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Delaware Chancery Court Addresses Stock Option Backdating and "Spring-Loading"

For much of the last year, alleged manipulations of stock option grants have been in the news and the subject of intense scrutiny by government officials, law enforcement agencies, corporate boards and the plaintiffs' bar. On February 6, Chancellor Chandler of the Delaware Court of Chancery issued two decisions addressing whether lawsuits can proceed that seek to hold directors liable for option backdating, as well as for so-called "spring-loaded" and "bullet-dodging" option grants. These decisions are the first by a Delaware court to address these important issues. *See In re Tyson Foods, Inc. Consol. S'holder Litig.*, C.A. No. 1106-N (Del. Ch. Feb. 6, 2007); *Ryan* v. *Gifford*, C.A. No. 2213-N (Del. Ch. Feb. 6, 2007).

Both decisions, in derivative lawsuits brought by shareholders purportedly on behalf of the corporation, denied directors' motions to dismiss the complaints as a matter of law, which required the Court to assume that the plaintiffs' factual allegations were true. A plaintiff bringing a derivative complaint is generally required to first make a demand on the corporation's board of directors to remedy the alleged misconduct and to decide whether a lawsuit would be in the best interests of the corporation. This demand requirement is excused, however, where there is a reason to doubt whether the challenged transactions involved valid exercise of business judgment or that a majority of the directors would have been independent and disinterested when considering the demand.

In *Ryan* v. *Gifford*, the plaintiff sued members of the compensation committee and other directors of Maxim Integrated Products, Inc., a chip maker, alleging that they had breached their fiduciary duties by approving backdated options that violated shareholder-approved stock option plans, which specifically provided that the exercise price of all options would be no less than the fair market value of Maxim's common stock on the day the options were granted. Based solely on empirical data and statistical analyses indicating that the advantageously low stock prices on option grant dates were unlikely to be the result of mere chance, the complaint alleged that Maxim's CEO was awarded backdated options on at least nine occasions. The Court concluded that the plaintiff should be excused from having to comply with the demand requirement, stating that "[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." The Court also found that the complaint's factual allegations were sufficient to support a finding that the directors' actions were intentional and a violation of their duty of loyalty. The Court stated that it was "convinced 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. . . . It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary."

In *In re Tyson Foods*, plaintiffs alleged that the board of directors of Tyson Foods, Inc. granted "spring-loaded" stock options to insiders. Spring-loaded options are granted before the release of material information reasonably expected to drive the stock price higher while the

company's public disclosures represent that the grants were issued at market rates. (Conversely, "bullet-dodging" takes place when options are granted after the release of materially damaging information.) While acknowledging that whether spring-loading constituted a form of insider trading under the federal securities laws was unclear, the Chancellor held that for purposes of Delaware law a director who intentionally uses inside information to enrich employees in violation of shareholder-approved stock option plans breaches his fiduciary duties of good faith and loyalty. The Court found, however, that the spring-loading claim was properly alleged only against the compensation committee members who actually approved the option grants, and not the entire board.

In both cases, the Court held that the directors could not rely on the statute of limitations as a defense because the failure to comply with the requirements of the shareholder-approved stock option plans had been fraudulently concealed from the shareholders.

The Court in *Ryan* was careful to note that, should the case go to trial, the plaintiff would still have the burden of proving by a preponderance of the evidence that the defendants actually backdated options. Moreover, because of their procedural context, the opinions do not address the extent to which directors' reliance on advice from officers or experts in connection with option grants may be a defense, ultimately, to liability. Nevertheless, the Chancellor's decisions are noteworthy because they establish that intentional stock option backdating and spring-loading, if proven, are violations of a director's duty of loyalty and do not constitute good faith conduct, either of which would preclude such director from being able to take advantage of certain liability protections afforded by the Delaware Corporation Law and leave the director open to liability for monetary damages to the corporation.

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