THE EMERGING STOCK OPTIONS BACKDATING SCANDAL AND STRATEGIC APPROACHES TO CLAIMS FOR COVERAGE

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I. OVERVIEW

In recent months, another corporate scandal in American business has become the subject of increasing media scrutiny and investigations by federal prosecutors' offices and government regulators -- the improper and undisclosed "backdating" of executive stock options. Needless to say, both shareholders and plaintiffs' securities lawyers have taken notice and the first wave of lawsuits arising out of the backdating scandal has already hit the courts. New York -- a frequent venue for securities lawsuits and home to an aggressive and experienced plaintiffs' bar -- is likely to be a target venue for backdating lawsuits. In fact, two of the earliest backdating lawsuits have been filed in the United States District Court for the Southern District of New York, located in Manhattan, and the United States District Court for the Eastern District of New York, located in Brooklyn.

The genesis of the scandal stems from the award of executive stock options. A stock option is a right to purchase stock at a fixed price, or "exercise" price, which is typically determined by the stock's price at 4 p.m. on the date of the stock option grant. An options holder usually has to wait at least one year before exercising his or her stock options at the exercise price. Naturally, an options holder benefits only when the company's stock price is above the exercise price at the time he or she exercises the option. Hence, the lower the exercise price is, the greater the potential value of the option.

Backdating occurs when stock options are granted on a particular date but the exercise price is intentionally backdated to the stock's price on an earlier date, when the price of the stock was lower than on its actual grant date. While backdating in and of itself is not illegal, failing to disclose backdating is. The companies under scrutiny are being investigated for, among other things, failing to disclose the backdating to their shareholders; failing to reflect the expenses resulting from backdating in the company's earnings and financial statements; and failing to report the backdating to the IRS.

First brought to light by academic studies and to the public's attention by the Wall Street Journal, the backdating scandal has the potential of unleashing a new torrent of criminal and civil litigation against companies and their individual directors and officers alleged to have engaged in improper backdating of stock options. Federal prosecutors' offices in Manhattan, Brooklyn and San Francisco, as well as the Securities and Exchange Commission (SEC) and the Federal Bureau of Investigation (FBI), have launched investigations into executive stock option grants at dozens of companies. In recent months, at least sixty-five corporations have disclosed that they are under investigation for past stock option grants alleged to have been improperly backdated. The SEC states that it has at least eighty companies under scrutiny, while the FBI is reportedly investigating over fifty companies that may have illegally backdated stock options. Among the companies under investigation are some of the most well-known names in American business, including Apple Computer, Barnes & Noble, Home Depot and Microsoft. A significant number of companies under the microscope are in the technology sector, where, beginning in the mid-1990s, stock options became an increasingly popular vehicle by which to attract executives and other high-level employees and, equally important, to keep those executives and employees from jumping to a competitor.

The statistics tell a troubling story -- time after time stock options were awarded to corporate executives on dates when the price of the company's stock was at it lowest or near its lowest point of the quarter or fiscal year. Time after time the stock's price rose soon after the stock option grant, sometimes to record levels, resulting in millions of dollars in income gains to many of the recipients of these grants. Looking at these seemingly fortuitous grants of lucrative stock options, academics first speculated that corporations were granting their executives stock options just before the release of favorable news anticipated to result in a rise in stock prices. While it was troubling enough to think that executives were exerting their influence on corporate boards of directors for personal gain through what was essentially inside information, further studies revealed an even more troubling reality -- corporations appeared to be deliberately and surreptitiously backdating stock option grants to coincide with low points in the company's stock price. The good fortune experienced by many executives seemed to defy the law of averages, and for good reason: one has a greater chance of winning the lottery than consistently being awarded stock options when a stock is trading at or near its low point, as was the case with many corporate executives during the 1990s and the early part of this decade.

According to academic investigations into the practice of backdating, the incidence of backdating significantly decreased after August 29, 2002, when new reporting requirements came into effect under the Sarbanes-Oxley Act, the well-known corporate reform law enacted by Congress amid the corporate scandals of earlier this decade. Under Sarbanes-Oxley, the time within which a company is required to report stock option grants was dramatically reduced to two business days from the issuance of the grant, down from forty-five days after the end of the fiscal year during which the options were awarded. Although this new reporting provision significantly narrowed the window within which backdating could occur, the practice has not altogether disappeared.

Many companies that have come under scrutiny have launched internal investigations into the practice of backdating. As a result of their findings, some companies have admitted to backdating and have begun to restate earnings to the tune of hundreds of millions of dollars.

Apple Computer, for example, announced on August 3, 2006, that it anticipates restating its financials to reflect compensation expenses related to past option grants. In addition, the emerging scandal and the ongoing investigations have already resulted in the resignation of senior officers at companies where backdating is alleged to have occurred.

Shareholders have taken notice and have begun taking action against the executives and directors implicated in the backdating scandal, typically in the form of shareholder derivative actions. In a shareholder derivative action, the nominal plaintiff shareholder sues on a right derived from the corporation -- hence, the term “derivative” action. In a successful derivative action, damages are paid to the corporation, not the shareholders. Defendants in derivative actions typically include a company’s directors, officers and controlling shareholders. Although derivative actions assert corporate rights, the corporation is normally aligned as a nominal party defendant because the suit is generally prosecuted over the opposition of company management. Derivative actions thereby differ from class actions, where plaintiff shareholders file suit on their own behalf seeking recovery of personal investment losses allegedly resulting from misleading disclosures or other actions taken by the company and its directors and officers in violation of federal securities laws. Although some securities class action claims have been filed in connection with the backdating scandal, they are not expected to be as common as derivative claims given the fact that options backdating generally did not result in investment losses to individual shareholders. However, if earnings restatements result in diminished stock prices -- as has been the case at some companies that have announced restatements -- shareholder class actions may yet emerge as another by-product of the backdating scandal.

On July 20, 2006, the United States Attorney for the Northern District of California filed the first criminal complaint in the backdating scandal against two former officers of Brocade Communication Systems, Inc., a data storage equipment maker headquartered in San Jose, California. The United States Attorney for the Eastern District of New York followed suit on August 9, 2006, when it filed criminal charges against three former executives of Comverse Technology, Inc., a New York based telecom software manufacturer.

Only time will tell how big this scandal will grow and what impact it will have on the insurance industry. Directors and officers of companies caught up in the backdating scandal may not be the only persons in the cross-hairs of prosecutors and plaintiffs -- accountants and attorneys who provided advice concerning backdating, actively participated in the practice, or helped cover it up after the fact may also be implicated. In fact, one of the defendants in the Brooklyn U.S. Attorney's Office's criminal complaint is Comverse Technology's former general counsel. It has also been reported that a prominent California attorney served as outside counsel to Brocade Communications and approximately 50% of the Silicon Valley companies currently under investigation for improper backdating and rendered advice to those companies on compensation issues, including options practices. Until the full extent of the backdating problem becomes known, insurers should brace for a potential firestorm of claims not only under D&O policies, but under lawyers and accountants professional liability policies as well.

II. BACKGROUND

A. STOCK OPTIONS

A stock option is a contractual right to purchase shares of common stock in a company at a fixed price, referred to as the "exercise" or "strike" price. The exercise price is usually the stock's 4 p.m. price on the date of the grant. In other words, stock options are generally granted "*at*-the-money;" that is, the exercise price is set equal to the market price of the stock on the grant date. Although a stock option usually does not vest for one or more years, once vested, the option can continue for several years. The lower the stock's price is on the date of the grant the more money the recipient of the stock option can possibly make when exercising the option.

For example, if an executive receives 100,000 stock options with an exercise price of $20 per share and exercises the options when the price of the stock has risen to $40 per share, he or she would have $2 million in profit, or the $20 increase in the stock's price times 100,000. On the other hand, this executive would make a $1 million profit if, instead of $20 per share, the exercise price of the options was $30 per share. If there is no gain in the price of the stock, the recipient makes no profit on the options.

Options grants are generally made by a corporation's board of directors, typically based on the recommendations and assistance of a compensation committee established by the board. Some boards have established committees whose powers extend beyond recommending stock option awards to actually granting the awards. In at least one reported instance, the power to grant stock options was given to a CEO who acted as a "committee of one." Most companies make their stock option grants at the same time each year, but no law currently requires that they do so.

Stock options are typically viewed as a means by which to lure executives and other high-level employees to a company, as well as a way to reward them for the company's performance and increases in the company's stock price. Some commentators believe that using options for compensation purposes may have advantages over other forms of remuneration. For example, unlike salary and bonus compensation, stock option compensation does not require the payment of cash by the company and, therefore, can be attractive to companies at which cash is a scarce resource. Stock options may also provide an incentive for employees to work to increase the company's stock price. Moreover, companies may additionally use stock options not only as a tool to recruit new employees, but also as a means to retain employees, because an employee with unvested options may forfeit their potential value if he or she leaves the company.

At the same time, other commentators believe that stock option compensation is not without its costs and disadvantages. For example, options granted to employees, if ultimately exercised with the resulting issuance of the underlying stock, give rise to a dilution of the interests in the company held by existing shareholders. Moreover, it is argued that options that fall "out-of-the-money" not only fail to motivate employees, but, in fact, can result in poor employee morale and resultant turnover, especially at companies where option compensation is an important component of total compensation. Additionally, options with shorter vesting periods, or longer-term options approaching their vesting dates, may provide incentives to employees to focus on increasing the company's stock price in the short term rather than working toward longer-term business goals and objectives that would enable the company to achieve and sustain future success.

Whatever their pros and cons, the practice of awarding stock options surged in the late 1990s, as young companies with bright prospects but little capital used options as a means of attracting and paying talented executives and employees needed for growth. This was especially true in the technology sector, with its many start-up companies waiting for dot-com and telecom stock prices to explode.

B. BACKDATING OF STOCK OPTIONS

Because the value of stock options is higher when the exercise price is lower, the recipient of stock options has the potential for greater profits if the options are granted when the stock price is at its lowest point.

The term "backdating" refers to the granting of stock options that carry a reported grant date prior to the date on which the options are actually awarded and at a time when the stock's price was lower than the price on the actual award date. In other words, instead of being granted "at-the-money," backdated stock options are already "*in*-the-money" -- that is, at the time of their granting they have an exercise price below the actual market price of the stock. Accordingly, the recipient of backdated stock options has a paper gain right from the start, while the company must recognize a compensation expense due to the fact that the options are "in-the-money."

The backdating of stock options is not improper if:

- No documents have been altered or forged, *i.e.*, no intentional falsification of the grant date;
- The company's compensation plan allows backdating;
- The backdating is clearly communicated to the company's shareholders who, in effect, are paying the inflated compensation resulting from the backdated stock options;
- The backdating is properly reflected in the company's books and records, where earnings should be reduced for the fiscal year of the backdated stock options grant in light of the fact that the backdated options are "in-the-money" and are an expense that the company must reflect in its financial statements;[1] and

[1] Generally Accepted Accounting Principles (GAAP) provide, under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), that companies are required to report as an expense on their financial statements the "intrinsic value" of a fixed stock option on its "measurement date." The measurement date is defined as the first date on which the following information is known: (i) the number of options that an individual employee is entitled to receive and (ii) the exercise price. An option that is in-the-

- The backdating is properly reflected in taxes. An artificially low exercise price has tax consequences to both the company granting the backdated option and the option recipient. For example, the exercise price affects the basis used in estimating both the company's compensation expense for tax purposes and the capital gain to the option recipient. Moreover, "at-the-money" stock options are considered performance-based compensation and can be deducted for tax purposes even if executives are paid over $1 million. Backdated, "in-the-money" stock options, on the other hand, might not qualify for such tax deductions.[2]

The blatant falsification of options-granting documents is but one of the means by which stock options can be backdated. Backdating can also occur when options granted to new employees at the date of commencement of employment, but based on the stock's price at the date of acceptance of employment, are not reported as being "in-the-money." Backdating issues may also arise when options are granted on a specific date but the required corporate formalities, such as signed consents from the board members, are not received until a subsequent date, by which time the stock price may have risen.

C. SARBANES-OXLEY ACT

The Sarbanes-Oxley Act, enacted on July 30, 2002, amid the Enron scandal and other now-infamous corporate scandals, changed the way in which companies reported stock option grants to the SEC.

Prior to Sarbanes-Oxley, companies were not required to report stock option grants until forty-five days after the end of the fiscal year in which the options were granted. Under

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money on the measurement date has intrinsic value, and the difference between its exercise price and the quoted market price must be recorded as a compensation expense to be recognized over the vesting period of the option. Options that are at-the-money or out-of-the-money on the measurement date need not be expensed.

[2] Section 162(m) of the Internal Revenue Code prohibits publicly-held corporations from deducting remuneration in excess of $1 million per executive unless the remuneration consists of stock options or is based on the attainment of one or more performance goals that have been established by a compensation comprised solely of two or more outside directors. The employees whose compensation is covered by § 162(m) consist of the CEO, or individual acting in such capacity, and the four most highly compensated officers other than the CEO.

Sarbanes-Oxley, however, the reporting window was reduced to two business days after the stock option grants.

Sarbanes-Oxley's new reporting requirements became effective on August 29, 2002. Not surprisingly, it appears that most of the illegal backdating occurred prior to August 29, 2002.

D. ACADEMIC STUDIES

The backdating scandal largely came to light as a result of a research study conducted by Professor Erik Lie of the University of Iowa's Tippie College of Business.

In 2003, Professor Lie began a study on stock options that was eventually published in the journal *Management Science* in May, 2005, in an article entitled "On the Timing of CEO Stock Option Awards."

Professor Lie's study grew out of research published in 1997 by New York University professor David Yermack, who found that stock prices tended to increase shortly after stock option grants to CEOs. Professor Yermack examined the returns made on approximately 620 stock option awards to CEOs made between 1992 and 1994. The Yermack study found that while stock returns leading up to the award date were normal, returns during the fifty trading days after the award significantly exceeded those of the market. Professor Yermack interpreted the results of his study as evidence of opportunistic behavior by corporate executives, who timed or influenced the timing of their awards to occur just before anticipated increases in the price of the stock.

For his study, Professor Lie gathered a sample of 5,997 CEO stock option awards from 1992 through 2002. From that sample, 1,426 were classified as "scheduled," while the remaining 1,668 were classified as "unscheduled." Professor Lie classified an award as scheduled if it occurred within one week of the one-year anniversary of the prior year's award date and unscheduled if it did not occur within one week of the anniversary or if no options were awarded during the prior year.

Professor Lie's study proposed an alternative way of opportunistically timing stock option awards that does not require the ability to forecast upward movements in stock prices: the grant date could simply be set to a past date on which the stock's market price was particularly low. Professor Lie found the stock pattern return for unscheduled awards to be "strong and striking," marked by returns that were unusually low before the unscheduled awards dates but abnormally high afterward. Furthermore, Professor Lie found that the pre- and post-grant price pattern around unscheduled awards appeared to have intensified over time, becoming so pronounced by the late 1990s that Professor Lie concluded that "unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements . . . the results [of the study] suggest that the official grant date must have been set retroactively."

In a 2005 study in which he collaborated with Professor Randall A. Heron of Indiana University's Kelley School of Business, Professor Lie examined the stock price pattern around stock option grants before and after Sarbanes-Oxley's truncated, two-day reporting requirement, which became effective on August 29, 2002. According to Professors Lie and Heron, "[t]his dramatic change [in options reporting requirements] create[d] a natural laboratory for us to test the backdating hypothesis." That is, if backdating was prevalent under the more relaxed reporting requirements in effect during the period before August 29, 2002, Lie and Heron hypothesized that the pattern of abnormal stock returns around option grants should significantly weaken after the reporting change came into effect.

Professors Lie and Heron tested their hypothesis by gathering a sample of 3,735 stock option grants made to CEOs between August 29, 2002 and November 30, 2004, and then excluded from the study all "scheduled" grants. Next, they compared the return pattern for this sample to the return sample from stock option grants from January 1, 2000 to August 28, 2002 (a sub-sample from Professor Lie's earlier study), again excluding scheduled grants. As expected, they found the abnormal return pattern to be much more pronounced for the period before August 29, 2002. In fact, about 80% of the abnormal returns disappeared from the earlier to the later period, suggesting that most, if not all, of the pattern before August 29, 2002 was attributable to backdating. Professors Lie and Heron's study, entitled "Does Backdating Explain the Stock Price Pattern around Executive Stock Option Grants?," is to be published in a forthcoming issue of the *Journal of Financial Economics*.

Recently, on or about July 14, 2006, Professors Lie and Heron released the results of another study in a paper entitled "What Fraction of Stock Option Grants to Top Executives have been Backdated or Manipulated?" Using a sample of 39,888 stock option grants to top executives dated between January 1, 1996 and December 1, 2005, they concluded that:

- An estimated 18.9% of unscheduled option grants to top executives between 1996-2005 were backdated or otherwise manipulated.
- For the period before August 29, 2002, an estimated 23% of unscheduled grants were backdated.
- For the period after August 29, 2002, an estimated 10% of unscheduled grants were backdated.
- For the minority of stock option grants that are still not filed within the required two-day window, the fraction backdated remains as high as 19.9%.

- There is a higher frequency of backdating among tech firms, small firms and firms with high stock price volatility.
- Firms that use smaller (non-big-five) auditing firms are more likely to file their grants late.
- An estimated 29.2% of firms manipulated grants to top executives at some point between 1996 and 2005.

E. WALL STREET JOURNAL ARTICLE

The backdating of stock options came to the general public's attention in an article published in the Wall Street Journal (WSJ) on March 18, 2006.

The WSJ asked Professor Lie to generate a list of companies that made stock option grants that were followed by large gains in the stock price. The WSJ then examined a number of the companies on Professor Lie's list, by focusing on their option grants between 1995 and mid-2002.

The WSJ began its article with the attention-grabbing story of Jeffrey Rich, the CEO of Affiliated Computer Services, Inc., who, in 2002, was granted stock options on a day on which the company's stock had dropped to its lowest level in a year. Had the stock options been dated a week later, when Affiliated's stock was trading 27% higher, the value of Mr. Rich's options would have been significantly lower. For Mr. Rich, seemingly fortuitous stock option grants such as this were nothing out of the ordinary, as all six of his grants from 1995 to 2002 were dated just prior to a rise in the stock price, often at the bottom of a steep drop. According to the WSJ's analysis, the odds of this happening by chance are extremely remote -- just one in 300 billion, compared to a one in 146 million chance of winning the multistate "Powerball" lottery.

The WSJ article also raised questions about one of the most lucrative stock option grants ever made -- the October 13, 1999 grant to William W. McGuire, CEO of insurer

UnitedHealth Group Inc. Dr. McGuire's grant amounted to a total of 14.6 million options, of which he has exercised his option on approximately 5%, for a total profit of about $39 million. As of the date of the WSJ's article, the value of Dr. McGuire's unexercised options amounted to about $717 million.

Dr. McGuire's 1999 stock options grant was dated the same day that UnitedHealth's stock hit its low point for the year. Likewise, his 1997 and 2000 grants were also dated on the day of the company's lowest stock price, while his 2001 grant came when the stock was near the bottom of a sharp drop in price. According to the WSJ, the overall odds of this pattern occurring by chance are more than one in 200 million.

UnitedHealth had the unusual policy of allowing Dr. McGuire to choose the day of his options grants. Interestingly, according to the terms of his 1999 employment agreement, Dr. McGuire was allowed to choose the grant dates by providing "oral notification" to the chairman of UnitedHealth's compensation committee. The employment agreement further stated that the exercise price of the grants would be the closing price on the date the grants were issued. Although UnitedHealth called the process by which the grants were awarded "appropriate," the statistics overwhelmingly suggest that Dr. McGuire's 1997-2001 stock options were backdated. The company's board has since revised Dr. McGuire's employment contract to provide for the granting of stock options at a regular time each year.

The WSJ article also discussed several other companies that may have engaged in backdating, including California-based software manufacturer Mercury Interactive Corp. Mercury's CEO and two other executives resigned in late 2005 amid an internal company probe that found 49 separate cases where the reported date of stock option grants differed from the date on which the options appear to have been awarded. As a result, Mercury announced that it would have to restate its financials.

F. AMENDMENTS TO SEC REPORTING REQUIREMENTS

In an attempt to prevent further backdating, the SEC voted on July 26, 2006, to adopt a plan requiring companies to provide more details of executive compensation. The new plan, effective November 7, 2006, will require public companies to furnish tables in their annual filings showing the total yearly compensation for their CEOs, CFOs and the next three highest-paid executives. These required tables will include the date on which stock options were granted. If the exercise price is less than the stock's market price on the date of the grant, a separate column will have to be added to the table showing the market price on that date.

The new SEC plan will require companies to provide detailed information on how they determine when executives receive option grants and, if they do, how and why the company backdates options. Companies will have to answer questions regarding the role of the board of directors' compensation committee in approving a program of timing option grants for executives; whether the company's executive officers had any role in such a program; and whether the company has timed its release of significant information in order to affect the value of executive stock options.

III. CRIMINAL AND CIVIL LITIGATION INVOLVING BACKDATING

A. CRIMINAL LITIGATION

***United States v. Gregory L. Reyes and Stephanie Jensen*, Case No. 3 06 70450 (United States District Court for the Northern District of California)**

With the news that corporate executives may have been improperly backdating stock option grants, federal authorities began their own investigations into the practice of backdating. Federal prosecutors in Manhattan, Brooklyn and San Francisco have opened at least thirty-three investigations into potential accounting problems or fraud. The SEC and FBI are also conducting their own investigations.

On July 20, 2006, the United States Attorney for the Northern District of California filed the first criminal charges in the backdating scandal when it brought a complaint against two former executives of Brocade Communications Systems, Inc., based in San Jose, California. Gregory L. Reyes, Brocade's former CEO, and Stephanie Jensen, its former vice president for human resources, have each been charged with one count of securities fraud for backdating that reportedly occurred between 2000 and 2004. As CEO and a member of Brocade's board of directors, Mr. Reyes was allegedly given sole authority by the board to grant stock options to all of Brocade's employees except for certain officers and directors. In effect, Mr. Reyes was a "compensation committee of one" for purposes of granting stock options. Ms. Jensen allegedly reported directly to Mr. Reyes, beginning in 2000.

Reyes' and Jensen's motive for backdating appears to have been to attract and retain employees rather than to gain direct personal profit through the exercise of their own stock options. In fact, the criminal complaint specifically alleges that Brocade used stock options to recruit and retain qualified personnel in Silicon Valley's competitive corporate environment, where technology companies routinely competed for the same employees.

Federal prosecutors allege that Mr. Reyes and Ms. Jensen doctored the minutes of board meetings, job-offer letters and other documents in order to make it appear that employees were granted stock options at an earlier date, when Brocade's share price was lower. According to witnesses employed within Brocade's human resources department, Brocade did not follow its own written procedures and practices regarding the awarding of stock options, including granting them only after a person's employment with Brocade started and setting the exercise price of the options equal to the market value of Brocade's stock on the grant date, which was supposed to be the date the Compensation Committee met and approved the options. Rather, Reyes and Jensen reportedly waited until the end of the fiscal quarter before granting stock options. At the close of each quarter, Ms. Jensen's staff would allegedly print out the historical closing prices for Brocade's stock and highlight the low dates posted during the quarter. Ms. Jensen or a member of her staff would allegedly then provide the historical pricing information, along with draft Compensation Committee meeting minutes, to Mr. Reyes, who it is charged would routinely sign the minutes and date them as if the meetings occurred on the highlighted low dates.

For example, in January, 2002, which was near the close of Brocade's first quarter for fiscal year 2002, Mr. Reyes and Ms. Jensen allegedly backdated the Compensation Committee meeting minutes approving a stock option grant to October 30, 2001, when Brocade's stock closed at $24.20, its lowest price during the first quarter of 2002. Mr. Reyes and Ms. Jensen also allegedly backdated employment letters and other records so that certain employees could be placed on earlier stock option grants that were purportedly made and priced when the fair market value of Brocade's stock was lower.

According to the criminal complaint, witnesses have stated that they told Mr. Reyes and Ms. Jensen that Brocade would incur a compensation expense if it granted in-the-money stock options, granted stock options to non-employees, repriced an already-existing stock option grant or cancelled an existing stock option grant and regranted the options with a more favorable exercise price. Witnesses have also stated that Mr. Reyes and Ms. Jensen told them that Brocade did not want to incur compensation expenses in connection with its stock option grants. When interviewed by attorneys for Brocade's Audit Committee in early 2002, Mr.

Reyes reportedly admitted that he knew that in-the-money stock options have accounting implications. However, he allegedly did not admit to backdating stock options, but rather claimed that he actually approved and granted the options on the dates reflected in the Compensation Committee meeting minutes and other documents.

In Brocade's Forms 10-K for fiscal years 2000, 2001, 2002 and 2003, all of which were signed by Mr. Reyes, Brocade stated that it accounted for its stock option grants in accordance with Generally Accepted Accounting Principles (GAAP), including Accounting Principles Board Opinion No. 25 (APB 25), under which the difference between the exercise price and the stock's fair market value on the date of the grant is recognized as a compensation expense on the company's financial statements. Except in a few minor instances, Brocade did not disclose any compensation expenses in connection with its stock option grants in its SEC filings.

Between May 1999 and June 2002, Arthur Andersen LLP acted as the outside auditor of Brocade's financial statements. Beginning in June, 2002, KPMG LLP began acting as Brocade's outside auditor. The criminal complaint does not implicate either Arthur Andersen or KPMG in the alleged fraud, but it does state that backdated documents were provided to Brocade's finance department and outside auditors, who relied on the dates and prices entered on them and, accordingly, did not record compensation expenses for the stock option grants.

In or about January, 2005, Brocade's Audit Committee made a preliminary determination that the company and its auditors could not rely on the accuracy of the Compensation Committee meeting minutes signed by Mr. Reyes. On January 24, 2005, Brocade announced that it would restate its financial statements as follows:

- Net loss for 2004 fiscal year increased from $2 million to $32 million;

- Net loss for 2003 fiscal year increased from \$136 million to \$147 million;
- Income from fiscal year 2002 increased by \$60 million to \$126 million; and
- Income for fiscal years 1999 through 2001 declined by a total of \$304 million.

Prosecutors have charged Reyes and Jensen with violating the following federal statutes:

- 15 U.S.C.A. § 78j(b), which makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to use and employ manipulative or deceptive devices or contrivances in connection with the purchase and sale of securities, in violation of –
- 17 C.F.R. § 240.10b-5, by (a) employing devices, schemes and artifices to defraud; (b) making and causing untrue statements of material fact or omitting to state facts necessary in order to make the statements made, in light of the circumstances in which they were made, mot misleading; or (c) engaging in acts, practices and courses of business which operated or would operate as a fraud or deceit upon purchasers of securities.

The defendants have also been charged under 18 U.S.C.A. § 2, which punishes those who aid and abet or willfully cause an offense against the United States. Reyes and Jensen face maximum penalties of up to twenty years in prison; a \$5 million fine; or, if they derived pecuniary gain from the offense or if the offense resulted in pecuniary loss to another person, a fine equal to twice the gross gain or twice the gross loss caused by the offense.

On July 20, 2006, the SEC also filed a civil enforcement action against Reyes, Jensen and Brocade's former CFO in the United States District Court for the Northern District of California, based on the same set of allegations. This action is not duplicative of the criminal action, but instead seeks civil penalties such as an Order enjoining the defendants from violating the federal securities laws; directing the defendants to disgorge all wrongfully obtained benefits, plus prejudgment interest; directing the defendants to pay civil monetary fines as provided under the federal securities laws; and barring them from serving as officers or directors of any public company.

***United States v. Jacob "Kobi" Alexander, David Kreinberg and William F. Sorin*, Case No. 1:2006mj00817 (United States District Court for the Eastern District of New York)**

The second criminal case to thus far emerge from the backdating scandal was filed on August 9, 2006, when the United States Attorney for the Eastern District of New York brought charges against two former top executive officers and the former general counsel of Comverse Technology, Inc., a New York based manufacturer of telecom software. These individuals are currently facing charges similar to those filed in the Brocade criminal matter, including jail time if convicted.

The Comverse criminal matter is significant in that it illustrates the other prime motivation behind the backdating of stock options: personal profit. Unlike Reyes and Jensen in the Brocade case, who its seems backdated stock options to recruit and retain personnel, it is alleged that the former Comverse executives and general counsel orchestrated a scheme that allegedly netted them millions of dollars in illicit compensation.

According to prosecutors, the "scheme" was orchestrated no later than 1991 by Jacob "Kobi" Alexander, Comverse's founder, former Chairman and CEO, and William F. Sorin, the company's former General Counsel, and later Senior General Counsel, who also served as a Director of the company and as its corporate Secretary. David Kreinberg, Comverse's former CFO, allegedly joined the scheme no later that 1998. It is alleged that all three men benefited tremendously from the scheme. Specifically, Alexander allegedly realized a gain of nearly $138 million from the exercise of stock options between 1991 and 2001. At least $6.4 million of the $138 million reportedly represents the in-the-money portion at the time of the grant.

Kreinberg allegedly realized a gain of nearly $13 million during the 1994 to 2001 period, with at least $1 million of the $13 million gain representing the in-the-money portion at the time of the grant. Finally, Sorin allegedly realized more than $14 million from 1991 to 2001, with approximately $1 million of the $14 million gain representing the in-the-money portion at the time of the grant. Each of the defendants is also alleged to currently hold millions of backdated options.

Comverse's stock option plans dictated that all stock options be granted at their fair market value, defined under the plans to be the closing share price of Comverse common stock on the date of the grant as published by the principal national securities exchange on which the stock was listed. Nevertheless, it is alleged that Alexander, later joined by Kreinberg, "cherry-picked" the grant dates by looking back at Comverse's historical stock prices and, with the benefit of hindsight, choosing a grant date that corresponded to a date on which Comverse's common stock was trading at a relative low. Alexander or Kreinberg would allegedly provide Sorin with a master list of proposed grants to be approved by Comverse's Compensation Committee, as required under the company's by-laws. Instead of holding a meeting of the Compensation Committee at which time the stock option grants would be voted on, Sorin allegedly drafted unanimous written consent forms that would be sent to Compensation Committee members for signature. Sorin would reportedly insert into the forms an "as of" date that falsely indicated for each grant that corporate action sufficient to approve the grant had taken place on the "as of" date. It is alleged by prosecutors that Alexander, Kreinberg and Sorin knew that the "as of" date was in reality the look-back date picked by Alexander or Kreinberg. Committee members allegedly signed, but did not date, their individual copies of the consents and forwarded the original consents to Sorin. The defendants allegedly backdated both "company-wide" options grants and "one-off" options grants to themselves and others.

Significantly, it is alleged that in or about 1999 Alexander and Kreinberg expanded the scheme through the creation of a "slush fund" of backdated options by issuing options from company-wide grants to fictitious employees. These fictitious employee names allegedly served as "placeholders" for options that Alexander and Kreinberg could, and did, give to actual employees at a later date, thus completely bypassing the Compensation Committee. Reportedly, Kreinberg later falsified certain documents to hide the existence of the slush fund from the Compensation Committee and, when backdating allegations came to light, from Comverse's auditor. It is alleged that the slush fund account was originally named "I.M. Fantom," *i.e.*, "phantom." Accordingly, then, in addition to gaining personal economic benefit through their alleged backdating scheme the Comverse defendants also employed backdated options as a means of recruiting or retaining employees, as the Brocade defendants allegedly did.

In addition to facing criminal charges, Alexander, Kreinberg and Sorin are also defendants in a civil enforcement action filed by the SEC on or about August 9, 2006. Like the SEC's action against Reyes and Jensen, the SEC's action against the three former Comverse executives seeks, among other penalties, disgorgement of any ill-gotten gains and civil monetary fines.

The Comverse case was again front-page news on September 27, 2006, when authorities arrested Alexander in the African nation of Namibia following a nearly two-month international manhunt. Alexander, who holds dual Israeli and United States citizenship, disappeared just prior to the unsealing of the criminal complaint, shortly after wiring $57 million to Israel and fueling speculation that he may have fled there.

B. CIVIL LITIGATION

Derivative Actions or Class Actions?

Although the current number of private civil lawsuits involving backdating claims is not clear, plaintiffs' attorneys are not waiting for more criminal indictments to be filed before filing suit on behalf of aggrieved shareholders. Schiffrin & Barroway, a Pennsylvania law firm specializing in shareholder derivative litigation, has already filed at least thirty-four civil lawsuits. New York City's Bernstein Litowitz Berger & Grossman has filed at least ten suits, including eight derivative actions and two class action claims. Significantly, the Bernstein firm served as co-lead counsel for the plaintiff class in the WorldCom securities litigation.

It is anticipated that most of the backdating litigation will likely be in the form of shareholders' derivative actions, and not class action suits brought by aggrieved shareholders on their own behalf. In the typical shareholders' derivative action, shareholders demand that the corporation take action against directors, officers or others for alleged wrongdoing that has harmed the company. When the corporation refuses to do so, the shareholders bring a derivative action against the alleged wrongdoers and join the corporation as a nominal defendant. Invariably, the corporation is recast as a plaintiff, because the action is brought to benefit the corporation and not the shareholder plaintiffs. Any recovery made by the plaintiffs goes to the corporation and not to the shareholder plaintiffs, with the exception of costs and attorneys' fees.

Class action securities claims, on the other hand, are brought by shareholders for their own benefit, typically under the general anti-fraud provision contained in Section 10(b) of the

Securities Exchange Act of 1934 and SEC Rule 10b-5 adopted thereunder. Among the basic elements of a 10b-5 claim is the requirement that the issuer of securities, through a misstatement or omission of material fact, intentionally or recklessly caused harm which affected the price of shares. This is typically not the case in the backdating scandal, where it is alleged that backdating occurred as stock prices rose. Accordingly, shareholders will have a difficult time proving that backdating caused damage to them individually, *i.e.*, by a financial loss caused by a drop in stock prices. This is one of the principal reasons why backdating cases will predominantly, though not exclusively, be styled as derivative actions on behalf of the corporation and not as Rule 10b-5 securities class actions on behalf of individual investors who suffered personal investment losses.

Backdating cases may be accompanied by the "forum shopping" that traditionally typified class action litigation. Last year, the United States Congress put in place new rules that expanded federal court jurisdiction over class action claims, in an effort to stem the practice of forum shopping. Prior to the passage of this new law -- the Class Action Fairness Act of 2005 -- plaintiffs' class action attorneys often engaged in abusive forum shopping aimed at having cases heard in state trial courts known for their favorable laws, liberal discovery rules and sympathetic juries. Derivative actions can be based on both state and federal law. Although they are typically filed in the state or federal court in the jurisdiction where the company is incorporated, has its principal place of business or where the allegedly improper acts occurred, we expect that creative plaintiffs' lawyers will look to venue the disputes in the most favorable forum. Given the recent verdicts that have come out of the New York courts we anticipate that New York will be a major venue.

In fact, derivative actions were recently filed in the United States District Court for the Eastern District of New York and the United States District Court for the Southern District of New York against New York based companies. These cases, Braverman v. Alexander and Parnes v. McKelvey, typify the derivative claims expected to be filed against companies that engaged in backdating and the causes of action alleged against those companies.

***Braverman v. Alexander, et al.*, Docket No. 06 CV 2017 (United States District Court for the Eastern District of New York)**

On May 1, 2006, plaintiff Bruce Braverman filed a shareholder's derivative Complaint against Jacob Alexander and other Comverse executives and directors, including David Kreinberg and William Sorin, in the United States District Court for the Eastern District of New York.

The Complaint alleges that Comverse engaged in the practice of backdating stock options, thereby improperly benefiting the defendants and resulting in the overstatement of Comverse's profits between 2001 and the first three quarters of 2006 because "options priced below the stock's fair market value when they were awarded brought the recipients an instant paper gain." According to the plaintiff, Comverse did not properly account for the options granted during that period, *i.e.*, the company did not treat them as additional compensation and a cost to the company, and will now be restating its financial statements for the fiscal years ended January 31, 2001 through January 31, 2005, as well as the first three quarters of fiscal year 2006. On March 14, 2006, Comverse announced the creation of a special committee of its Board of Directors to review the company's stock option grants, including the accuracy of the purported dates of the option grants, and stated in its press release that "management believes that certain restatements will be required." The Complaint alleges that upon release of this news, Comverse's stock decreased by $4.30 per share on March 14, 2006, to a closing price of $24.85 per share.

The causes of action alleged in the Braverman Complaint include acts and omissions in violation of SEC Rule 14a-9; breach of fiduciary duty to the company and its stockholders; breach of the duty of loyalty and/or duty of care to the company; and unjust enrichment. SEC Rule 14a-9 provides that it is unlawful to make a false or misleading statement of material fact in a proxy statement, or to omit stating a material fact that is necessary to prevent any statement in the proxy statement from being false or misleading.

Braverman is seeking a declaration that the defendants have violated the federal securities laws and breached their fiduciary duties to the company, along with an Order requiring Alexander, the former CEO, and Kreinberg, the former CFO, to reimburse the company for all bonuses, options and incentive compensation they received or profits they realized from trading in Comverse common stock and requiring all other defendants to return any options to acquire shares of Comverse common stock awarded to them. Damages sought in the Complaint also include an Order setting aside the company's incentive stock plan and judgment against the defendants and in favor of the company in the amount of damages sustained by Comverse as a result of backdating. The plaintiff is also seeking an award to the company of compensatory and punitive damages, including pre-judgment and post-judgment interest.

Significantly, the Braverman Complaint alleges that the decrease in Comverse's stock price allegedly stemming from the March 14, 2006, announcement of a possible earnings restatement has resulted in class action claims brought by "defrauded investors." Accordingly, plaintiff is also seeking, on behalf of the company, contribution from the defendants for any damages for which the company is ultimately found liable in any of the shareholder securities fraud actions. Although most of the current litigation arising out of the backdating scandal is anticipated to be in the form of shareholder derivative actions, there may ultimately be a rise in the number of securities class action cases -- that is, claims by "defrauded investors" -- if earnings restatements result in decreased stock prices.

***Parnes v. McKelvey, et al.*, Docket No. 06 CV 4622 (United States District Court for the Southern District of New York)**

In another derivative action, plaintiff Ruthy Parnes filed suit in the United States District Court for the Southern District of New York on June 15, 2006. Defendants named in the action are Monster Worldwide Inc.'s founder, board chairman, CEO and director, Andrew J. McKelvey, and other current or former directors and/or officers of the company. Monster is the New York based internet job-search company.

It is alleged that under Monster's 1996 Stock Option Plan and 1999 Long Term Incentive Plan, the per share exercise price of an incentive stock option may not be less than the fair market value of the common stock of the company on the date of grant. According to the Complaint, on June 12, 2006, the WSJ published an article entitled "Monster Worldwide Gave Officials Options Ahead of Share Run-ups," which explained that four out of seven grants given to one of the defendants in the Parnes action were "suspicious." Specifically, one of the grants was made on the stock's lowest closing price of 1997 and three others were made on the quarterly low. Also on June 12, 2006, Monster announced that a committee of "independent directors" of the company had been conducting an internal review and analysis of all stock option grants previously issued by the company and that the company had received a subpoena from the United States Attorney for the Southern District of New York related to stock option grants. On June 14, 2006, Monster further disclosed that it is the subject of an SEC investigation concerning the backdating of stock option grants. There is no allegation in the Complaint that Monster has yet announced an earnings restatement.

The Parnes Complaint alleges the following causes of action: violations of Rule 14a-9; breach of fiduciary duty; gross mismanagement; unjust enrichment; and breach of duty of loyalty.

Parnes is seeking judgment against all of the defendants and in favor of the company in the amount of damages sustained by the company as a result of defendants' alleged breaches of fiduciary duties, gross mismanagement and unjust enrichment, as well as restitution to the company from all defendants who were awarded backdated options. Moreover, in order to assure that the company has an effective remedy, plaintiff is seeking to impose a constructive trust or otherwise attach and impound the proceeds of defendants' trading activities.

C. POTENTIAL LIABILITY OF ACCOUNTANTS AND LAWYERS

The extent to which accountants and lawyers may be implicated in the backdating scandal is unclear at the moment. Nevertheless, these professionals may be held liable to the extent that they rendered bad advice regarding the awarding and subsequent reporting of backdated stock options, or otherwise directly participated in improper backdating.

Though not accused of any wrongdoing at this time, one of Silicon Valley's most venerable lawyers has already found himself embroiled in the backdating scandal. Larry Sonsini of Palo Alto, California's Wilson Sonsini Goodrich & Rosati represents or represented approximately 50% of Silicon Valley companies under investigation for backdating, including Brocade Communications, whose former CEO, Gregory Reyes, and former vice president for human resources, Stephanie Jensen, were recently named as defendants in the criminal indictment brought by the United States Attorney for the Northern District of California. In addition to serving as outside counsel, Mr. Sonsini served as a director of Brocade and as a member of the company's compensation committee until last year. Reportedly, earlier this year Mr. Reyes stated that Mr. Sonsini rendered advice to Brocade on its stock option policies.

One of the three defendants in the Brooklyn federal prosecutor's criminal indictment relating to alleged backdating at Comverse Technology is the company's former general counsel, William Sorin. The Comverse investigation is believed to be the first to focus on an in-house lawyer. However, other attorneys may soon be implicated in the scandal due to the fact that general counsel at many companies had to approve individual option grants.

Like lawyers, accountants who rendered accounting and tax advice related to backdating or who performed auditing functions for the company may also emerge as participants in improper backdating and targets of criminal and civil actions.

IV. INSURANCE IMPLICATIONS OF THE BACKDATING SCANDAL

The impact of the backdating scandal, like other securities-type lawsuits, will be felt in the insurance sector when the companies implicated in the scandal, along with their directors and officers, begin seeking coverage under their D&O and other policies for the investigations, shareholders derivative actions and other claims that have been or will soon be filed. Depending on the nature of their involvement, if any, in improper backdating, accountants and lawyers may also be faced with claims for which they will seek coverage under their professional liability policies. Backdating claims will raise a number of potential coverage defenses and other important issues that should be considered in light of the facts giving rise to the claims and the nature of the damages being claimed.

Potential Coverage Exclusions

Various exclusions typically found in D&O policies may relieve insurers of their obligation to provide coverage for backdating claims.

One such exclusion is the Personal Profit or Advantage Exclusion that excludes from coverage any claim "arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which the Insured was not legally entitled." This exclusion may be of particular significance where it is alleged that the defendant director or officer personally profited from the backdating of his or her own stock options, rather than participated in the backdating of other employee's stock options as a means of recruiting and retaining qualified personnel.

Another potentially applicable exclusion, given the nature of the backdating scandal, is the Bad Acts or Intentional Acts Exclusion barring coverage for claims "arising out of, based upon or attributable to the committing in fact of any deliberate criminal or deliberate fraudulent act by the Insured." To invoke this exclusion it may be necessary to review the company's compensation plan to determine whether it provides for backdating and whether, and to what extent, there was a conscious deviation from that plan and an intent not to disclose the backdating to shareholders, the SEC and the IRS. Moreover, because most policies provide that in order for the Bad Acts Exclusion to apply there must first be a final adjudication of the allegedly wrongful conduct, insurers are generally unable to disclaim coverage based on the exclusion given the fact that securities cases almost never go to trial. Moreover, most D&O policies contain broad severability language providing that the exclusion will not apply to "innocent" directors and officers who were not involved in the allegedly intentional wrongdoing. Irrespective of the Bad Acts Exclusion, another more fundamental issue is whether a claim against a self-dealing executive who profited as a result of ill-gotten gains even falls within the policy's insuring agreement, as it can be argued that he or she was not performing a corporate function when, for all intents and purposes, he or she stole money from the corporation.

Some D&O policies also contain exclusions for claims that allege violation of "securities laws," which may be applicable in the context of backdating claims. In addition to the Violation of Securities Law Exclusion, D&O policies often contain a Regulatory Exclusion stating that the policy does not provide coverage for losses arising out of proceedings brought by regulatory agencies. The Regulatory Exclusion typically provides that:

> It is understood and agreed that the Insurer shall not be liable to make any payment for Loss in connection with any claim made against the Directors or Officers based upon or attributable to: any action or proceeding brought by or on behalf of any national or state regulatory agency, including any type of legal action which such agency has the legal right to bring as receiver, conservator, liquidator or otherwise, whether such action or proceeding is brought in the name of such agency or by or on behalf of such agency in the name of any other entity or solely in the name of any Third Party.

The Regulatory Exclusion may be implicated in connection with the backdating scandal given the many ongoing regulatory investigations of companies alleged to have engaged in illegal backdating.

Most professional liability policies, including D&O policies, also contain an Insured vs. Insured Exclusion. The typical Insured vs. Insured Exclusion states that:

> It is understood and agreed that the insurer shall not be liable to make any payment for loss . . . which is based upon or attributable to any claim made against any director or officer by any other director or officer or by the institution . . .

The Insured vs. Insured Exclusion may bar coverage for claims brought by anyone directly or indirectly affiliated with an insured, including a shareholder acting at the behest of an insured. The exclusion essentially prevents a company from suing or orchestrating a suit against its directors or officers in order to collect insurance proceeds. The Insured vs. Insured Exclusion may not, however, be applicable in the context of a derivative action, where, although any damages awarded go to the company, the plaintiffs bringing the action are shareholders acting independently and without any assistance from directors, officers, or any other insured. In fact, Insured vs. Insured Exclusions often expressly provide that the exclusion does not apply to "a shareholder derivative action by a shareholder of the institution other than an insured."

These are but some of the exclusions that may potentially apply to a backdating claim. Others may be applicable depending on the exact nature of the claims alleged.

Rescission Based on Material Misrepresentation

An issue that may arise in backdating cases is whether the policy can be rescinded based on material misrepresentations or omissions made by the insured during the application process. Typically, an application for D&O insurance will ask whether anyone for whom coverage is intended has knowledge or information about any act, error or omission that may give rise to a claim falling within the scope of the insurance. In applying for coverage, an insured may have been required to disclose company options practices, including backdating, and whether the company was the subject of any regulatory investigations or inquiries that could potentially give rise to any claims. Additional grounds for rescission might be found in corporate financial statements that have been restated due to previously unreported backdating or found to contain misrepresentations relating to the company's compensation practices and awarding of stock options. Again, the policy may, however, contain severability language protecting an "innocent" insured.

Definition of "Claim"

The definition of a "claim" under a D&O policy generally encompasses lawsuits and may include written or verbal demands of monetary, non-monetary or injunctive relief. A claim may also include civil, criminal, administrative, regulatory or arbitration proceedings commenced by service of a complaint, issuance of an indictment or receipt or filing of a notice of charges. Policies may also provide that claims include civil, criminal, administrative or regulatory investigations identified in writing by the investigating authority against a person who may be subject to one of the aforementioned types of formal proceedings. Investigations by the SEC or similar government authority may rise to the level of a claim, but only after the service of a subpoena on the insured. The definition of a claim may be broader or narrower depending on the policy.

Advancement or Reimbursement of Defense Costs

Instead of the duty to defend, D&O policies typically provide that the insurer will advance or reimburse defense costs incurred by the insured in connection with potentially covered claims. Under most policies, an insurer's advancement or reimbursement of its insured's defense costs reduces the policy limits available to pay judgments and other covered losses.

A typical defense costs provision in a D&O policy provides that:

> Under Coverages A, B and C of this policy, except as hereinafter stated, the Insurer shall advance, excess of any applicable retention amount, covered Defense Costs no later than ninety (90) days after the receipt by the Insurer of such defense bills. Such advance payments by the Insurer shall be repaid to the Insurer by each and every Insured . . . in the event and to the extent that any

> such Insured . . . shall not be entitled under this policy to payment of such Loss.

Securities-type claims are typically very costly to defend. Accordingly, one of the most, if not the most, important aspect of coverage under a D&O policy is the payment of defense costs. Although there is mixed case law on the topic, courts have generally held that the insurer must advance defense costs despite serious coverage questions or a rescission threat.

Claims Made Coverage

Most D&O policies provide "claims made" coverage, and that claims relating to or arising out of the same wrongful acts as those alleged in a prior claim will be deemed to have been made at the same time as the prior claim. Many D&O policies also require that the claim be reported to the insurer during the policy period. Given the recent emergence of the backdating scandal, this may not be a significant issue for insurers. However, it may be argued, for example, that a criminal complaint arising out of a formal criminal investigation commenced in a prior policy year is a claim that should have been made under the prior policy.

Definition of "Loss"

Some of the damages sought in backdating claims may not constitute covered losses.

As defined under a standard D&O policy, the term "loss" typically includes damages, settlements, judgments (including pre/post-judgment interest on a covered judgment) and defense costs. Loss typically does not include such items as civil or criminal fines or penalties or punitive or exemplary damages. Moreover, D&O policies typically do not cover the multiplied portion of damages, *e.g.*, treble damages.

Some of the damages and relief requested in the backdating actions may not be covered as a "loss," particularly the plaintiffs' claims for restitution to the company and disgorgement of ill-gotten profits from the defendant directors and officers, as well as punitive damages.

Retention

As in other types of litigation, the options backdating claims will raise the issue of whether a claim is subject to one retention or multiple retentions. For example, is a company's backdating practice considered a single wrongful act subject to one retention, or is each award of improperly backdated stock options to be considered a separate wrongful act, thereby subjecting the company to multiple retentions? It is inevitable that insureds and insurers will fight over this issue.

Potential Coverage Under Fidelity Bonds

Companies involved in the backdating scandal may try to claim that they are afforded coverage under Fidelity Bonds that insure for loss caused by the fraud or dishonesty of the insured's own employees. The Insuring Agreement of Fidelity Bonds typically provides that the carrier agrees to indemnify the insured for "loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others." These acts must be committed with the manifest intent to either "cause the Insured to sustain such loss" or "obtain financial benefit for the Employee or another person or entity." The potential applicability of Fidelity Bond coverage to backdating claims should also be examined and anticipated.

In short, there are a number of potential coverage defenses and other issues that will come to the fore when companies and their executives begin seeking coverage under their policies. Insurers need to recognize these potential issues and prepare to respond to insureds' claims for D&O coverage. As discussed, accountants and lawyers may also be implicated in the backdating scandal and insurers should likewise prepare themselves to respond to claims for coverage under their professional liability policies. As a final note, should securities class actions become more common -- for example, as a result of falling stock prices in the wake of earnings restatements arising out of improper backdating -- companies will likely seek coverage under their general liability policies as well.

V. CONCLUSION

It is still too early to tell how big the backdating scandal will grow and whether it will emerge as the next big corporate scandal in American business. In the coming months we will have a better idea as to the magnitude of this scandal and whether it will result in extensive civil litigation filed by aggrieved shareholders from coast to coast. With plaintiffs' civil suits, mostly in the form of derivative actions, and one criminal complaint already on the docket, New York City is certain to emerge as one of the prime venues for backdating cases. As the backdating scandal continues to unfold, insurers should educate themselves on the issues relating to backdating and prepare for the worst -- all the while hoping that the practice of backdating proves to be more limited than initial evidence would suggest. Unfortunately, with possibly eighty or more companies already under investigation, that does not appear to be the case.