Delaware Court of Chancery Addresses Stock Option Dating & Timing Issues

By Alexandra A. E. Shapiro & Blair G. Connelly

Alexandra A. E. Shapiro and Blair G. Connelly are partners in the New York office of Latham & Watkins LLP. Ms. Shapiro specializes in securities, white collar and appellate litigation. Mr. Connelly specializes in corporate governance, securities and insurance coverage litigation. The authors are grateful to associate Derrick Farrell for editorial and research assistance. Contact: alexandra.shapiro@lw.com or blair.connelly@lw.com.

In response to a media avalanche beginning with an article published in The Wall Street Journal on March 18, 2006, as well as academic studies questioning the timing of stock option grants at numerous corporations, approximately 150 public companies in the U.S. have now been subjected to investigations related to their stock option practices and procedures. Many companies have subsequently announced the need for restatements due to accounting errors resulting from options timing problems. Inevitably, this flurry of investigative activity—by the companies’ own Boards of Directors, as well as the Securities and Exchange Commission, the U.S. Attorney’s Offices, and the Internal Revenue Service—and the potential for restatements has led to a wave of private litigation, including federal class-action securities cases and shareholder derivative actions. However, in contrast to the other corporate scandals in recent years, the class-action “stock drop” lawsuits arising from option timing issues do not appear to pose as significant a threat to companies and their officers and directors as the many derivative suits that have been filed. The reason is that, unlike many class-action cases stemming from investigations of accounting fraud—where the impact to the bottom-line can be significant and sometimes enterprise-threatening—the share price of most companies under investigation for options timing issues recovered quite quickly, and the impact of the disclosures does not appear to pose a long-term threat to shareholder value.

Many of the derivative suits that have been filed in federal and state courts across the country raise significant issues arising under not only the federal securities laws, but also state corporate law. On February 6, 2007, the Delaware Court of Chancery decided two major cases that address issues related to stock option backdating (Ryan v. Gifford) and spring-loading (In re Tyson Foods, Inc.). Given Delaware’s prominent status in the field of corporate law, these decisions can be expected to have far-reaching implications even for companies incorporated in other states. These cases provide insight into how courts in Delaware and possibly other jurisdictions may resolve key questions arising in many options timing derivative suits, including the circumstances in which demand may be excused as futile, when the business judgment rule will
shield directors’ decisions relating to stock option grants, when the statute of limitations may be tolled in these cases on grounds of fraudulent concealment. The two decisions and their potential scope are discussed below.

**Ryan v. Gifford**

Maxim is a Delaware corporation that designs and manufactures electronic circuits used in microprocessor-based electronic equipment. Its shares are publicly traded. From 1998 to mid-2002, Maxim’s board of directors and compensation committee granted millions of stock options to John Gifford, Maxim’s founder, chairman of the board, and CEO. These options were granted pursuant to a shareholder-approved stock option plan. According to the complaint, the plans required that “[t]he exercise price of each option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the option on the date the option is granted.”

In early 2006, Merrill Lynch conducted an analysis of the timing of stock options granted between 1997 and 2002 by semiconductor and semiconductor equipment companies comprising the Philadelphia Semiconductor Index. Merrill Lynch found that the twenty-day return on options granted to Maxim’s management averaged 14% over the five-year period between 1997 and 2002, which amounted to an annualized return of 243%—almost ten times higher than the 29% annualized market returns in the same period.

Based in part on this report, shareholder Robert McKinney filed a federal derivative action in the Northern District of California on May 22, 2006. His complaint alleges breach of fiduciary duty, abuse of control, gross mismanagement, constructive fraud, corporate waste, and violations of sections 10(b) and 14(a) of the Securities Exchange Act of 1934 and SEC Rules 10b-5 and 14a-9. Three weeks later, on June 2, 2006, a different plaintiff (Walter Ryan) filed a derivative action in Delaware, asserting claims for breach of fiduciary duty and unjust enrichment. Both complaints allege, in essence, that the board members violated their fiduciary duties by actively allowing Maxim to “backdate” at least nine option grants issued to Gifford. “Backdating” in this context refers to allegations that the company purported to grant “at-the-money” options bearing an exercise price equivalent to the fair market value of the shares’ closing price on the date of the grant, but actually granted the options at a later date, when the share price was higher. If true, this would mean that the options were actually granted “in-the-money”—in other words, they were discounted options and thus subject to different accounting and tax rules. Ryan’s complaint alleges that the “backdating” caused Maxim to (1) receive lower payments when Gifford exercised his options, (2) suffer adverse tax and accounting effects and (3) overstate its profits while at the same time unjustly enriching Gifford in violation of the shareholder-approved plans. Ryan also alleged that the backdating rendered the company’s disclosures regarding executive compensation false and misleading.

The defendants subsequently moved to dismiss or stay the Delaware case on the ground that the California case was filed earlier. Alternatively, the defendants argued, *inter alia*, that (1) plaintiff had not made a demand on the board requesting that the company bring the lawsuit itself, and had not adequately alleged that making such a demand would be futile; and (2) in any event, the challenged conduct was protected by the business judgment rule.

**The Court refused to defer to the first-filed suit because the stock option backdating allegations raised important issues of Delaware law**

The Court declined the defendant’s invitation to dismiss or stay the case in deference to the earlier California litigation, finding that the suit raised important issues of first impression on which the Delaware courts should opine. The Court explained that allegations of stock option backdating raise many novel issues “including the propriety of this type of executive compensation, requisite disclosures that must accompany such compensation, and the legal implications of intentional non-compliance with shareholder-approved plans . . . to name only a few.” The Court opined that whether backdating options violates fiduciary duties is a question “of great import to the law of corporations” and that “[i]nvestors are challenging this very practice in many courts throughout the United States,” including the Court of Chancery, which has “not as yet addressed these fundamental issues.”

The Court held that because Delaware has an “overwhelming” interest in resolving questions of first impression under Delaware law, it would not stay the action in favor of the prior filed California litigation. The Court explained that “[a]n answer regarding the legality of these practices pursuant to Delaware law plainly will affect not only the parties to this action, but also parties in other civil and criminal proceedings where Delaware law controls or applies.”

**The court held that a demand on the board was excused because the board had no discretion to backdate option grants under the plan terms**

Settled Delaware law establishes that there are two situations in which a shareholder purporting to sue on behalf of the corporation will be excused from making a demand: “Failure to make demand may be excused if a plaintiff can raise a reason to doubt that: (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.” Here, the Court rejected the defendants’ argument that the plaintiff had failed to allege facts sufficient to show that a demand on the board would be futile, on two alternative grounds.

First, the Court held that the stock plans in question prohibited the Compensation Committee from granting discounted options and, accordingly, “backdating” the options, as alleged, could not be a valid exercise of business judgment. The stock option plans required that “[t]he exercise price
of each option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the option on the date the option is granted”; thus, the board lacked discretion to contravene those terms by “falsifying the date on which options were granted,” which would amount to violating “an express provision of two option plans and exceed[ing] the shareholders’ grant of express authority.”11 The Court held that the “unusual facts alleged” raised enough reason to doubt “that the challenged transactions resulted from a valid exercise of business judgment,” and demand was therefore excused.12

Second, the Court also found, as an alternative ground, sufficient reason to doubt that the board could be independent and disinterested when considering a demand. Such doubt can exist when the directors who have been sued have a potential for liability that “is not a mere threat but instead may rise to a substantial likelihood.”13 In this case, all three of the Compensation Committee members who approved the challenged grants were still on the board at the time the complaint was filed. Thus, out of the six-member board, plaintiff had alleged that three had approved the grants (and another had accepted them).14

The Court concluded that 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 . . . and yet satisfy his duty of loyalty.”15 Even though allegations of demand futility based on the theory that the directors likely would not vote to sue themselves are normally insufficient to defeat the business judgment rule, here, according to the Court, “[b]ackdating 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.”16 Accordingly, the plaintiff had made “sufficient allegations to raise a reason to doubt the disinterestedness of the current board and to suggest that they are incapable of impartially considering a demand.”17

The Court Classified Deliberate Stock Option Backdating In Violation Of An Approved Plan, Coupled With False Disclosures, As “Bad Faith” Conduct That Is Not Protected By The Business Judgment Rule

The Court rejected defendants’ argument that the board’s conduct was protected by the business judgment rule, concluding that plaintiff had successfully rebutted the rule by a showing that the board breached its duty of loyalty, and that “such a breach may be shown where the board acts intentionally, in bad faith, or for personal gain.”18 Again accepting the pleaded facts as true for purposes of the motion to dismiss, the Court held that “the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors’ purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith.”19 The Court added that it was “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 compiled honestly with the shareholder-approved option plan, is anything but an act of bad faith.”20 Thus, the Court denied the motion to dismiss based on the business judgment rule.21

The Court Held That The Statute of Limitations Was Tolled Based On Fraudulent Concealment

The defendants argued that the suit was barred by Delaware’s applicable 3-year statute of limitations, and that there was no basis to toll the statute because plaintiff could have discovered the alleged backdating by reviewing the company’s filings, as the Merrill Lynch study illustrated. The Court rejected this argument, holding that the statute of limitations was equitably tolled under the fraudulent concealment doctrine to the extent that defendants concealed that the dates on which the options were granted were not the same as the date defendants had represented were the grant dates in the company’s public filings. Even though a shareholder theoretically could have discovered the alleged wrongdoing through publicly available documents the Court concluded that this did not preclude tolling the statute under the circumstances. The Court reasoned that although “[s]hareholders may be expected to exercise reasonable diligence with respect to their shares . . . this diligence does not require a shareholder to conduct complicated statistical analysis in order to uncover alleged malfeasance.”22

Plaintiff Stated a Claim for Unjust Enrichment Even Though Defendant’s Stock Options Were Neither Sold Nor Exercised

Finally, the defendants argued that plaintiff’s unjust enrichment claim should be dismissed because the complaint did not allege that Gifford exercised any of the allegedly backdated options, and therefore he did not obtain any benefit to which he was not entitled to the detriment of another. The Court disagreed, and held that there may be a reasonably conceivable set of circumstances under which Gifford may have been unjustly enriched. The Court noted that Gifford still retains the alleged backdated stock options and can exercise them at any time. Thus, the Court opined that pursuant to an unjust enrichment theory it could “rely on expert testimony to determine the true value of the option grants or simply rescind them.”23

In re Tyson Foods, Inc.

Eric Meyer, a Tyson shareholder, brought a derivative action in September 2005 in the Delaware Court of Chancery alleging corporate waste, unjust enrichment and breach of fiduciary duty. Meyer’s complaint challenged the legality of $163 million in payments by Tyson Foods to members of the Don Tyson family and Tyson Foods’ board members. On January 11, 2006, the Court consolidated this action with a similar action filed in February 2005 by an institutional Tyson Foods shareholder.24
The consolidated complaint concentrates on three types of alleged board malfeasance: (1) approval of consulting contracts that provided lucrative and undisclosed benefits to corporate insiders; (2) stock options granted between 1999 and 2003 to insiders, which were “spring-loaded” stock options (i.e., granted just before the release of news that insiders knew would cause the stock price to rise); and (3) acceptance of related-party transactions that favored insiders at the expense of shareholders.  

Subsequently, defendants moved to dismiss on the grounds that: (1) many of the claims were barred by the statute of limitations; (2) many of the claims were brought against directors who had little or nothing to do with the challenged transactions; (3) demand was not excused; and (4) plaintiffs failed to state a claim for which relief can be granted. The discussion below focuses only on those aspects of the opinion that relate to spring-loading stock options.

**The Court Told The Statute of Limitations Under The Fraudulent Concealment Doctrine**

As in Ryan, defendants asserted that the fraudulent concealment doctrine did not apply because plaintiff could have discovered the improper conduct through public filings. Defendants pointed out that “any shareholder could have compared the stock option award with the year’s news clippings and realized that, for instance, the 1999 options had been granted the day before Tyson announced the sale of the Pork Group for $80 million.” The Court disagreed, however, holding that plaintiff adequately plead fraudulent concealment by alleging that defendants knowingly spring-loaded options to key executives and directors while maintaining in public disclosures that such options were issued at market rates. The Court concluded that “it would be manifest injustice for this Court to conclude, as a matter of law, that ‘reasonable diligence’ includes an obligation to sift through a proxy statement, on the one hand, and a year’s worth of press clippings and other filings, on the other, in order to establish a pattern concealed by those whose duty is to guard the interests of the investor.”

The Court also suggested that even if fraudulent concealment did not apply, the statute of limitations would be equitably tolled, because plaintiffs were entitled to rely on the competence and good faith of those protecting their interest. The Court reasoned 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.” Nevertheless, the Court suggested that if defendants could establish that financial analysts, institutional investors, or academic researchers had published research suggesting that the directors favorably timed option grants long before the consolidated complaint was filed, then that might justify a strict application of the statute of limitations.

**Spring-loading Options Can Violate the Duty of Loyalty**

The Court found spring-loading to present a “more difficult question” than backdating, but nonetheless held that 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.” In order to demonstrate that a spring-loaded option issued by a disinterested and independent board was nevertheless beyond the bounds of business judgment and adequate to demonstrate at the pleading stage that a director acted disloyally and in bad faith, according to the Court, “a plaintiff must allege that options were issued according to a shareholder approved employee compensation plan” and also “that the directors that approved spring-loaded (or bullet-dodging) options possessed material non-public information soon to be released that would impact the company’s share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options.”

**Potential Implications of the Decisions**

Although the full implications of Ryan and Tyson Foods remain to be seen, several points are worth bearing in mind in terms of their potential scope:

**First**, the lynchpin of Ryan’s holding on demand futility appears to have been the Court’s conclusion that the stock plan did not authorize the board to grant discounted options. The Court expressly relied on plan language providing that “the exercise price of each option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the option on the date the option is granted.” Not all of the 150 or so companies involved in options timing investigations and litigation have stock plans requiring all grants to be “at-the-money,” as Maxim’s plan did.

In fact, a number of these companies granted options pursuant to plans containing language that expressly authorized the compensation committee or board to grant discounted options. If these companies effectively granted discounted options, even if not intentionally (e.g., as a result of mistakes in their grant administration process that led to accounting errors), that would not exceed the directors’ authority under the plans and thus, the reasoning in Ryan excusing the demand requirement would not seem to apply. Indeed, in Tyson the Court observed that plaintiffs’ allegation that the plan there “required that the price of the option be no lower than the fair market value of the company’s stock on the day of the grant,” was an oversimplification of “a more complex and nuanced Stock Incentive Plan.” Specifically, the Court pointed out, the Tyson plan (in contrast to the Ryan plan) only required that “incentive stock options” be priced at fair market value on the date of the grant, whereas, with respect to “nonqualified stock options,” the price could be “equal to, less than or more than” fair market value on the date of the grant. Accordingly, the business judgment rule...
should remain available in cases in which the stock plan may be read to authorize discounted options, even if the options were intended to be granted at-the-money.

Second, the Court noted “unique facts” about the composition of the board that were critical to its finding of demand futility in Ryan that might not be present in other cases. As noted above, in Ryan the challenged grants had been made by a three-member Compensation Committee that comprised half of the total board, and all three members remained on the board at the time the complaint was filed. Under those circumstances, the Court found that it would be futile to make a demand because half the board on which the demand would be made was directly implicated in the challenged conduct. The same conclusion would not necessarily apply if, for example: (i) the Compensation Committee comprised less than half the board, or (ii) the membership of the board had changed, such that there was a majority of disinterested and independent directors free to consider the demand at the time the complaint was filed.

Third, in refusing to dismiss or stay the case, the Ryan Court was not presented with a situation in which the board of directors delegates its authority to consider whether to bring an action against officers and directors to a special litigation committee (“SLC”). There is settled case law in Delaware as well as other jurisdictions establishing that where the board has delegated this authority to a disinterested SLC, a shareholder derivative suit should be stayed or dismissed in favor of the SLC. In fact, the Delaware Court of Chancery has explained that “[t]he first thing that takes place is that the Special Litigation Committee, upon being appointed, promptly moves on the corporation’s behalf for a stay of all discovery by the plaintiff pending the investigation and report of the Committee. It is a foregone conclusion that such a stay must be granted. Otherwise . . . the inherent right of the board of directors to control and look to the well-being of the corporation in the first instance [] collapses.”

Indeed, at least one court has stayed a derivative case raising options timing issues in deference to an SLC notwithstanding allegations that the conduct was prohibited by the plan’s terms. Thus, to the extent that defendants can establish that the SLC is independent and excludes all directors who may have been involved in the decisions related to the challenged option grants, they may secure dismissal or a stay even if plaintiffs can allege that the option grants contravened the board’s authority under the stock plan.

Fourth, although the Court’s refusal to dismiss on statute of limitations grounds is not particularly encouraging, the fact that academics such as Erik Lie and reporters at The Wall Street Journal were able to put forth “backdating” theories based on analysis of years of publicly-available information disclosed in company filings, does suggest that shareholders have been on notice as to this possibility for information disclosed in company filings, does suggest that theories based on analysis of years of publicly-available Wall Street Journal articles are not particularly encouraging, the Court’s refusal to defer to a first-filed suit. Moreover, many of the derivative actions in these cases—even those involving Delaware corporations—have been filed in other jurisdictions in any event.

Sixth, Tyson suggests that it will be difficult to prove (even if not to plead) a claim of breach of the duty of loyalty based on allegedly spring-loaded (or bullet-dodging) options. The Court states that in order to show that spring-loading is “beyond the bounds of business judgment,” the plaintiff must allege (1) that the options were issued pursuant to a shareholder-approved plan, and (2) that the directors who approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options. In other words, where the stock plan in question was adopted by the board and not put to a shareholder vote, the holding does not apply. More significantly, it will likely be difficult to prove that directors issued options with specific intent to evade shareholder-approved restrictions on the exercise price. In that regard, the Court seems to contemplate a showing of scienter that will be difficult for plaintiffs to demonstrate in the vast majority of cases.

It is important to bear in mind that both cases were decided on motions to dismiss, and therefore the Court was obliged to assume that the allegations were true and draw all inferences in favor of the plaintiff. In many cases, of course, the facts will refute allegations that directors and officers acted in bad faith, and defendants will be able to demonstrate that, even if the company accounted for its option grants improperly or made mistakes in its public disclosures, these errors were unintentional and the challenged decisions should therefore be shielded by the business judgment rule. Similarly, the Court’s holding on the statute of limitations in Ryan necessarily depends upon an assumption that facts were fraudulently concealed. Clearly, if the facts developed in discovery show that defendants acted in good faith and did not commit fraudulent backdating, a valid business judgment rule defense may be available at summary judgment in appropriate circumstances.

Notes
2. Id. at *8.
3. Id. at *2.
4. Id. at *2-3.
5. Id. at *3-4.
6. Id. at *5.6
7. Id.
8. Id.
9. Id. at *7.
10. Id. at *10.
11. Id. at *8-9.
12. Id.
13. Id. at *10.
14. Id. at *8.
15. Id. at *10.
16. Id. (emphasis added).
17. Id.
18. Id.
19. Id. at *11.
20. Id. at *12.
21. Id.
22. Id. at *12-13.
23. Id. at *14.
25. Id. at *4.
26. Id. at *10.
27. Id. at *16.
28. Id. *16-17.
29. Id. at *17.
30. Id.
31. Id.
32. Id. at *18.
33. Bullet-dodging is the practice by which a company intentionally postpones an option grant until after bad news is disclosed so that employees receive lower-priced options.
34. Id. at *19.
35. Ryan at *8.
36. Tyson at *5, n. 15.
37. Id.
38. Ryan at *8.
41. Ryan at *5.
42. Tyson at *19.