



JONES DAY COMMENTARY

TWO DELAWARE CHANCERY COURT CASES ON BACKDATING AND SPRING-LOADING STOCK OPTIONS INCREASE THE STAKES FOR DIRECTORS

Two potentially important Delaware law decisions were published on February 6, relating to potential director liability in the highly charged area of option pricing, particularly “spring-loading” and “backdating.” While each case was decided in response to a motion to dismiss where all facts alleged must be considered to be true, and the decisions do not constitute findings of actual liability, unless they are reversed on appeal or superseded, they are likely to add to the supercharged atmosphere in which directors of public companies are making decisions about granting equity-linked incentive awards. The cases will also be of concern to the roughly 150 companies presently involved in options-related investigations.

KEY OBSERVATIONS ABOUT THE DECISIONS

Spring-Loading and Backdating May Breach Duty of Loyalty. Depending on the particular facts at hand, the decisions indicate that a director may be deemed

to have breached his or her duty of loyalty by acting deceptively and in bad faith (and therefore outside the protections of the business judgment rule and personal liability limitations in the charters of most public companies) by authorizing the granting of options priced at a time when the director knows those options will be quickly worth more upon the subsequent release of material, nonpublic information. To quote one of the decisions, intentional backdating is 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.”

Disclosures Critical. Depending on the circumstances, where directors intentionally violate a stockholder-approved option plan by backdating options, and a company makes fraudulent disclosures regarding the directors’ purported compliance with such plan in SEC filings or other public disclosures, the

directors may be deemed to have acted in bad faith. In such circumstances, directors may lose the indemnification and other liability protections afforded by the Delaware General Corporation Law and may be personally liable for resulting damages to the company.

However, Liability Not Shown. Notably, neither case involved a finding of liability; instead, both decisions merely allowed the cases to proceed. While we expect to see more lawsuits alleging that managers or compensation committee members authorized the grant of options in a manner prohibited by such plans or while in possession of material, nonpublic information, it is likely that in many “spring-loading” cases, plaintiffs will have substantial difficulty proving that a compensation committee “knew” that the company’s stock price would increase. In short, like the much-ballyhooed *Disney* parachute decision at the motion-to-dismiss stage, it may be that such complaints will survive motions to dismiss but not give rise to actual liability when litigated to conclusion.

Effects on Future Practices. The SEC recently amended the compensation disclosure rules for public companies’ proxy statements and other reports. The new rules, among other things, require companies, in their compensation discussion and analysis (“CD&A”), to discuss practices regarding the timing and pricing of stock option grants, including practices of selecting option grant dates for executive officers in coordination with the release of material, nonpublic information; the timing of option grants to executive officers in relation to option grants to employees generally; the role of the compensation committee and the executive officers in determining the timing of option grants; and the formula used to set the exercise price of an option grant. These cases are likely to cause companies to consider changing the process by which they grant equity-linked awards, including, possibly, modifying plan terms to specifically give directors more discretion or, possibly, less latitude in determining the strike price of option grants. For example, we may see plans amended to permit grants only during a company’s “trading window.”

THE CASES

A summary of the key facts of the *Tyson* and *Ryan* cases and the courts’ analyses follows.

In re Tyson Foods, Inc. Consol. S’holder Litig., C.A. No. 1106-N (Del. Ch. Feb. 6, 2007), 2007 WL 416132, involved allegations that members of Tyson Foods’ compensation committee violated their fiduciary duties by approving spring-loaded options from 1999 to 2003. The alleged instances of “well-timed” option grants included several instances in which grants were made immediately preceding the announcement of a material divestiture or acquisition or the announcement of highly favorable quarterly earnings. The plaintiffs claimed that these announcements increased Tyson’s stock price and put the newly granted options “in the money.” In each instance, the announcement resulted in a significant increase in Tyson’s stock price. The plaintiffs alleged that the options were granted pursuant to a stock incentive plan approved by Tyson’s stockholders that required, as equity plans typically do, the exercise price of every option to be at or above the fair market value of Tyson’s stock on the date of grant.

The *Tyson* court concluded that, without explicit authorization from the stockholders, the granting of options at a time when the director is in possession of positive material, nonpublic information involved indirect deception by the director. The court’s rationale for this conclusion was that it is inconsistent with a director’s fiduciary duty to ask for stockholder approval of a stock option plan that requires granting of options at fair market value and then later grant options in such a way as to undermine the terms approved by stockholders.

The *Tyson* court stated that “[a] director who intentionally uses inside knowledge not available to stockholders in order to enrich employees while avoiding shareholder-imposed requirements” contained in stock incentive plans cannot “be said to be acting loyally and in good faith.” But, according to the decision, it was the deception involved, not the “in the money” nature of the option, that is actionable and made the business judgment rule unavailable. The *Tyson* court said that it was “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.”

Ultimately, *Tyson* may be reversed, but even if permitted to stand, its holdings will not necessarily result in the imposition of personal liability on the members of the Tyson compensation committee if litigated to conclusion. Prior federal securities law cases have held that the award of equity-linked rights to management cannot be challenged when the compensation committee is apprised of material, nonpublic information. To us, recognizing that the terms of a particular plan may dictate a result, a determination of “fair market value” is not formulaistic or susceptible of exact definition. If, for example, the compensation committee approves awards at 8:00 a.m. on a given day, should “market price” be the closing sales price on the prior day, the current day, some average of closing prices over a period, or a weighted average and, if so, over what period? Is it good policy, or consistent with decades of Delaware jurisprudence, for plan terms to be interpreted in such a manner as to foreclose the exercise of director judgment in this regard? Moreover, the *Tyson* complaint alleges that the compensation committee “knew” that the value of Tyson stock would go up, but this will likely be difficult to prove at trial.¹

Ryan v. Gifford, C.A. No. 2213-N (Del. Ch. Feb. 6, 2007), 2007 WL 416162, involved allegations that options granted to management of Maxim Integrated Products by that company’s compensation committee were backdated. The 20-day return on options granted to management averaged 243 percent (annualized) over a five-year period. This return was 20 times higher than the annualized returns for the company’s stock during the same five-year period. The plaintiff-stockholder sued the company’s directors derivatively.

As in *Tyson*, the *Ryan* court excused the plaintiff from making demand, in part, because, in the court’s view, 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.’” The plaintiff’s allegations were, according to the *Ryan* court, sufficient to raise a reason to doubt the disinterestedness of Maxim’s board and to suggest that they were incapable of impartially considering demand. The *Ryan* court stated that intentional violation of a stockholder-approved option plan, coupled with inaccurate disclosures in proxy statements regarding the directors’ purported compliance with that plan, constitutes conduct that is disloyal to the corporation and in bad faith. In this regard, the *Ryan* court observed that a board has “no discretion to contravene the terms of stock-option plans.”²

PROCEDURAL NOTE

Both opinions addressed defendants’ motions to dismiss the complaints, and in *Ryan*, the court was careful to note that:

- At this stage (a motion to dismiss), a plaintiff’s allegations are assumed to be true, and
- If the cases were ultimately to reach trial, to prevail, the plaintiff would need to demonstrate by a preponderance of the evidence that the defendants backdated or spring-loaded options and intended to circumvent company-approved policies and procedures regarding the grant or exercise price of company stock options (in which case they would not be afforded the protections of the business judgment rule).

Nonetheless, given the practical dynamics of derivative litigation, the Chancery Court’s analysis in *Tyson* and *Ryan* is likely to give the plaintiffs’ bar more leverage in the early stages of litigation that alleges the granting of backdated and spring-loaded options and make it more likely that such suits will survive a motion to dismiss.

1. The *Tyson* court also held that the statute of limitations may not run where it would be practically impossible for a plaintiff to discover the existence of a cause of action, where a defendant has fraudulently concealed the facts necessary to put a plaintiff on notice of the breach, or where the plaintiff reasonably relied upon the competence and good faith of a fiduciary.

2. Mirroring the opinion in *Tyson*, the *Ryan* court also concluded that fraudulent concealment of facts related to the alleged backdating of options tolled the statute of limitations.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Robert Profusek

1.212.326.3800

rprofusek@jonesday.com

Louis Rorimer

1.216.586.7224

lrorimer@jonesday.com

Lizanne Thomas

1.404.581.8411

lthomas@jonesday.com

Manan Shah

1.212.326.3986

mdshah@jonesday.com

Philip Stamatakos

1.312.269.4097

pstamatakos@jonesday.com

Gidon Caine

1.650.739.3952

gcaine@jonesday.com

Lyle Ganske

1.216.586.7264

lgganske@jonesday.com

Robert Clarkson

1.650.739.3996

rtclarkson@jonesday.com

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