

## BRIEFINGS

## KFP WINS APPEAL IN SEVENTH CIRCUIT

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- Reinsurance Intermediary Ruling
- Proposed legislation
- Discrimination decision
- Link to EPL Case Notes
- Backdating of Stock Option Grants

In a case of first impression, the Seventh Circuit Court of Appeals in Chicago recently reversed a federal district court decision and held that the Illinois Insurance Producers Limitation Act, 735 ILCS 5/13-314.4 (“ILPA”), does not apply to reinsurance intermediaries or contracts of reinsurance. *BCS Insurance Co. v. Guy Carpenter & Co., Inc.*, 2007 WL 1732279 (7th Cir., June 18, 2007). A team of KFP lawyers led by Marc Pearlman successfully argued that the district court had erred in applying the two year limitations period set forth in the ILPA to the tort and contract claims that BCS filed against its former reinsurance

nois Insurance Act and reinsurance intermediaries should therefore be considered insurance producers subject to the ILPA.

In reversing the district court decision, the Seventh Circuit noted that the Illinois Supreme Court has concluded that the terms insurance and reinsurance have distinct and separate meanings. Reinsurance agreements are different in form and substance from policies of insurance and are accorded different



7th Circuit U.S. Court of Appeals issues ruling with respect to the Illinois Insurance Producers Limitation Act

intermediary, Guy Carpenter. BCS’ suit claims that Guy Carpenter failed to properly procure and document reinsurance for BCS from the London reinsurance market for a consumer warranty program that BCS insured. As a result of Guy

Carpenter’s failings, BCS was held liable in an arbitration with its London Reinsurers and sought recovery for its losses. In dismissing BCS’ claims, the district court concluded that reinsurance was subsumed within the statutory scheme of the Illi-

treatment under the Illinois Insurance Code, reflecting the different roles of the two arrangements in the insurance markets. The Court concluded that the IPLA does not apply to reinsurance intermediaries and, therefore, did not govern the dispute between BCS and Guy Carpenter. The Seventh Circuit remanded the case to the district court with instructions for that court to determine the statutes of limitations applicable to BCS’ claims.

*“[t]he Illinois Supreme Court’s analysis in Reserve Insurance should be applied here with the same result—just as a reinsurance agreement is not an ‘insurance policy’ ... it is also not a ‘policy of insurance.’” [quoting from an Illinois Attorney General Amicus Brief].*

Contributors to the briefs were Marc Pearlman, Mark Wilson, Michael Brooks, Scott Hanfling and Meghan Welch.



## I-SPY, SPY –ACT and COUNTER SPY ACT

Proposed federal legislation to combat illicit Internet schemes and malicious spying in order to protect sensitive data.

*“[The I-SPY ACT states:] ‘No person may bring a civil action under the law of any State if such action is premised in whole or in part upon the defendant’s violating this section... ‘ [t]he purpose of this clause is to not create a ‘litigation bonanza in fifty states.’”*

### Stats:

Recent studies have estimated that ninety percent of U.S. computers are infected with some form of spyware, and Americans spend \$2.6 billion per year to protect their computers from malicious software.

## LEGISLATIVE UPDATE: *COMPETING ANTI-SPYWARE BILLS* BY MARGARET REETZ, HEATHER CHELBERG

U.S. legislators recently introduced three separate bills making it illegal to install malicious or deceptive software onto PCs, in an effort to address privacy and security concerns for businesses and consumers. Spyware programs hide in PCs and secretly monitor user activity. Typically, spyware arrives bundled with freeware or shareware, or through e-mail or instant messages. The programs are difficult to remove and may cause computers to run slowly or even crash. Spyware also may allow someone to duplicate another website, including financial or retail site personal information such as credit card numbers. While many states already have bans in place, the new bills appear to ban the illegal use of spyware under federal law even though “spyware” itself may not be illegal.

In May 2007, the U.S. House

additionally includes provisions to prohibit unfair or deceptive behavior including computer hijacking, ‘phishing’, and the display of advertisements that cannot be closed.

By comparison, **I-SPY** aims to penalize the malicious or deceptive use of software, while giving a freer rein to software and website design as long as it is not put to use in a fraudulent or duplicitous manner. Speaking about the **I-SPY** legislation, Phil Bond, president of the Information Technology Association of America stated, “Representatives Lofgren and Goodlatte are offering tools for the government to take on spyware without creating a sweeping regulatory regime that

passed legislation known as the Internet Spyware Prevention Act or **“I-SPY Act”**. Re-introduced by Reps. Lofgren (D-CA) and Goodlatte (R-VA) in mid-March, the bill proposes sentences of up to five years for violations. The **I-SPY Act** would make it a crime to copy code onto a computer without permission, if doing so would reveal personal information or impair the computer’s security. Microsoft and Dell support the proposed bill, as do many online advertisers.

There is no private right of action in the proposal, which states: “No person may bring a civil action under the law of any State if such action is premised in whole or in part upon the defendant’s violating this section.” Rep. Lofgren stated that the purpose of the bill is not to create a “litigation bonanza in fifty states”. The bill would authorize funds to the Justice Department “for prosecutions

could trample innovation.”

Then, in June 2007, additional legislation was introduced by Sen. Pryor (D-AR), who introduced the **Counter Spy Act** of 2007. This bill makes it illegal for companies or fraudsters to implant software on a computer without consent. Sen. Pryor noted the malicious nature of such software that collects information about a consumer’s browsing habits, enables pop-up ads, and/or changes a user’s home page. The most recent proposal appears closer to the language already in the **SPY-ACT**.

In May, the first two spyware bills passed the U.S. House but did not make it through the Senate, in part, because of how they were

needed to discourage the use of spyware and the practices commonly called phishing and pharming”.

A related bill, known as the Securely Protect Yourself Against Cyber Trespass Act or **“SPY-ACT”**, prohibits the collection of personal information unless computer users are notified and grant their consent, which was re-introduced in February by Reps. Towns (D-N.Y) Bono (R-CA). It aims to prevent spyware purveyors from hijacking a homepage or tracking users’ keystrokes; requires that spyware programs be easily identifiable and removable; and allows for the collection of personal information only after express consent is given by users.

The **SPY-ACT**, first proposed three years ago, came under fire for its vague terms and the likelihood that legitimate programs, particularly advertisers, may be affected by its broad coverage. The bill

worded. Essentially the first two bills competed against one another but most tech companies and software developers preferred the wording of the **I-SPY Act**. The three proposed bills have similar aims but passage of the bills in their current form is uncertain.

Meanwhile, prosecution of criminal cyber activity continues under existing computer fraud statutes (affecting government or financial institutions). (See DOJ Press Release 6/13/07, OPERATION BOT ROAST, an ongoing initiative to disrupt and dismantle “botnets,” a collection of compromised computers under the remote command and control of a criminal “botherder.”)

**SUPREME COURT DECISION—EMPLOYER LIABILITY  
LEDBETTER V. GOODYEAR TIRE & RUBBER CO.**  
BY MARK WILSON, DAVID GROUNDWATER

The Supreme Court's May 29, 2007 decision in *Ledbetter v. Goodyear Tire & Rubber Co.* provides employers protection from Title VII claims where an employee claims to have suffered from the cumulative effect of ongoing discrimination.

Lilly Ledbetter worked as a plant supervisor for Goodyear for eleven years. When she was hired, her pay was comparable to her male counterparts. However, by the time of her retirement, Ms. Ledbetter earned substantially less than her male counterparts. Ms. Ledbetter claimed she was the victim of discrimination while Goodyear contended that her lower salary resulted from her poor performance over the years, rather than discrimination. She introduced evidence showing that her performance was adequate and could not

explain the pay differential. The jury agreed, and awarded her almost \$225,000 in back pay and almost \$3.3 million in punitive damages.

The Supreme Court ruled that Ms. Ledbetter could not pursue her sex discrimination case against Goodyear because she waited too long to charge Goodyear with discrimination. Title VII requires employees to submit discrimination claims to the EEOC (or similar state agency) within 180 days (or 300 days in some states). The employee must identify a discrete act or occurrence motivated by discriminatory intent, and that "employment practice" must have occurred within 180 days of the date the employee approaches the EEOC. The Court rejected Ms. Ledbetter's argument that each paycheck was "tainted" with the effect of prior

*"current effects alone cannot breathe life into prior, uncharged discrimination."*

discrimination. The Court said that: "Ledbetter should have filed an EEOC charge within 180 days after each allegedly discriminatory pay decision was made and communicated to her." Although each paycheck was affected by the earlier discriminatory acts, the Court said that "current effects alone cannot breathe life into prior, uncharged discrimination." Goodyear's last allegedly discriminatory salary decision had been more than 180 days before Ms. Ledbetter submitted her claim to the EEOC. Therefore, that salary decision was immune from review and Ms. Ledbetter could not sue for discrimination.

Justice Ginsberg, on behalf of the four dissenting Justices, took the unusual step of reading her



dissent from the bench to emphasize her disagreement with the majority of the Court. The dissenting Justices noted that salaries are viewed as private matters and an employee may not know that another employee is compensated differently, despite similar duties and performance. Justice Ginsberg invited Congress "to correct this Court's parsimonious reading of Title VII." Senators Kennedy (D-MA), Harkin (D-IA), Clinton (D-NY), and Mikulski (D-MD), as well as members of the House have announced that they introduce legislation to overturn the Ledbetter decision.

*For more EPL case notes, go to:*  
<http://www.kpfplaw.com/articles/>

**Backdating of Stock Option Grants** by Kristin McMahon, Scott Wallace



The issue of stock option backdating is a hot topic for corporate boardrooms, government regulatory and enforcement agencies, civil and criminal securities class action attorneys, and the media. The Se-

curities and Exchange Commission ("SEC") first began looking into stock options back-dating in 2005, after academic research found certain patterns emerging from stock movement around the dates of stock option grants.

As reported in a July 17, 2006 New York Times article entitled *Study Finds Backdating of Options Widespread* by Stephanie Saul, University of Iowa and Indiana University studies estimate that 29.2% of companies granted backdated options and that 13.6% of options granted between 1996 and 2005 were manipulated in some fashion. Federal and state regulatory agencies have taken notice, and the SEC is currently investigating over 150 companies concerning possible back-

*i. A company grants stock options to its employees at a certain exercise or strike price which gives the employee the right to purchase the stock at the exercise price at a later date after the option vests. If the stock price rises, the employee stands to make a profit. If the stock price falls below the exercise price, the option is worth less to the employee. Options where the exercise price is at the market prices as of the date of the grant are referred to as "at the money" options. Options where the exercise price is lower than the market price as of the grant date are referred to as "in the money" options and are a windfall to the recipient. For financial reporting purposes, companies are required to record compensation costs for granting "in the money" options because the company effectively receives a lower price than it could get for the shares on the open market. No compensation needs to be recorded for "at the money options" because the exercise price is the same as the market price. Backdating is the act of intentionally employing hindsight to adjust the grant date to an advantageously low price to enrich the employee/grantee. Backdating is especially problematic if the company's option grant practices do not conform with the company compensation plans filed with the SEC or if the company does not make the appropriate accounting of the option (i.e., recording the "in the money" options as a compensation expenses thus decreasing the company's profitability).*

Continued on page 4

dating of stock option grants.<sup>i</sup> On May 31, 2007, California-based companies, Mercury Interactive LLC and Brocade Communications Systems Inc., agreed to pay \$28 million and \$7 million in penalties, respectively, to settle SEC civil fraud charges alleging stock option backdating. These two settlements will serve as a significant precedent in future SEC enforcement cases.

The first criminal trial alleging suspect timing of stock option awards began on June 18, 2007 in San Francisco, California against Gregory Reyes, the former chief executive of Brocade Communications Systems, Inc., a data-storage network firm. The prosecution charges Mr. Reyes with 10 felony counts of securities fraud and other violations

and accuses Mr. Reyes of falsifying board of directors meeting records, signing off on false financial statements, and lying to the company's financial auditors and investors to hide the fact that the company should have been paying compensation expenses for options grants that already had value at the time they were awarded. Jurors will have to decide whether Reyes intentionally concealed information about the company's options grants to avoid paying hefty compensation expenses and boost the bottom line or whether Mr. Reyes fell victim to murky accounting laws. To date, ten executives at six companies have been charged with backdating related crimes. Five have pleaded guilty; one has fled to

Namibia but, prior to Gregory Reyes, no one has defended himself/herself at trial on these issues.

Numerous civil suits have also been filed against the corporations as well as the individual directors and officers of corporations that awarded backdated stock option grants. These include: securities class actions and shareholder derivative suits. The securities class actions allege violation of the federal securities laws and are filed in those cases where there is a per share stock price drop that is causally related to a company's announcement that it would be restating earnings due to its inappropriate accounting of prior stock options grants. In early June 2007, the court in one of the more publicized stock option backdating cases,

*Krause, et. al. v. United Health Group*, D. Minnesota 06-CV-01691, denied the defendants' Motion To Dismiss and allowed the stock drop case to proceed.<sup>ii</sup> The second type of suit, the shareholder derivative action, is filed on behalf of the corporation itself and accuses certain executives and/or board members of having manipulated stock option grants for their own benefit and of "wasting" corporate assets. It is unclear what the future holds for shareholder derivative lawsuits involving backdating, as courts across the U.S. have just begun to grapple with the first wave of dispositive motion practice.

The first two decisions by the Delaware Chan-

cery court were not favorable for the backdating defendants while the most recent federal California case rulings appear more promising for the defense. On February 6, 2007, Chancellor Chandler of the Delaware Court of Chancery denied motions to dismiss derivative claims alleging backdating of options (*Ryan v. Gifford*, 918 A.2d 341) and spring loading of options<sup>iii</sup> (*In*

*Re Tyson Foods, Inc.*, 919 A.2d 563). In both of these decisions, Chancellor Chandler rejected the defendants' argument that the plaintiffs failed to meet the burden of pleading demand futility with particularity.<sup>iv</sup> In *Ryan*, Chancellor Chandler noted that, since three of the six board members approved the backdated options and another board member received them,

doubt existed as to the disinterestedness of the board. Chancellor Chandler also agreed with the plaintiff in *Ryan* that knowing and intentional violations of stock option plans cannot be an exercise of a valid business judgment based on the "unusual facts alleged."

In an effort to circumvent the court's holdings in *Ryan* and *Tyson*, the backdating defendants now argue that their

cases are factually distinguishable. See, *In re CNET Networks, Inc. Shareholder Derivative Litigation*, 2007 WL 1089690 (N.D. Cal. April 11, 2007) and *In re Computer Sciences Corporation (CSC) Derivative Litigation* (C.D. Cal. March 26, 2007). Unlike *Ryan*, the defendant company in *CNET* created a Special Litigation Committee to investigate stock option granting

ii. On June 5, 2007, the U.S. District Court Judge James M. Rosenbaum ruled that a shareholder class action suit against United Health alleging that the company and its former Chairman and CEO inflated the company's stock price by failing to disclose it had backdated stock options given to the former CEO and employees could proceed. As the truth concerning United Health's practice of backdating option grants became known to the market, the price of United Health Stock fell 12% over several trading sessions resulting in billions of dollars of market cap losses.

iii. Unlike backdating where a date is selected to be the exercise price for the options, not at the time of the grant but rather at a past date when the stock was trading at a lower price, spring loading involves a different scheme. In spring loading, the stock price is almost always the grant date, but the grant itself is times to take place a few days before favorable earnings or other "good news" is release to the public. Thus, the options are spring loaded to almost certainly leap "into the money" once the stock price rises on the release of the favorable news.

iv. When a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires a shareholder to first make a demand upon the corporation's board of directors, giving the board an opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interests of the corporation. However, the two instances in which a plaintiff is excused from making demand are: (1) a majority of the board is disinterested or independent; or (2) the challenged acts were the product of the board's valid exercise of business judgment.

In his 2007 decision refusing to dismiss the plaintiffs' backdating derivative action in *Ryan v. Gifford*, Chancellor Wm. Chandler of the Delaware Chancery Court opined:

*"I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to fanciful and devoted conduct of a loyal fiduciary. Well pleaded allegations of such conduct are sufficient in my opinion, to rebut the business judgment rule and to survive a motion to dismiss."*

practices within days of publication of a report that CNET was at risk for having granted backdate stock options. While the Special Litigation Committee Report noted that there were deficiencies with the process by which options were granted at CNET, it concluded that there was no intentional wrongdoing by any

current officer or director. Unlike the plaintiffs in *Ryan*, the CNET plaintiffs did not allege that the options were granted sporadically or outside a specific overall plan. For these reasons and others, the *CNET* court dismissed the complaint for failure to plead demand futility with particularity.

the court of demand futility in *Ryan* alleged that: (1) every challenged option grant occurred during the lowest market price of the month or year in which the option was granted; and (2) empirical evidence in the form of an investment bank's analysis showed the annualized return on the option grants to the company management was nearly ten (10) times higher than that of the market for the same period. In contrast, the plaintiffs in *Computer Science* relied on two press releases announcing the government investigations and a stock price analysis that purports to show the options grants invariably preceded known rises in *Computer Science*'s stock price. According to the *Computer Science* court, the stock

price analysis in plaintiffs' complaint demonstrated a less convincing and compelling picture as it relates to options backdating than in *Ryan*. Thus, the *Computer Science* court declined to follow *Ryan* and dismissed the complaint for failure to plead demand futility with particularity.

The *Ryan* and *Tyson* decisions are good for stock option backdating derivative plaintiffs and may increase the settlement value of these cases on terms more favorable than before the decision. To the extent the derivative suits survive the motion to dismiss, the amount of defense costs incurred by the backdating derivative defendants, and their D&O insurers,

Similarly, the *Computer Science* court found that *Ryan* and *Tyson* were factually distinguishable. In both of these cases, the court found that the total number of interested directors comprised half or more of the total directors who would be considering a shareholder demand. In the case of *Computer Science*, the court found that the option grants were executed by a subcommittee comprised of at most two of the seven directors on *Computer Science*'s board. Second, the *Computer Science* court found that the pleaded facts and options manipulation in *Ryan* and *Tyson* differed from the ones before it. The Complaint that persuaded

will only increase. However, the more recent *CNET* and *Computer Science* pro-stock option backdating defendant decisions dismissing plaintiffs' Complaints illustrate the "fact intensive" approach some courts adopt in finding the matters before them are distinguishable from *Ryan* and *Tyson*.

#### Related News:

July 2007, San Francisco

The defense opened in the case of Gregory Reyes, former CEO of Brocade Communications. A former employee in Brocade's human resources department, testified that Reyes told her "it's not illegal if you don't get caught," but under cross-examination, could not specifically identify what the "it" was. She said it had to be about stock-option grants because that was the only topic she ever discussed with him.

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