The Delaware Court of Chancery Speaks on Option Backdating and Spring-Loading

Stuart M. Grant and Megan D. McIntyre[1]

INTRODUCTION

On February 6, 2007, the Delaware Court of Chancery issued two significant decisions in derivative cases involving allegations of stock option backdating[2] and spring-loading.[3] In the first decision, involving allegations of backdating at Maxim Integrated Products, Inc., the Chancellor recognized that stock option backdating is inherently deceptive and that "[a] director who approves the backdating of options faces at the very *least* a substantial likelihood of liability" for breaching the fiduciary duty of loyalty. In the second case, involving allegations of stock option spring-loading at Tyson Foods, Inc., the Chancellor held that spring-loading — while not always as clearly deceptive as backdating — will give rise to breach of fiduciary duty claims when it is done with the intent to evade stockholder-approved limitations on the exercise price of stock options.

Maxim

Maxim was one of numerous companies whose stock option timing was the subject of a 2006 report by Merrill Lynch, which concluded that these companies' executives had received so many fortuitously timed stock options that backdating seemed to be a likely explanation. Following the release of this report, derivative actions were filed in federal court and in the Delaware Court of Chancery, alleging that stock options had been backdated and seeking to recover the damages caused to Maxim as a result of the alleged backdating. The Delaware case, entitled Ryan v. Gifford, Civil Action No. 2213-N (Del. Ch.), alleged that Maxim's shareholder-approved employee stock option plan expressly forbade the granting of options at exercise prices below the closing price on the date of the grant, but that Maxim's compensation committee had deliberately violated that plan by surreptitiously backdating option grants to earlier dates when the stock price was at low levels. Then, the plaintiffs alleged, the directors failed to disclose this conduct to the shareholders and instead falsely represented the dates of the option grants in public disclosures.

The defendants moved to stay the Delaware proceeding in favor of an earlier-filed federal action, or in the alternative to dismiss the case on a variety of grounds. In an opinion dated February 6, 2007, the Court of Chancery denied the motion to stay the case in deference to the federal action, finding that the question of whether stock option backdating violates Delaware's common law fiduciary duties is a question "of great import to the law of corporations" and that "Delaware has an overwhelming interest in resolving requests of first impression under Delaware law." Mem. Op. at 12-13.

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 plaintiffs 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. 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. For the same reasons, the Court rejected the defendants' argument that the plaintiffs had failed to state a claim for breach of fiduciary duty.

In coming to these conclusions, the Court rejected the defendants' suggestion that the fortuitous timing of their option grants was merely coincidental:

> Plaintiff supports his claim that backdating occurred by pointing to nine option grants over a six-year period where each option was granted during a low point. That is, 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.
>
> *　　　*　　　*　　　*
>
> 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…

Mem. Op. at 22-23 & n.34.

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 held that "[a] board's knowing and intentional decision to exceed the shareholders' grant of express (but limited) authority raises doubt regarding whether such decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand." Mem. Op. at 22. Significantly, the Court then went a step further and 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."
>
> * * * *
>
> 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. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.

Mem. Op. at 25, 30 (citation and footnote omitted). Thus, it is very clear from this opinion that the Court of Chancery takes a very dim view of stock option backdating, and that cases alleging breach of fiduciary duty based on such practices will have a high likelihood of success in Delaware.

Tyson

In the case entitled In re Tyson Foods, Inc. Consolidated Shareholder Litigation, Consol. C.A. No. 1106 (Del. Ch.), the plaintiffs challenged a variety of transactions, including several option grants, as breaches of fiduciary duty by Tyson's directors. With regard to the option grants, the plaintiffs alleged that at least four grants were spring-loaded — i.e., deliberately timed to occur shortly before public announcements that the directors knew would increase the stock price. As in the Maxim case, Tyson's shareholder-approved stock option plan required options' exercise prices to be no less than the closing price on the day of the grant. 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.

In an opinion issued on the same day as the opinion in the Maxim case, 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'…" Mem. Op. at 48. 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." Id. at 49. 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." Id.

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." Mem. Op. at 52. 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." 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.
>
> * * * *
>
> 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.

Mem. Op. at 53-54 (internal footnote omitted)

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*. Id. at 52 n.75. 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. Id. at 55.

The Court concluded that allegations of spring-loading[4] 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. Mem. Op. at 54-55. 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." Mem. Op. at 51 n.72 (internal quotations and citation omitted). Therefore, a defendant may be required to disgorge a benefit under an unjust enrichment theory, "even though he may have received [it] honestly in the first instance." Id. at 75 (citation omitted).[5]

Conclusion

Both of these cases represent strong pronouncements by the Delaware Court of Chancery that directors who backdate or spring-load options in violation of either the letter or the spirit of shareholder-approved option plans are likely to be found liable for breaches of the fiduciary duty of loyalty. Additionally, the Court has recognized that a company (or its shareholders acting derivatively) can pursue claims for unjust enrichment against the recipients of the options, even if those recipients are not blameworthy in connection with the option timing itself. These holdings will undoubtedly be very influential in future cases involving option timing, given the prominence of the Delaware courts in matters of Delaware law.

1 This article appears in the **Practising Law Institute Course Handbook**, No. 10849 / April 2007. Stuart M. Grant and Megan D, McIntyre are directors of the law firm of Grant & Eisenhofer P.A., a litigation boutique with offices in New York City and Wilmington, Delaware, representing institutional investors in securities litigation and corporate governance matters in state and federal courts throughout the United States. Mr. Grant and Ms. McIntyre are co-lead counsel for the plaintiffs in the Tyson litigation which is discussed in this article.

2 Stock option backdating occurs when stock options are granted on one date, but dated so they appear to have been granted on an earlier date when the stock price was lower. This results in a reduction of the exercise price of the option — which is typically tied to the stock price — to the benefit of the option recipient and to the detriment of the issuing company.

3 Stock option spring-loading refers to the practice of intentionally timing stock option grants so they occur just prior to the release of information which is expected to result in an increase in the stock price. The result is similar to backdating, in that the option receives a lower exercise price than would have applied if the options were granted after the information became public.

4 The Court indicated that its comments would be equally applicable to cases involving allegations of "bullet-dodging" — a practice in which option grants are deliberately delayed until after the issuance of negative news which is expected to decrease the stock price (and, therefore, the exercise price).

5 5 In the Maxim case, the Court held that an unjust enrichment claim can be pursued regardless of whether the options have been exercised.

This page has been intentionally left blank.

Grant & Eisenhofer

info@gelaw.com
www.gelaw.com

1201 North Market Street
Wilmington, DE 19801
Office.302.622.7000
Fax.302.622.7100

485 Lexington Avenue
New York, NY 10017
Office.646.722.8500
Fax.646.722.8501