



focus

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Backdating Stock Options

By: Matthew P. Connelly & Geoffrey J. Haas, Jr.*

In the wake of the fallout from scandals at companies such as Enron, WorldCom, and Tyco, there has been a renewed government focus on executive compensation.

While there are many ways of compensating high-level employees, one of the most attractive is offering them executive stock options. This allows their compensation to reflect the well-being of the company, thus giving them an incentive to ensure profitability for the company as a whole. However, some executives have attempted to increase their compensation even further by “backdating” the options they receive.

What is Backdating?

Backdating an option is the practice of marking it with a date that precedes its actual issue date. Stock options are generally issued with an exercise price equal to the current market price, and therefore have no immediate value. However, since an option is more valuable if its exercise price is lower, executives prefer to be granted options when the stock price is at its lowest. Backdating allows executives to pick a past date when the stock was at its lowest as the exercise price for the options they are receiving. By choosing an earlier date when the stock was lower, the options are instantly worth the difference between the strike price and current market price.

Is Backdating Illegal?

Though not necessarily illegal, in many cases it could be. In order to avoid legality issues, the following conditions must be met:

- No documents have been forged
- The backdating is clearly communicated to the company’s shareholders
- The backdating is properly reflected in the earnings
- The backdating is properly reflected in taxes

However, these conditions are rarely met, making backdating of options illegal in most instances.

What Is Being Done About It?

The type of legal challenges companies potentially face depends largely on the individual circumstances of each case. Generally, backdating stock options can violate tax laws, securities regulations and laws prohibiting fraud. Additionally, companies such as Mercury Interactive Corp. and Converse Technology, Inc. have been required to restate earnings to reflect the accurate value of the options and have suffered significant hits to both their stock price and public image.

“FAIR VALUE” LIVES UP TO ITS NAME: *New Rules Against Discounting Will Help Minority Shareholders*

By: Matthew Connelly and Timothy Eavenson*

Things are getting easier in Illinois for minority shareholders.

Effective January 1, 2007, the Illinois Business Corporations Act will eliminate the much-used practice of discounting minority shares during appraisals based solely on their minority status.

The Illinois Business Corporations Act (or “BCA”) provides relief for minority shareholders who dissent to major corporate activity that affects their stake in the corporation. The remedy is generally a buyout by the corporation, which requires an assessment of the “fair value” of the minority stockholder’s shares.

Prior to this new amendment, Illinois courts had held that appraisals of fair value could be discounted based on the minority status of the stock. The thought was, since the shares being appraised do not carry any control over the corporation, they are worth less than a controlling block would be.

For example, in one 1997 Illinois case, a closely-held corporation conducted a “reverse stock split”, where 1750 “old” shares of the corporation’s stock would be replaced with one “new” share. Anyone with less than 1750 “old” shares would get cash for the value of their stocks. The purpose of this change was to eliminate all of the minority shareholders in the corporation.

When some of the minority shareholders dissented, an appraisal proceeding was held, and the court agreed with the corporation that a discount should be levied on the stock because of its lack of marketability. As a result, the value of the minority shareholder’s interest in the corporation was cut in half.

Discounting minority shares had often been criticized as replacing “fair value” with “fair market value”, or an assessment of what someone on the open market would pay in an arms-length transaction for the stock. In the aforementioned example, the Illinois court held that, because the Illinois BCA did not define “fair value”, it was within the court’s discretion to consider any factors it deemed appropriate.

The Illinois legislature has responded to what it believed was an inequitable judicial interpretation of the existing Act by adding language to the three sections of the BCA that control minority stock appraisals. The statute now defines “fair value” as “the proportionate interest of the shareholder in the corporation, without any discount for minority status, or absent extraordinary circumstances, lack of marketability.” (P.A. 94-889, amending 805 ILCS 5/6.15, 11.70(j)(1), and 12/56(e).)

These amendments to the BCA will now give minority shareholders awards based on their portion of the actual value of the business, rather than what their shares would be worth on the open market. The changes also stand to eliminate much of the leverage now enjoyed by majority shareholders who wish to do away with minority blocks.

The major question posed by the added language is what “extraordinary circumstances” could lead to courts permitting discounts based on marketability. While the Illinois legislature has not left any clues, one potential answer might be found in the Model Business Corporations Act (or “MBCA”), which most states’ laws are based on. In the MBCA, fair value cannot be discounted for any appraisal right granted by the language of the act. But for any appraisal right created by the corporation’s own bylaws, fair value can be discounted. This is why majority shareholders may want to revisit their bylaws if their intention is to make their shares worth more in a potential transaction than the minority shares.

The recent changes to the Illinois Business Corporations Act will affect a wide range of issues for both majority and minority shareholders. At Connelly Roberts & McGivney, we understand the intricacies of valuation and the reasons for the recent changes, and we know what they will mean for you and your business. Feel free to contact us with any questions you may have about these or any other corporate issues you are facing.

For more information, visit our website at www.crmlaw.com. If you have questions about this article, contact Matthew P. Connelly at mpconnelly@crmlaw.com or at 312-251-9600.

*Timothy Eavenson is a law clerk at Connelly Roberts & McGivney LLC and a Juris Doctor candidate at The John Marshall Law School. He expects to earn his Juris Doctorate in January 2008.

The Good and the Bad Faith: Combating an Insurer's Bad Faith

By: Craig E. Donnelly

As consumers, we expect that our insurance company will be there for us when needed. We also assume that they will fulfill their contractual obligations to provide coverage. Unfortunately, this is not always the case. Large insurance companies are just like any other business. They seek to make a profit. An old adage among attorneys is that insurance companies are in the business of collecting premiums; they are not in the business of paying out claims. These competing interests will occasionally result in claims being wrongfully denied. Sometime, those denials are in error, however other times the denial is deliberate and made in bad faith.

Generally, Illinois law makes it rather difficult for an aggrieved policyholder to go after the insurer in a tort action for bad faith. For instance, all contracts – including insurance contracts- have an implied covenant of good faith and fair dealing among the parties embedded within them. However, Illinois is one of a minority of states that does not allow for an independent tort action for a breach of the covenant of good faith and fair dealing.

The most common avenue to pursue an insurer for bad faith is through Section 155 of the Illinois Insurance code. 215 ILCS 5/155. Section 155 provides an aggrieved policyholder with a means to recover more than simply contract damages. For example, Section 155 allows an insurer to be punished for unreasonably and vexatious delay in meeting their obligations to their policyholders by penalizing insurer and also providing for attorneys fees to be awarded to aggrieved policyholders. To proceed under Section 155, the policyholder must establish, among other things, that the insurer failed to reasonably settle a claim, disputed the amount of the loss payable or refused to provide coverage when the question of coverage was not fairly debatable. Second, and the more difficult element, is to establish that the insurer's actions or delay was unreasonable or vexatious. Considerations as to the reasonableness of the delay include the insurer's attitude and treatment of the policyholder and whether the policyholder was forced to file suit to gain coverage.

The available recovery under Section 155 however is capped. A further difficulty is that the burden of proof is on the policyholder to establish the unreasonable and vexatious action or delay. Because of the structure of Section 155 and the other limitations placed on action against insurers by the courts, Section 155 actions are often filed in combination with other theories of recovery, including consumer fraud.

A recent case involving Section 155 was *Williams v. American Country Insurance Company*, 359 Ill. App. 3d 128 (1st Dist. 2005). In *Williams*, a taxi driver was forced to file an action against his insurance company seeking a declaration that he was entitled to have his insurance company provide him with independent counsel to defend him in a related negligence action after he discovered an undisclosed conflict of interest with his attorney provided by his insurer, which was alleged to have been known by the insurer. In the end, the court found the insurer's conduct was vexatious and unreasonable and ordered the insurance company to pay attorneys fees to the driver incurred during the pendency of the underlying tort action, the declaratory judgment action relating to the conflict of interest and \$25,000 as a penalty for its conduct.

We at Connelly Roberts & McGivney LLC have extensive experience representing aggrieved policyholders in insurance coverage issues, including bad faith action on the part of insurance companies. We have repeatedly represented clients and successfully attained favorable outcomes against the bad faith by insurance companies despite the limited avenues for bad faith recovery.

For more information, please visit our website at www.crmlaw.com. For specific questions, please contact Craig E. Donnelly by e-mail at cdonnelly@crmlaw.com or at (312) 251-9600.

Backdating Stock Options

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The backdating of stock options has greatly been limited since the Sarbanes-Oxley Act was passed in 2002 in the wake of the accounting scandals that have brought such issues to a head. After Sarbanes-Oxley took effect, companies were supposed to report stock options within two days. To the extent that companies comply with this new regulation, backdating should be significantly curbed.

We at Connelly Roberts & McGivney LLC are familiar with the current court trends dealing with this and other topics. We know how to avoid the pitfalls and how to achieve your company's goal without running afoul of the law.

For more information, visit our website at www.crmlaw.com. If you have questions about this article, contact Matthew P. Connelly at mpconnelly@crmlaw.com or 312-251-9600.

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ATTORNEY UPDATE

Victoria A. Grzelak joined the Firm's Corporate department as an Associate in August 2006. Victoria earned her Juris Doctor degree in 2003 from the John Marshall School of Law and an L.L.M. in Intellectual Property in 2004. Her principle areas of practice are corporate and securities transactions, intellectual property, and commercial real estate.

David R. Fletcher recently passed the Illinois Bar Exam and is now an Associate in the Firm's Corporate department. David first joined the Firm in May 2004 as a law clerk. He is a 2006 Graduate of the DePaul College of Law. His principle areas of practice are corporate and securities transactions, intellectual property, and commercial real estate.

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