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Client Alert

DELAWARE CHANCERY COURT ONCE AGAIN TAKES ON STOCK OPTION "BACKDATING" AND "SPRING-LOADING"

In recent months, the Delaware Chancery Court has issued several decisions with important ramifications for what has become a hot topic in corporate litigation—stock option grant dating. While much of the discussion to date has focused on actions brought by the Securities and Exchange Commission or federal prosecutors alleging violations of the federal securities laws, the recent Delaware cases are notable because they were brought by private litigants seeking damages from directors for allegedly breaching their fiduciary duties under state law. In the first two opinions released in February 2007, the Court refused to dismiss derivative suits alleging that the boards of directors of Maxim Integrated Products[1] and Tyson Foods[2] breached their fiduciary duties by engaging in manipulative option dating practices.[3] In so ruling, the Court made clear its position that a *knowing* or *intentional* grant of options in violation of shareholder-adopted plans can constitute a breach of a director's fiduciary duties to act loyally and in good faith.

In both *Ryan* and *Tyson*, shareholders had adopted an option plan which required that options be granted with a strike price of not less than the fair market value of the underlying shares on the grant date. In *Ryan*, the plaintiff asserted a classic "backdating" scheme, alleging that Maxim's compensation committee granted options on one date but issued false documents which indicated that the options were actually issued earlier. The Court condemned the practice of backdating in unusually harsh terms. "I am unable to fathom a situation," Chancellor Chandler explained, "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." In the Court's view, the directors' actions did not "amount to faithful and devoted conduct of a loyal fiduciary." As a result, the allegations were sufficient to rebut the application of the business judgment rule and to survive a motion to dismiss.

In *Tyson*, the plaintiffs alleged that the compensation committee "spring-loaded" option grants by issuing stock options shortly before the announcement of positive news that they knew would cause the stock price to rise. According to the Court, if the directors, at the time of the grants, were aware of material non-public positive information, then they knew that they were granting options with exercise prices that were less than the actual value of the underlying shares on the date of the grant, even though such prices technically equaled the then current market price of those shares. This, the Court posited, may "implicate a much more subtle deception" than backdating and, if proven at trial, would constitute conduct that is inconsistent with a director's

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[1] *Ryan v. Gifford*, 2007 WL 416162 (Del. Ch.).

[2] *In re Tyson Foods, Inc. Consol. Shareholder Litig.*, 2007 WL 416132 (Del. Ch.).

[3] The *Ryan* and *Tyson* decisions are discussed in greater detail in our Client Alert entitled "Delaware Chancery Court Takes on Stock Option 'Backdating' and 'Spring-Loading'" dated February 28, 2007.

"duty to deal fairly and honestly with the shareholders for whom he is a fiduciary" where it is done "in such a way as to undermine the very objectives approved by shareholders."

Together, *Ryan* and *Tyson* established the proposition that, in the view of the Chancery Court, *knowingly* or *intentionally* backdating or spring-loading stock option grants, in violation of either the letter or spirit of limitations imposed by shareholder-adopted plans, may very well constitute a breach of a director's fiduciary duties of loyalty and good faith.

Earlier this month, the Chancery Court issued its most recent decision regarding stock option grant dating.[4] In *Desimone*, the plaintiff alleged that the directors of Sycamore Networks breached their fiduciary duties by backdating and spring-loading option grants. Sycamore Networks found itself the subject of U.S. Department of Justice and Securities and Exchange Commission investigations, and was forced to restate its financial statements, due to stock option grant improprieties. Despite this, in dismissing the plaintiff's complaint, the Chancery Court distinguished *Desimone* from both *Ryan* and *Tyson* in two important respects. First, unlike in *Ryan* and *Tyson*, the directors in *Desimone* were operating under a shareholder-approved plan that expressly permitted them to grant options below market value. Second, the Court found that the plaintiff in *Desimone* pled no facts which suggested that the directors included in the option grants intentionally manipulated the options or were incapable of acting independently of those directors who themselves received options. In fact, the Court was very critical of the level of diligence performed by the plaintiff in *Desimone* in putting together its case.[5] In the Court's own words, "it is not rational to infer from the pled facts that the board harbored any illicit intent to enrich the recipients at the expense of the Sycamore stockholders or to subvert the purposes of Sycamore's stockholder-approved plan through clever timing." For these reasons, the Court ruled that the plaintiff's complaint failed to state a claim under the standards established in *Ryan* and *Tyson*, and it was therefore dismissed.

The dismissal of the plaintiff's complaint in *Desimone* re-affirms the Court's earlier holdings in *Ryan* and *Tyson*: a claim exists where the directors knowingly or intentionally backdate or spring-load option grants in violation of a shareholder-approved plan. On the other hand, if a plaintiff fails to present allegations as substantial as those pled in *Ryan* and particularly in *Tyson*, the Court will not allow the case to proceed. In other words, it will not be sufficient to refer to instances of backdating or spring-loading and expect the Court to infer that directors knowingly or intentionally participated. Rather, there must be some compelling linkage between the improper option grants and the directors' conduct.

It should be noted that one very important implication flows from the Chancery Court's recent discussion of option dating issues. Because the Chancery Court characterized the directors' alleged actions in *Ryan* and *Tyson* as potential violations of their duties of good faith and loyalty, directors who intentionally backdate or spring-load options may face personal liability. Under Section 102(b)(7) of the Delaware General Corporation Law, while directors cannot be held

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[4] *Desimone v. Barrows*, C.A. No. 2210-VCS (Del. Ch. June 7, 2007)

[5] According to the Court:

> "The weakness of Desimone's allegations in comparison to those in the *Tyson* case may not be entirely coincidental. Just as his allegations are strikingly less substantial, so was the amount of effort put into his pleading. In *Tyson*, the plaintiffs tenaciously sought books and records from a reluctant corporation for a year before filing their derivative complaint, and they used those books and records to file the sort of particularized pleading expected from derivative plaintiffs. Desimone rushed into court, making generalized charges of wrongdoing unaccompanied by fact pleading about the involvement of the directors in the improprieties he contends occurred. Perhaps as a result, his complaint must be dismissed."

personally liable for breaches of their duty of care (assuming that their corporation's certificate of incorporation gives effect to Section 102(b)(7)), they cannot be excused from liability for actions taken in bad faith or actions that constitute a breach of their duty of loyalty. The Chancery Court's refusal to dismiss the *Ryan* and *Tyson* lawsuits will likely encourage plaintiffs to bring actions against the boards of other corporations that have been touched by the recent stock option dating scandals, and to seek to hold the directors personally liable. However, *Desimone* suggests that the Court will act with restraint when confronted with future option dating claims, and that plaintiffs looking to extend the Court's decisions in *Ryan* and *Tyson* may have difficulty doing so.

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