Managing Risks Through Good Corporate Governance SPONSORED CONTENT

Lessons Learned From Options Backdating

Strong internal controls and the right "tone at the top" will help companies avoid future scandals.

PHOTOS BY DIEGO M. RADZINSCHI

From left, Jonathan Cohen, Steven Stanton, Ted Allen, and Andrew Karron.

Participants

Jonathan M. Cohen
Partner,
Gilbert Randolph LLP

Steven Stanton
Managing Director,
Navigant Consulting

Andrew T. Karron
Partner,
Arnold & Porter LLP

Charles "Ted" E. Allen III
Director of Publications,
Institutional Shareholder Services

In the past year, more than 200 companies have announced internal or regulatory probes into their stock option practices. The options backdating scandal provides a good starting point to discuss what steps companies and their attorneys should take to address corporate governance risk in general. We asked three distinguished panelists to discuss the lessons that can be drawn from options backdating and how companies can avoid future governance problems. They are: Jonathan M. Cohen, a partner with Gilbert Randolph who represents companies in insurance coverage disputes; Andrew T. Karron, a partner in Arnold & Porter's securities litigation enforcement group; and Steven Stanton, a managing director with Navigant Consulting who specializes in forensic accounting investigations. This abridged transcript is from a live panel discussion conducted March 6, 2007, at the Hilton McLean Tysons Corner in McLean, Virginia, and was presented by Legal Times *and the Washington Metropolitan Chapter of the Association of Corporate Counsel. The panel was moderated by Charles "Ted" Allen, director of publications at Institutional Shareholder Services.*

Ted Allen, MODERATOR: We'll start with opening comments from the panelists.

Jonathan Cohen, GILBERT RANDOLPH: The last chapter in backdating hasn't yet been written. On the insurance side, it is not entirely clear to me that we've even gotten much further than the preface. Many companies haven't yet turned to their insurance in a serious way, and there are no public cases that have dealt with backdating with respect to insurance coverage.

The good news for people in companies that may be experiencing these types of governance allegations is that there generally is insurance coverage that most companies will have that cover many directors and officers. Those types of policies generally cover claims for losses arising out of alleged wrongful acts taken by directors or officers in their official capacities. Unlike other types of insurance coverage, directors and officers' policies tend to have quite a bit of variation in their policy terms, which can have a great deal of significance.

First, it is important to understand that from an insurance perspective the decisions that you make very early in the process can have very profound consequences. Before the problems arise, it is important during the underwriting process to mesh your business strategy to your policy terms because there are substantial variations in the way policies are written. For example, directors and officers' policies typically cover claims for losses arising out of alleged wrongful acts of directors and officers. Each of those terms has potential variations that can play out in backdating and other corporate governance areas. By way of example, the term "claim" can mean a lawsuit. Typically, it means something that's actually been brought, but language in these policies also can cover things like a formal investigation by an administrative agency or an informal investigation taken by a board.

Similarly, the term "wrongful act" typically is defined broadly, but in some instances it can be defined much more broadly or, in other instances, much less broadly. And that may mean that things like allegations of negligence may be covered under one policy, but may not be covered under another.

When you are evaluating your risk, you need to understand that it is the amount of risk that you are willing to take that may be reflected more or less precisely in an insurance policy. And so when a company is looking at the underwriting side, it is very important that the company have these issues in mind and try to negotiate the kind of language that it deems most helpful if and when a claim actually arises.

The second place where early decisions can play a very significant role is once a claim is made, and this is where the rubber really hits the road for a lot of companies. The first thing that companies need to focus on is when and how to give notice to their insurance company. Most insurance policies and certainly most D&O policies require prompt notice, and some only cover claims that are noticed in a particular claims-reporting period. You also need to be very careful that when you write your notice you are doing it in a way that plays correctly with your defense.

Another concern is that these policies contain exclusions that insurance companies often will rely on in an effort to limit or eliminate coverage for directors and officers on a company's claim. It is important to understand that some of the things that you do in defense of your claim can inadvertently have ramifications on some of the things that you are trying to do on insurance, and vice versa. Just by way of example, there's an exclusion which essentially applies to intentional wrongdoing of the director or officer. During the backdating scandal, insurers have made a lot of statements in the press that they think that exclusion likely applies. The kicker on this exclusion for the policyholder's perspective is that this exclusion generally doesn't apply until a court, through a final order, decides that the underlying conduct was intentional. So while you are defending your claim, you have to be cognizant of the fact that if you settle and you don't admit liability or you don't admit that it was intentional, that can have very significant ramifications in terms of what insurance coverage and terms apply.

Andrew Karron, ARNOLD & PORTER: I want to talk about the things companies can do once a problem is discovered. That's affected by the regulatory climate but also by the fact that you're likely also to face securities class-action litigation and derivative litigation. You may be fighting a war on many fronts, and you really need to come up with a coordinated plan.

The bottom line these days is that the regulatory climate really is one of zero tolerance, and it's zero tolerance of violations in the first instance, but also of failure to respond appropriately. The notion is that both the Securities and Exchange Commission and the Department of Justice and, to some extent, the listing agencies, all expect that when a company identifies potential problems or is on notice of potential problems, it will self-detect, it will investigate, it will report, and it will remediate. Companies have the duty to take action. That's reflected in the SEC's Seaboard report and the DOJ's Thompson memorandum, which has been superseded by the McNulty memorandum.

So what does this mean as a practical matter? Once you've identified this problem, you need to investigate thoroughly. A lot of times, you wind up doing a lot of work at the front end to figure out how big a problem it is. It is important to realize the past actions are what they are. You can't change

Managing Risks Through Good Corporate Governance

SPONSORED CONTENT

Ted Allen

Jonathan Cohen

them when you discover what those are, but your future conduct is something that can be, and will be, evaluated.

In addition, your auditors will have concerns about whether there is a potential mistake in the financial statements. Company executives will be concerned about that, because they won't want to be in a position of signing what turn out to be false or erroneous financial statements. In the options cases, almost all of the companies have delayed issuing their periodic financial reports. That has led to issues with the exchanges, which have rules that require the timely filing of periodic reports. While one can request additional time, those exchanges will want a plan of how you're going to become compliant.

Probably the most important thing that you can do is to preserve and collect all of the documents that would be relevant to government investigations and any shareholder litigation. The government and private plaintiffs are extremely sophisticated regarding document preservation issues, including electronic documents and metadata. Frequently in this case, you want to engage document management professionals. They can work with your IT people to identify potential sources of electronic documents and to make sure that any copies are made forensically. That may be very relevant; in a lot of the options-related cases, the evidence of backdating has been based on metadata that, according to the allegations, show that certain documents were created or last edited after the date on which they were reportedly created. So you will need to have people working with you who understand metadata and understand how to preserve it accurately.

If you are investigating on behalf of the company, you want to make clear who the client is. The client is the company. When you do interviews, you need to make sure that you give Upjohn warnings to company employees. That warning clarifies the situation: You are not the lawyer of the individual person. Information that they provide will be turned over to the company. The privilege, to the extent that it exists, is the company's privilege, not the individual's privilege, and people have to understand that the company may at some future date waive the privilege and turn over information to government agencies.

You want to look, obviously, at the key documents. You go in quickly, and you try to figure out what are key things to look at and what are things that will give a sense of whether there really is a problem. If you see, for instance, a totally random pattern or that you don't see any grants on any low price dates, that suggests that there's probably not anything intentional going on, and maybe that there is no problem at all.

You want to take a look at the documentation underlying board or compensation committee minutes. And again it is useful to look at the metadata and see if you appear to have any situations where the metadata seems inconsistent with the document. That's not conclusive, but it will raise questions and you can then do further investigation.

You want to take a look at the grants and see if they comply with the requirements of the company's equity plan. This is really a corporate law matter, but you can have situations where there is inadequate delegation of authority. You want to make sure that the amounts are correct. You want to make sure that there are sufficient shares in the plan. These are all technical issues and you can have situations where inadvertent mistakes are made, but you want to make sure these are lawful grants.

Another thing that you want to do upfront is to engage a forensic accountant. In many cases, these firms are involved in multiple different cases, and they'll just have some perspective about what they've seen at other companies and know what to look for.

When you deal with the regulators, probably the most important thing is to set the right tone. You want your tone to be one of cooperation. You want to get them the information that they're entitled to and do it in a cooperative and efficient way. You want to show that you presented information that is reliable and accurate.

Steven Stanton, NAVIGANT CONSULTING: One thing that I'll re-emphasize is the importance of preserving documents, particularly electronic documents. Amazingly, we still encounter situations where companies are not doing everything that they really should to preserve those documents. For those of you who are in-house counsel, make sure you also talk to your IT department to have them cease their usual back-up processes because most companies when they back-up their e-mail servers, they will overwrite an older tape with data for the current month and that destroys whatever was out there from months ago.

I am going to comment on some of the common problems that we've been seeing in the options investigations and the restatements that those companies are doing. Most of the problems occurred prior to 2002 when the Sarbanes-Oxley regulations started requiring companies to report options within two days of when they were awarded. Since then, companies seem to have improved their processes. Before then, there were a lot of situations of poor procedures or poor documentation. Often, it was a result of ineffective communication within the company.

There have also been situations where there has been a lack of adherence to the provisions of the options plans. Often, a company's plans have been modified over time, and the actual administrative processes that the companies have been following haven't necessarily kept pace with those plans.

Backdating and favorable pricing often results in in-the-money options or options that are priced below their fair market value on the date of the award. Some plans allow for that, and it's perfectly appropriate for companies to grant those. Other plans do not.

Another problem has been a lack of oversight by boards, and particularly by compensation committees. In many of these situations, you've got companies that are giving awards to a broad spectrum of employees. While press accounts have focused on cases where corporate officers have personally benefited, the situations where you see the biggest accounting restatements are those companies that gave awards to a wide range, if not all, employees of the company. Because of the practical aspects of administering that volume of awards, most compensation committees delegated that authority to members of management but didn't pay close enough attention to help management with executing that authority.

Many of the affected companies are smaller, start-up companies where options were a valuable tool for compensation. Many of those companies, because of their start-up nature or their size, didn't build the infrastructure in the human resources departments, legal departments, and accounting departments to have the good internal control processes they would have liked to have.

Most of the accounting rules that affect backdating issues were promulgated in 1975 and were still in effect up until about two years ago. And under those rules, if you issued options where the award price was the same as the stock price on the date of the award, you didn't have to record an expense in your financial statements. However, if they had a price lower than the current market value of the stock, then that would create an accounting consequence. The difference between the award price and the current market value should be reported as an expense over the vested period of that option. That's the part that most companies didn't do. If they inadvertently or even intentionally priced those options favorably, they didn't reflect that expense in their financial statements.

The other situation where you can have some accounting consequences is if you modify an award. If you made an award nine months ago that was at the money, but then you modify it today when it is at a lower price, then that would create an accounting consequence as well. Often, those modifications were not reflected in financial statements, and that's why companies are going back and making restatements.

Allen: What issues should corporate counsel be considering as they prepare for

Managing Risks Through Good Corporate Governance

SPONSORED CONTENT

Andrew Karron

Steven Stanton

and, hopefully, prevent the next corporate governance or financial reporting crisis?

Cohen: There are a couple of things a company can do right out of the gate. On the underwriting side, a company ought to be evaluating its risk in a meaningful way and making sure it is acquiring the types of insurance coverage and the scope of coverage that will be useful if one of these problems arises.

There are a couple of other things that create some issues on the insurance side. Insurance companies look at waiver of attorney-client privilege from a slightly different perspective than the way that the government does. The insurers often will look to a provision in their policies called the cooperation clause that purports to say that the policyholder is supposed to do everything that they're supposed to do in defending the claim in order to maintain the coverage. And insurers can point to waivers of attorney-client privilege in an effort to try and argue that the cooperation clause has been somehow violated or otherwise undercut coverage. Before making the decision to waive attorney-client privilege, it is important to evaluate what the reaction may be from your insurance companies, and what counter-arguments you may have.

Another important point is that most of these cases have arisen from behavior that is pretty old and dated. That can have insurance consequences because insurance policies often will have retroactive dates or prior act exclusions that basically say that if the issues that give rise to coverage happen at or before a certain date, then they won't be covered. If you argue that each grant of stock options is a separate event, that may mean that some older grants won't be covered. By contrast, if the grants are part of a single, continuing event, you would have an argument that the entire claim is covered.

Karron: With respect to waivers, this is a matter of some real controversy. Companies have been resistant to waivers because of concern over securities and derivative litigation. Once you waived with respect to the government, even if you try to negotiate a confidentiality arrangement, there is a lot of authority that says that a waiver is a waiver and you run the risk of waiving for all purposes. The McNulty memo in December 2006 makes some changes in the waiver area. Prosecutors can still request a waiver, but there is more of a process that they have to go through. Senator [Arlen] Specter (R-PA) has introduced a bill that would address protecting the attorney-client and work-product privilege. The American Bar Association has sent a letter to the SEC suggesting that there ought to be revisions to the Seaboard report.

With respect to what to do going forward, there are a few things for companies and boards to consider. One general area to think about is the tone at the top of the company. In a lot of cases where government investigations have led to actions against the company, one of the things that the government has looked at has been poor tone at the top. If the company really has a tone at the top of integrity, accuracy in financial reporting, and compliance with procedures, that sets the right tone and people will do the right thing.

Secondly, under Sarbanes-Oxley, there is a complete emphasis on internal controls, and if those kinds of reviews are being done and they're taken seriously, those reviews should help companies identify potential areas of weakness that can be remedied.

Finally, it is useful to look at academic literature and, to some extent, the criticism of standard industry practices. The options matters really are the culmination of what's been going on for decades. Government authorities look at this sort of literature and consider whether it identifies issues that are worthy of investigation. This literature can be an early warning system of issues that you may want to be aware of.

Allen: What should companies be doing from a risk assessment standpoint, and should they go on beyond their internal and external audits to look at other practices?

Stanton: The two most important things are to have a very effective internal control structure within the company, and you need to have a very strong, engaged, and knowledgeable board. If you look back at the underlying cause of some of these options problems, you will find a lack of communication between company departments, a lack of adequate systems, and in some cases, a tone from the top that discouraged employees from questioning things.

From a corporate counsel's standpoint, you can play a role in helping the board members be knowledgeable about not only what is going on in the company, but also the risks and issues that are facing the industry. Hopefully, they bring some baseline knowledge, but it is also up to members of management to keep them knowledgeable.

Allen: What should companies do from an internal compliance standpoint? Are there any other steps that should be taken with their internal compliance programs to help prepare for the next crisis?

Karron: I would echo Steve's point that you really want to have your internal controls be taken seriously. Companies have been doing internal control reviews and you want to detail those findings for the audit committee, really to make sure they understand what's going on and how those processes work. You need to have a reasonably open system so that employees will feel comfortable raising issues and know that those issues will be appropriately explored.

Stanton: I recommend keeping your eyes open and your ears to the ground to determine the issues that are affecting other companies. Certainly, the backdating issue was well publicized back in March of last year. When you are reading those kinds of articles in *The Wall Street Journal*, that is an issue that you ought to look at. I do a fair number of investigations in the healthcare industry, and one thing that's very helpful is that the HHS Office of Inspector General publishes every year its work plan of issues to focus on. In other industries, you should try to find those early signals of where regulators are looking and then do a quick diagnostic check internally to see if you have some more issues.

Allen: What we can expect to see from the SEC and the government? There have been a handful of indictments so far, but there's an expectation that there will be more.

Stanton: Well, it is really early. I think now there are six cases – the real question is where the government agencies are going to draw the line. So far, the proceedings that I'm aware of have primarily been with respect to individuals. The question will be what happens to companies. It is more likely for the government to bring options cases over things such as intentional backdating, lying, document destruction, fictitious employees, and other classic fraud situations. I think the agencies have been careful not to stake out a final position on some options issues as this is something that they will obviously have to evaluate. They will be able to look at the full spectrum of what they find as a result of their investigation and make judgments.

With respect to shareholder litigation in this area, those cases also are just beginning. There are a couple of recent decisions from the Delaware Chancery Court, *Ryan vs. Gilford* and *In re: Tyson Foods*, where there were allegations of intentional backdating, contravention of the company's options plan, and deliberate falsification of records. Not surprisingly, the court concluded that if you accepted those allegations as true, they might state a claim, but the court was also careful to caution that the plaintiffs would have to prove those alleged facts in order to recover.

Having had the opportunity in the last few weeks to hear several SEC commissioners, SEC enforcement staff, Department of Justice people, and even a high-ranking FBI official, it is pretty clear that the regulators are looking very closely at all of these new issues. As Andy says, the challenge is going to be differentiating between those cases that were administrative problems and those that were intentional wrongdoing. There are about six companies where there has been legal action taken. Two of those are fairly dated, but in recent weeks, four new ones have surfaced, including a couple of people who have pled guilty to criminal acts. I think we will see more activity there. Hopefully, it will be more directed at individuals and not at the companies, but it is unclear.

Allen: According to press reports, there appears to be some division within the SEC on whether to take action against companies. Any thoughts on how the SEC might come down on that issue?

Karron: I don't think I can predict what the SEC will do, but I do think that one can identify factors that may well be taken into account. It is certainly the case that companies act through their employees, and employee conduct, which is really senior management, can be attributed to a company. The government may look at what you do once you're in the process of an investigation, and what you do going forward. Does the company cooperate? Does it self-investigate? Does it self-report? Does it remediate? These are the kinds of issues that historically the enforcement agents have taken into account, and I would expect that they would here as well.

There is certainly an argument for some companies that they are victims of all of this conduct and should not be punished. The goal of the company, I would suggest, in an investigation is to really show that once it became aware of the problem, it did essentially the right thing and showed real cooperation.

Stanton: I think it is exactly right that the government will look at how companies reacted. What corrective action did you take with your processes and controls, but also what action did you take with respect to who benefited from the alleged backdating? In some ways, the onus will be on the board, rather than the government, to be the arbitrator of these issues. As a board member or as a member of management, you may be in a position of trying to determine: "Was this a mistake?" and if so, "how do I deal with it?" Was it something that was intentional and you should deal with that differently? How do you determine what people did? But those are the kinds of things that the government's going to look at, and these are certainly the kind of questions the government will be asking the internal investigative team.

Cohen: From an insurance point of view, there have been no cases filed yet. Insurers are taking a sit-and-wait perspective on this. Initially, in the first few months of the backdating crisis, starting last March [2006], the insurers made a number of statements describing backdating as a crisis, saying that they thought there would be a lot of claims coming out of it. They're now much more silent about that. They've started to say that this may be principally a defense cost issue. But we're still at an early point in the process where it's not yet entirely clear what happened on the underlying claim side, so it is not yet entirely clear how the insurers are going to make arguments about that.

On the underwriting side, there already have been some ripples with respect to backdating. I think a number of insurance companies have proposed exclusions that would apply to certain behaviors related to stock options. Policyholders, by and large, are trying to resist those exclusions, in large part because those exclusions tend to be written in a fairly ambiguous way, which could lead to a much broader application. From a pricing point of view, backdating hasn't yet had an enormous significance, although the insurers are at least talking about the fact that they may differentiate among companies based on how serious the allegations are.

Karron: With respect to remediation, one more thing that companies can do is look at the policies and procedures that were in place, and what steps could be taken to change them. For example, if companies used a variety of different grant dates, and there was a lot of discretion setting dates, that could have facilitated some manipulation of dates. To the extent that companies decide to go, for example, to fixed dates, either an annual date or periodic date, that policy change can address those issues. If there were paperwork and record-keeping issues, and a company enhanced those procedures and made one person or area responsible for collating and maintaining relevant material, that can help address those issues. While companies will benefit in terms of risk mitigation, these concrete steps can demonstrate good governance and help in the audit process. ■