Options Backdating —

The Delaware Perspective

Stuart M. Grant and Cynthia A. Calder[1]

Much has been written about the burgeoning stock options backdating scandal – from the claims of mere coincidence to criminal convictions. Once touted as a cheap compensation device that aligned officers' and directors' interests with those of the shareholders, stock options have now been revealed to have been pervasively and fraudulently manipulated by scores of corporate boards. In this article, we discuss what option manipulation is and examine recent precedent from the Delaware Court of Chancery dealing with shareholders' allegations of such manipulation.

Identifying Option Manipulation

Most companies' stock option plans require options to carry an exercise price (also known as a strike price) equivalent to the fair market value of the company's stock on the date of grant. Most plans provide that the fair market value is determined by reference to the stock's closing price on the day before the grant. For example, a board following the terms of a plan would, therefore, make certain that an option granted on June 25th would carry a strike price no lower than the stock's closing price on June 24th. This is commonly known as an "at the money" grant, meaning that the stock's price would have to go up in the future for the option to have any real economic value to the recipient.

Backdating occurs when the board misrepresents that date of grant. Using the example above, a backdating board would not use the true June 25th grant date, but rather would assign an earlier grant date when the stock price was lower. In this scenario, the option carries a strike price lower than it should and gives the recipient an immediate (and undisclosed) gain. An option carrying such an immediate gain is known as an "in the money" grant.

Spring-loading is a less obvious but similarly pernicious practice. Rather than adopting a false date of grant, a spring-loading board will grant options in compliance with the terms of the plan, *i.e.*, the option is assigned an exercise price that is no less than the fair market value associated with the true date of grant. The manipulation, however, stems from the fact that the board chose the timing of the grant to precede an announcement of a development at the corporation that is very likely to drive the stock price up. Going back to our example, the spring-loading board makes an option grant on the day before the company releases its quarterly results which the company knows will beat estimates by a substantial margin. The announcement of same is almost certain to cause a jump in the stock price. That price jump results in an immediate profit for the option recipient.

How, though, is a shareholder to know if its company's fiduciaries have engaged in manipulation of option grants if the behavior is undisclosed and the board affirmatively represents that all option grants have been made in accordance with the stock option plan? The short answer is that only time will tell. Option grants can only be evaluated for such abuses once there is sufficient trading data over a span of months and years to see where the purported grant date falls on that continuum. Where a company continually makes option grants on dates when the stock's trading place is at a low for the month, quarter or year, the odds overwhelmingly favor the existence of backdating. As stated in the Wall Street Journal article widely credited for exposing the practice of backdating, the odds of consistently hitting such low points in the company's trading history by mere fortuity are billions to one.[2] Spring-loading is similarly identified by an examination of the trading price history, but its telltale mark is a grant preceding a sharp increase in stock price associated with a favorable corporate announcement.

Another approach is to evaluate how aggressively a company has priced its options by comparing annualized returns on the options vis-à-vis annualized returns experienced by the shareholders in general. Merrill Lynch conducted just such a study of companies on the Philadelphia Semiconductor Index and released the results in May 2006.[3] What it found was eye-opening. For the worst-offending company in its study, KLA Tencor, it found that the stock option grants to KLA's employees had an average annualized return of 777%, compared to an average annualized return of just 23% for the shareholders. Other offenders included Marvell (640% for options, -14% for shareholders), Novellus (425% for options, 28% for shareholders), and Linear (416% for options, 23% for shareholders). As a means of comparison, Merrill Lynch included Vitesse Semiconductor – a company already being investigated by the SEC for backdating – in the study and found that the annualized returns for its option grants outstripped those for Vitesse's shareholders by an average of 1066%.

The Maxim And Tyson Opinions Set The Standard

Options manipulation is an act of deception and an illegal transfer of assets from the company to the option recipient. No one would suggest that a CEO could rectify an act of skimming the corporate till of millions of dollars merely by paying it back once caught. The deliberate violation of a company's stock option plan constitutes a bad faith act and a breach of fiduciary duty to the company and to the shareholders. Chancellor William B. Chandler, III, of the Delaware Court of Chancery, held precisely that in the first opinion from that Court to address the substance of a shareholder's backdating allegations, *Ryan v. Gifford*.[4]

In this derivative action, more commonly known by the name of the corporation involved, Maxim, the shareholder plaintiff alleged that Maxim's compensation committee had granted stock options in violation of the shareholder-approved option plan's requirement that the exercise price of the options be no less than the fair market value of the company's stock on the date of grant. The plaintiff also alleged that the board failed to disclose the granting of options with exercise prices lower than fair market value on the true date of grant, and instead misrepresented the actual dates of grant for those options. Defendants moved to dismiss the complaint for, *inter alia*, the failure to make a demand on the board, or, in the alternative, to stay the action in favor of an earlier filed federal action.

In denying the motion to stay the action, the Chancellor made clear that this novel issue would be addressed by the Delaware courts. Indeed, the Court concluded that the question of whether stock option backdating violates Delaware's common law fiduciary duties was a question "of great import to the law of corporations."[5]

The Court then addressed the defendants' arguments that the case should be dismissed because the plaintiffs had failed to make a demand upon Maxim's board of directors to bring the suit, or because the plaintiff had failed to allege a breach of fiduciary duty. Under Delaware law, the demand requirement is excused when: (a) there is reason to doubt that a majority of the board is disinterested or independent; or (b) there is reason to doubt that the alleged misconduct was the product of the directors' valid exercise of business judgment.[6] The Court found that the demand requirement was excused under both prongs of the test because the compensation committee members who approved the backdated options — and who constituted half of the board — faced a substantial likelihood of liability for their conduct.

The Court also rejected the defendants' argument that the plaintiffs had failed to state a claim for breach of fiduciary duty. Defendants argued that the granting of a series of options at Maxim that coincided with monthly or quarterly lows for the stock price was simply coincidence. Plaintiff's complaint relied on the May 2006 Merrill Lynch study to show the contrary. The Court concluded that:

> every challenged option grant occurred during the lowest market price of the month or year in which it was granted… This timing, by my judgment and by support of empirical data, seems too fortuitous to be mere coincidence. The appearance of impropriety grows even more when one considers the fact that the board granted options, not at set or designated times, but by a sporadic method.
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> Defendants argue repeatedly that plaintiff's allegations ultimately rest upon nothing more than statistical abstractions. Nevertheless, this Court is required to draw reasonable inferences and need not be blind to probability… Given the choice between improbable good fortune and knowing manipulation of option grants, the Court may reasonably infer the latter…[7]

Faced with the plaintiffs' allegations of intentional backdating of stock options in violation of the stock option plan approved by Maxim's shareholders, the Court found that such conduct does not merely raise doubts about the directors' compliance with their fiduciary duties; it creates a substantial likelihood of liability because it is virtually inconceivable that such conduct could ever be found to be consistent with a director's fiduciary duty of loyalty:

> A director who approves the backdating of options faces at the very least a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty. Backdating options qualifies as one of those "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."
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> 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 faithful and devoted conduct of a loyal fiduciary.[8]

In an opinion issued the same day as the *Maxim* case, the Chancellor addressed the other variant on option manipulation — spring-loading. The shareholder-approved option plan at issue in *In re Tyson Foods, Inc. Consolidated Shareholder Litigation* required options' exercise prices to be no less than the closing price on the day of the grant. The plaintiffs alleged that at least four option grants were deliberately timed to occur shortly before public announcements that the directors knew would increase the stock price, making the options much more valuable virtually overnight. The plaintiffs alleged that Tyson's directors represented to shareholders that options were issued at "market rate" strike prices pursuant to the plan, while knowingly violating the letter and spirit of that plan by manipulating the grants of stock options so as to precede the Company's release of positive, market-moving news.

The Chancellor characterized the director defendants' public representation of compliance with the stock option plan as a "partial, selective disclosure — if not itself a lie, certainly exceptional parsimony with the truth — [which] constitutes an act of 'actual artifice'…"[9] Further, the Court declared that "[i]t is difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at 'market rate' and simultaneously withhold that both the fiduciary and the recipient knew at the time that those options would quickly be worth much more."[10] Thus, the Court held that for purposes of the motion to dismiss stage of the litigation, "plaintiffs are entitled to the reasonable inference of conduct inconsistent with a fiduciary duty."[11]

Turning to whether the directors who approved the spring-loaded options could possibly demonstrate that they did so in good faith, the Court found that "[w]hether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating" because "[a]t their heart, all backdated options involve a fundamental, incontrovertible lie" regarding the date of the grant, whereas "[a]llegations of spring-loading implicate a much more subtle deception."[12] Specifically, unlike backdating, spring-loading may not violate the letter of a stock option plan, because the exercise price of the options is set at the market price on the date of the grant. Nonetheless, the Court held that "[g] ranting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception."[13] As the Court explained:

> A director's duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary. It is inconsistent with such duty for a board of directors to ask for shareholder approval of an incentive stock option plan and then later to distribute shares to managers in such a way as to undermine the very objectives approved by shareholders. This remains true even if the board complies with the strict letter of a shareholder-approved plan as it relates to strike prices or issue dates.
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> A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.[14]

The Court emphasized, however, that not all instances of spring-loading would necessarily violate a board's fiduciary duties. In particular, when the element of deception is not present, spring-loading might not be found unlawful. As an example, the Court noted that directors might, in the exercise of good faith business judgment, determine that in-the-money options are an appropriate form of executive compensation, and that they might not breach any duties if they grant such options and disclose to shareholders that they have done so. Alternatively, there would be no breach of fiduciary duty if the shareholders have expressly empowered the board to use spring-loading as part of the company's executive compensation.

The Court concluded that allegations of spring-loading will be sufficient to allege a breach of the fiduciary duty of loyalty, as long as the plaintiff alleges that (a) the options were issued pursuant to a shareholder-approved stock option plan, (b) the directors approved the options while in the possession of material non-public information soon to be released that would impact the company's stock price, and (c) the directors issued the options with the intent to circumvent shareholder-approved restrictions on the exercise price.[15] Because the plaintiffs in the *Tyson* case had alleged these facts, the Court denied the defendants' motion to dismiss the fiduciary duty claim based on spring-loading.

The Court also declined to dismiss the plaintiffs' "unjust enrichment" claims against the recipients of the spring-loaded options, including persons who were not involved in the actual granting of those options. The Court explained that "[w]here the beneficiary of disloyalty is not directly liable for losses, that beneficiary might still be found to retain money or property of another against the fundamental principles of justice or equity and good conscience, and thus to be unjustly enriched."[16] Therefore, a defendant may be required to disgorge a benefit under an unjust enrichment theory even if he did not cause the spring-loading.

The Application Of The Maxim/Tyson Standards: Desimone V. Barrows And Conrad V. Blank

The next two opinions to address the precepts set forth in *Maxim* and *Tyson* were *DeSimone v. Barrows*[17] and *Conrad v. Blank*.[18] In *DeSimone*, the plaintiff alleged both backdating and spring-loading in the grant of options to rank and file employees, officers and outside directors. As to the employee options, the plaintiff alleged that an internal memorandum set forth specific facts that detailed exactly how the options had been deliberately backdated. Because none of the directors were alleged to have a financial interest in these options or were alleged to lack independence, the demand excusal analysis was limited to whether any of the directors faced a substantial threat of personal liability.

The Court held that demand was not excused as to the employee grants claim because the complaint pled "no facts to suggest that any member of the board was involved in the details" of the employee grants.[19] Rather, the complaint merely alleged that the compensation committee administered the option plan — an option plan that expressly allowed the delegation of granting rank and file employee options to the company's executive officers. In light of that delegation, the plaintiff could not allege that the compensation committee knowingly approved the grants. While the Court found that a strong inference could be drawn that the chief financial officer, a defendant, had deliberately backdated the options and covered it up, those facts could not implicate any of the directors. The plaintiff also argued that the directors abdicated their duty of oversight by ignoring deficient internal controls on the options granting system. The Court determined that conclusory allegations of deficient internal controls and a failure to plead facts to show that the board had reason to suspect wrongdoing were insufficient. The claim was dismissed for failure to adequately plead that demand would be futile.

The next set of option grants the Court examined, the grants to officers of the corporation, fared no better. Once again, the plaintiff had to admit that he did not have any idea "how, when or by whom" the officer grants were issued.[20] Even if the Court were to presume that the compensation committee either issued these grants or had direct knowledge of them, the compensation committee constituted only one third of the board. This claim was dismissed for the failure to satisfy demand excusal.

The plaintiff challenged the officer grants in the alternative as having been either spring-loaded or issued immediately after a negative news release (the less-common form of manipulation known as "bullet-dodging"). As to the bullet-dodging allegation, the Court noted that "I am skeptical that a bare allegation that a board of directors made a discretionary issuance of stock options at the market stock price after releasing negative information can ever be sufficient in itself to state a claim of director disloyalty…"[21] The Court rejected the spring-loading allegations because the complaint did not allege that the directors were aware of the positive information at the time they made the grant and because the positive information was not "clearly market-moving" as had been the allegation by the plaintiffs in *Tyson*.[22]

The plaintiff's final salvo was to challenge two grants to the outside directors as having been manipulated. Because a majority of the board was financially interested in these grants, the Court held that demand was excused. The Court went on to dismiss the claim for failure to state a claim because the plaintiff admitted that the grants were non-discretionary and were automatically granted each year on the date of the annual shareholders' meeting.[23]

In *Conrad v. Blank*, the plaintiff challenged twelve option grants at Staples, Inc. as having been backdated. The complaint was filed after Staples had taken a $10.8 million charge to account for options that an internal review committee determined had "incorrect measurement dates."[24] Because the complaint alleged that the compensation committee — not the board — issued the grants in question, *Rales v. Blasband*[25] governed the demand analysis. At the beginning of its *Rales* analysis, the Court noted its displeasure that the company had not disclosed any details about the review committee's findings, that there appeared to be no attempt to seek reparation from anyone, and that the corporation and directors moving to dismiss the complaint were represented by the same counsel. The Court stated that:

> after finding substantial evidence that options were, in fact, mispriced, the company and the audit committee ended their "review" without explanation and apparently without seeking redress of any kind. In these circumstances, it would be odd if Delaware required a stockholder to make demand on the board of directors before suing on those very same theories of recovery.[26]

Under these facts, the Court held that demand was excused.

Defendants argued that the *DeSimone* holding required the plaintiff to allege that the compensation committee, which had the responsibility of administering the option plans, *knowingly* approved backdated options. The Court distinguished *DeSimone*, noting that the *DeSimone* plan gave the compensation committee powers of delegation, while the plan in this case did not. The Court therefore determined that "it is less likely than was true in *DeSimone* that the compensation committee could innocently or unknowingly authorize backdated options."[27]

Finally, defendants challenged the plaintiff's derivative standing under 8 Del. C. § 327 to assert breach of fiduciary duty claims for option grants that occurred before she acquired her stock. The plaintiff argued that the backdating was a unitary scheme, and therefore constituted a "continuing wrong" that could be excepted from the standing requirement. The Court determined that each option grant was a separate transaction, and that the plaintiff lacked standing to challenge those grants that occurred before she acquired her stock. The Court did not dismiss the claims, however. Troubled by the lack of disclosure about what the internal review committee found with regard to the backdating and the lack of remediation from any of the defendants or others at the corporation, the Court directed the parties to make supplemental submissions about whether a stockholder with standing to address those earlier grants would be willing to intervene in the action.[28]

Conclusion

Chancery's examination of allegations of options manipulation is still in its nascent stage. To the authors' knowledge, no such case has yet advanced far beyond the motion to dismiss stage. How the Court will handle matters of evidence, etc., remains to be seen. If the opinions examined in this article are any guide, however, the Court will have little tolerance for officers and directors who appear to have deliberately engaged in this self-interested behavior and have hidden it from the company's shareholders.

1 Stuart M. Grant is a Managing Director and Cynthia A. Calder is a Director of Grant & Eisenhofer P.A., a firm concentrating its practice in securities, corporate governance and class action litigation on behalf of institutional investors. Contact: sgrant@gelaw.com.

2 Charles Forelle & James Bandler, *The Perfect Payday – Some CEOs Reap Millions By Landing Stock Options When They Are Most Valuable; Luck – Or Something Else?*, Wall St. J., Mar. 18, 2006. For example, the Perfect Payday article noted that the odds of Affiliated Computer Services' CEO receiving options on days associated with trading lows in six different years merely by coincidence were *one in 300 billion*.

3 *Options Pricing: Hindsight Is 20/20*, Merrill Lynch Pierce Fenner & Smith, May 23, 2006.

4 918 A.2d 341 (Del. Ch. 2007).

5 *Id.* at 350; *see also Brandin v. Deason*, ___ A.2d ___, C.A. No. 2123-VCL, 2007 WL 4788444, at * 3 (Del. Ch., July 20, 2007) (denying motion to stay action alleging options backdating in favor of litigation in another jurisdiction, based, in part, on fact that allegations presented novel issues of Delaware corporate law).

6 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

7 918 A.2d at 354-55. Interestingly, the Court only grudgingly accepted statistical evidence of option backdating presented by an expert at a trial seeking to enforce a shareholder's §220 rights in *Louisiana Municipal Police Employees' Retirement System v. Countrywide Financial Corp.*, C.A. No. 2608-VCN, 2007 WL 2896540 (Del. Ch. Oct. 2, 2007). That reluctance could be explained, in part, by the procedural context (trial, compared to a motion to dismiss in *Maxim*) and by the fact that the corporation also presented expert testimony that it was not statistically improbable that the options were granted at low prices by fortuity.

8 *Id.* at 355-56.

9 919 A.2d 563, 590 (Del. Ch. 2007).

10 *Id.* at 590-91.

11 *Id.*

12 *Id.* at 592.

13 *Id.*

14 *Id.* at 592-93.

15 *Id.* at 593.

16 *Id.* at n. 72.

17 924 A.2d 908 (Del. Ch. 2007).

18 940 A.2d 28 (Del. Ch. 2007).

19 924 A.2d at 938.

20 *Id.* at 942.

21 *Id.* at 944.

22 *Id.* at 945.

23 *Id.* at 948-49.

24 940 A.2d at 37.

25 634 A.2d 927 (Del. 1993).

26 940 A.2d at 38.

27 *Id.* at 38-39.

28 *Id.* at 41. *In Melzer v. CNET Networks*, Inc., 934 A.2d 912 (Del. Ch. 2007), the Court granted a shareholder §220 inspection rights as to option grants that occurred before the shareholder acquired the company's stock. The Court held that such information could be used by the shareholder to demonstrate a sustained or systemic failure of oversight by the board sufficient to excuse demand.

Grant & Eisenhofer