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Client Alert

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

Earlier this month, the Delaware Chancery Court issued two decisions with important ramifications for what is sure to be one of this year's hot topics in corporate litigation—stock option grant dating. While most 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 two recent Delaware cases are notable in that they were brought by private litigants and seek damages for alleged breaches by directors of their fiduciary duties under state law. In two strongly-worded opinions, Chancellor William Chandler refused to dismiss derivative suits alleging breaches of fiduciary duty by the boards of directors of Maxim Integrated Products[1] and Tyson Foods.[2] 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 duty 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 other words, both plans prohibited the granting of "in-the-money" options. The plaintiffs in both cases alleged that the compensation committees of the respective boards intentionally granted options that were effectively in-the-money options on the date they were granted.

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. Importantly, the plaintiff had not alleged any specific facts showing *actual* backdating by the committee. Rather, the plaintiff relied on the fact that each of the challenged grants was made on a date on which Maxim's stock traded at unusually low (if not the lowest) trading days of the year in question, or on days immediately preceding sharp increases in the market price of the stock. The Court found the timing of these grants to be "too fortuitous to be mere coincidence."[3] Still, the Court noted the procedural posture of the case — the Court was addressing a motion to dismiss — and made it clear that such a statistical probability would likely *not* be enough if the case were to proceed to trial. In such case, the plaintiff would have to demonstrate by a preponderance of the evidence that the directors "*in fact* backdated options."[4]

Nevertheless, 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

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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] *Id.* at *9.
[4] *Id.* at *12, n.49 (emphasis added).

to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith."[5] In the Court's view, the plaintiff's allegations of conduct that "certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary"[6] were sufficient both 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 were aware 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 would have known that they were granting options with exercise prices that were less than the actual value of the underlying shares on the date of grant, even though such exercises prices technically equaled the then current market price of those shares. In this regard, the Chancery Court focused on what would amount to the directors' violation of the spirit—if not the technical requirements—of the shareholder-adopted option plan. 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 "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."[7]

These are the first cases decided by the Delaware Chancery Court involving stock option grant timing issues. Prior cases had focused on backdating or spring-loading as violations of SEC disclosure obligations, tax and accounting rules or anti-fraud laws. Moreover, at least one prior case[8] had refused to infer wrongdoing from the repeatedly fortuitous timing of option grants and held that plaintiffs had not overcome the business judgment rule's presumptions that the directors had satisfied their dual duties of care and loyalty. But *Ryan* and *Tyson* demonstrate that the Chancery Court considers that instances of knowing and intentional backdating and spring-loading, in violation of either the letter or spirit of limitations imposed by shareholder-adopted option plans, may very well constitute a breach of directors' fiduciary duties of loyalty and good faith.

One very important implication of the Chancery Court's focus on the potential bad faith and disloyalty evidenced by the directors' alleged actions in *Ryan* and *Tyson* is that directors may face personal liability for intentionally backdating or spring-loading options. Under Section 102(b)(7) of the Delaware General Corporation Law, while directors cannot be held personally liable for breaches of their duty of care, they are not exculpated for actions taken in bad faith or that constitute a breach of their duty of loyalty. The Chancery Court's refusal to dismiss the *Ryan* and *Tyson* lawsuits, coupled with the strong language used by the Court to condemn stock option backdating and spring-loading, will likely encourage plaintiffs not only to bring actions against the boards of other corporations that have been touched by the recent stock option dating scandals, but to seek to hold the directors personally liable.

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[5] *Id.* at *12.
[6] *Id.* at *12.
[7] *In re Tyson*, 2007 WL 416132 at **17-18.
[8] *See In re Linear Technology Corp. Derivative Litig.*, C-06-3290-MMC (N.D. Cal. Dec. 7, 2006).

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