, the timeline for reporting executive stock options was sharply accelerated to two business days after the options are granted, and backdating options as a practice vanished virtually overnight. Nearly all litigation dealing with backdating options is based on the period between 1992 and 2002.

The tangible consequences of these backdating cases include regulatory investigations, shareholder litigation as well as tax implications for both the company and the individual receiving the options. Possible outcomes include fines, penalties, jail time, disgorgement, derivative settlements and prohibitions from serving on public company boards (and/or disbarment for in-house counsel). The intangible repercussions include reputational risk as well as eroded shareholder trust.



In addition to regulatory and enforcement actions, individual stockholders have brought lawsuits against those in management who have allegedly engaged in or permitted such activities. Most of these are in the form of derivative lawsuits. Derivative lawsuits are those brought by the stockholders on behalf of the corporation against a third party, generally an officer or director of that company, in order to right a wrong or bring about changes to the practices of that company. (See the ER Alert: *Anatomy of a Derivative Claim*.) In relatively few cases,

these claims are accompanied by more traditional securities stock-drop class actions. Options dating cases are not ideal for class action lawsuits as there is generally not a marked effect on stock price after a company announces an options dating problem. Therefore, most of the private shareholder litigation to date has been in the form of derivative lawsuits.

Canada has its own options case. In September 2006, Research in Motion (RIM) advised that a restatement of financials resulting from its internal review of past options could shave \$25 million to \$45 million from earnings in the period following its initial public offering in 1997. Less than a month later, it said the amount would be substantially higher, as it found additional mistakes. The company announced a \$250 million earnings restatement relating to past stock option reporting errors.

RIM said it found no intentional misconduct by executives, directors or other employees responsible for administering options grants. However, the story may not be over: both the US Securities and Exchange Commission and the Ontario Securities Commission are conducting investigations.

## The Maxim and Tyson Foods Decisions

The Delaware Court of Chancery, among the most influential on corporate law issues, recently made two interesting rulings. The first involved Maxim Integrated Products Inc., concerning the alleged backdating of options. The second case dealt with allegations of *spring loading* options at Tyson Foods. Spring-loading is a similar option-granting practice whereby the corporation knowingly grants options days *before* good news is released. When, several days later, the information is released, the stock price goes up and the options are in-the-money.

In both cases, the companies filed motions to dismiss the cases against them based on several potential defenses. In both cases, the motion to dismiss was denied, and the suits were allowed to continue, for reasons that include:

- **Questionable Exercise of Business Judgment Rule** – Defendants argued a procedural foul in that the plaintiffs did not follow proper procedure for bringing a derivative action. Plaintiffs claimed that their failure to bring a derivative demand prior to their legal action should be excused based on futility. The court supported the plaintiffs and refused to dismiss the action.
- **Unjust Enrichment Claim** – Defendants argued that since the plaintiffs did not allege the manner in which the executive was unjustly enriched, their claim for unjust enrichment must fail. However, the court ruled that even

though the defendant had not used the backdated options, the executive was not *prohibited* from exercising them and thus still held something of value at the expense of the corporation and shareholders; this led the court to allow the unjust enrichment claim to proceed.

- **Statute of Limitations** – The court ruled that the statute of limitations defense wouldn't stand *because the defendants fraudulently concealed the information pertaining to the stock option grants* in public filings by not disclosing the issue dates of the grants.

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When deciding the *Tyson Foods* case, Chancellor Chandler of the Delaware Court also distinguished between backdating and spring loading. In powerful language he concluded that spring loading "is a somewhat more difficult question than that posed by options backdating," because, in his view, "all backdated options involve a fundamental, incontrovertible lie," while spring loading implicates a "much more subtle deception."

The impact of these cases on future backdating litigation remains to be seen, as the facts, as well as the strength of the evidence, will be different in every case. Still, these decisions suggest that directors in certain cases may face challenging hurdles in connection with option dating litigation.

## Wal-Mart EPL Class Certification Decision

Earlier this year, a San Francisco Federal Appeals Court granted class certification to a very closely watched, national gender discrimination lawsuit against Wal-Mart, allowing the class of roughly two million plaintiffs to proceed. The suit was first filed back in 2001 by six female employees, alleging that the company systematically paid similarly qualified women less than men for the same jobs and frequently overlooked women for promotions. After considering the plaintiffs' statistical data, a federal district court judge ruled in 2004 that the suit could include *all* women who have worked for Wal-Mart since December 1998. This ruling was then appealed, leading to last month's decision affirming class certification. Today, the number of potential plaintiffs has increased to more than two million. Wal-Mart is, unsurprisingly, appealing the latest decision.

## What Does This Mean for Purchasers of EPL Insurance?

Not much has changed as a result of the recent activity because this case has been closely watched for several years. Insurance carriers have been aware that however the class certification issue might be resolved, the well-funded plaintiffs' law firm in this case has already announced that it will proceed – either as one jumbo class or in as many as 50 separate state-based class actions. A decision against class certification would not put an end to the costly fight.

What is sobering and distressing to insurance carriers and industry observers alike is the enormous amount of time and money being spent in the fight over class action status. Presumably, with a suitable limit of Employment Practices Liability (EPL) coverage behind it, Wal-Mart has not yet needed to take an accounting reserve for potential damages. Not every company would be as comfortably situated. Spending tens of millions of dollars in the fight against class certification, even if the defendant wins, still leaves the substantive issues on the table for subsequent litigation.

If the substantive issues in this case are later settled or adversely decided, the math is simple: with two million plaintiffs, even \$1,000 per individual equates to damages of \$2 billion – *real money* even for really large companies. Should this occur, count on a significant reaction in the EPL insurance marketplace.

## Wider Implications

In the bigger picture, the decision to grant class certification to the plaintiffs in Wal-Mart's glass-ceiling gender discrimination lawsuit sets the stage for a battle royal between the Second and the Ninth Circuits regarding the standard to be applied when considering class certification. Based upon the reasoning set out by the New York Federal Appeals Court in *In re IPO Securities Litigation* (the focus of our February FI Alert and on our January *Top 10 List of Court Awards and Settlements for 2007*), the dissenting judge in *Wal-Mart* disagreed with the majority's decision to allow the class to proceed, agreeing with the New York decision and pitting the reasoning of the largest D&O class action ever against the largest EPL class action in history. Unless the current *Wal-Mart* decision granting class certification is overturned, the US Supreme Court will likely hear the issue in order to avoid a conflict within the federal circuit on such an important issue.

Setting appropriate standards for class action certification has *significant implications* for all forms of federal class action litigation in the US – consumer, environmental, products, etc. – and is not limited to employment or securities actions. The appeals court in *Wal-Mart* used a fairly low standard; the Second Circuit would have the courts use a more rigorous standard, making it more difficult for class actions to proceed.

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## Class Action Waivers

When considering the future of class action litigation, another recent decision with potentially wide implications is worth noting. The California Court of Appeal has held that an employment agreement requiring employees to forgo their right to participate in a class action lawsuit (a waiver), and instead arbitrate those claims individually, is *not* unconscionable under California law. In doing so, the court upheld the agreement in *Konig v. U-Haul Co. of California*. Significantly, *U-Haul* extends the landmark holding in *Discover Bank v. Superior Court* – a consumer class action – into the employment context. In *U-Haul*, the court found that a class action waiver is only substantively unconscionable in California – and so unenforceable – if each employee could hope to recover no more than a "predictably...small amount of damages." Of course, plaintiffs in employment actions *do not* predictably receive only minimal damages if they win (especially in California). So the good news for companies, at least in some jurisdictions, is that properly worded class action waivers may be upheld. The rare day that a California court comes down on the side of employers is a day to remember.

## Conclusion

Know your carriers, know your coverage. Not that long ago, it was unusual to see cases go to adjudication in the area of Executive Risks; most just settled. Today the stakes are often so high that companies and their executives are willing to go to the mat, so to speak, and litigate the claims made against them. This can make the issue of insurance and insurance carrier relationships more important than ever before. There is no such thing as *business as usual*.

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