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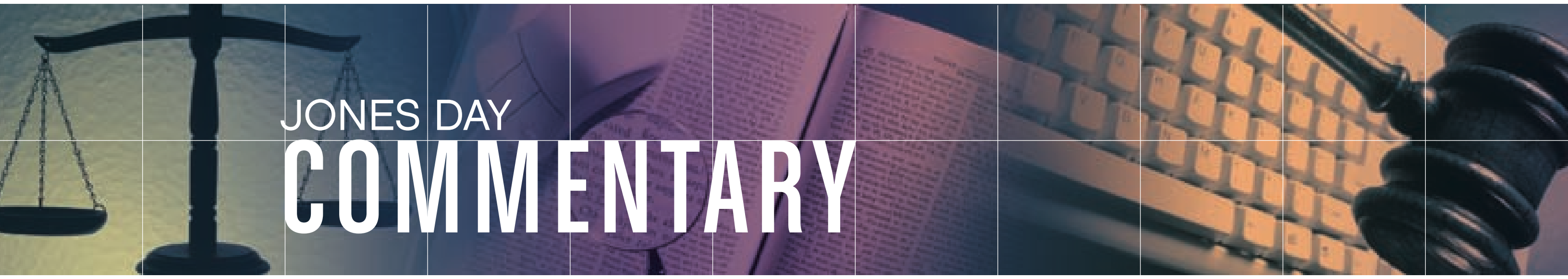

REASSURING NEW DELAWARE DECISION ON OPTION MEASUREMENT DATE ISSUES

Vice Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery recently decided an option dating case (*Desimone v. Barrows*, C.A. No. 2210-VCS (Del. Ch. June 7, 2007) involving Sycamore Networks that takes much of the sting out of his colleague Chancellor Chandler's previous *Tyson* and *Ryan* decisions. It's a very long decision (copies available by request) on a motion to dismiss a derivative case, written in Vice Chancellor Strine's typically cerebral (and sometimes acerbic) style.

The practical lessons of the *Desimone* decision are two—one that instructs companies on award practices that should protect against option dating claims in the future, and one that heightens support for boards in addressing any option dating claims that may arise. First, Vice Chancellor Strine calls out a number of option award practices that operate as meaningful counterpoints to any allegations of measurement date manipulation: vesting schedules, restrictions on transfer or pledge, preannounced grant dates, and formula or nondiscretionary awards, particularly for directors. Notably, while these award practices are not universal, they certainly are not novel, either. Second, for those companies facing derivative actions involving option dating, Vice Chancellor Strine broadly supported a board's ability to consider the allegations itself (to avoid the so-called demand futility, which would allow a plaintiff to proceed directly in court). In fact, he concluded that to state a claim, a plaintiff must allege specifically and director-by-director that *more than half of the board* knew and chose to disregard the inadequacy of internal controls that would have prevented measure date manipulation. A high hurdle indeed.

A more lengthy discussion follows. The key holdings in *Desimone* are:

- The plaintiff lacked standing to challenge grants made prior to the time he became a stockholder and could not use the "continuing wrong" doctrine because the option grants were discrete events.

- The circumstances were not sufficient to establish demand futility. As to allegedly "springloaded" options (which, of course, were at issue in *Tyson*), Vice Chancellor Strine held:

  "[Plaintiff's] insinuation that the April 9, 2001 Grants were intended as a hidden bonus is undercut by the reality that the Grants were subject to a three-year vesting schedule with sharp restrictions on pledging the options received. Put simply, 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 options plan through clever timing of these Grants." (p. 9.)

- As to the formula-based director grants, Vice Chancellor Strine held that the plaintiff did not state a claim:

  > The Sycamore stockholders approved the issuance of the exact number of options to be awarded annually to the Outside Directors and the date of issuance. All that is alleged by [plaintiff] is that in two of the years, the plan-specified date of issuance was preceded by the regular disclosure of an earnings release containing negative information. The only difference between that and every other year is the negative nature of the information; in other years, the annual meeting was also preceded by the company's disclosure of its results for the preceding quarter. In sum, the complaint does not plead any deviation from the precise terms of the non-discretionary plan or from Sycamore's regular disclosure schedule. *To hold that [plaintiff] states a claim in these circumstances would prevent corporations from fairly implementing a non-suspicious program for awarding options, by penalizing participants by denying them (because the law would label it suspect to do otherwise) a regularly-scheduled award of options whenever the market price on the date that the plan dictates that the annual award be made is affected in a negative way by the news in a prior, regularly-scheduled quarterly report.* The very point of a plan like Sycamore's that sets in advance, with stockholder approval, the amount and dates on which grants of options to directors will be made is to ensure integrity by making the directors suffer the ugly and enjoy the good that comes with a consistent, non-discretionary approach. (pp. 10-11; emphasis added.)

Had Vice Chancellor Strine stopped here, the decision might not have been of great import. As he is wont to do, however, he then spent 60 additional pages cosmically analyzing the entire range of option backdating/spring-loading/bullet-dodging issues, all with the obvious intent of tamping down the enthusiasm of strike suitors.

First, Vice Chancellor Strine clarified that the "continuing wrong" doctrine is a very narrow exception to the requirement that the plaintiff own shares as of the time of the alleged wrong, and that it does not sweep up transactions "simply because they are similar or relate to transactions or other conduct that occurred later." (p. 25.) This is important because, in most option backdating cases, it will be difficult to find a willing plaintiff who held stock during the period of actual backdating (which, interestingly, seems to be almost exclusively a pre-Enron activity). Likewise, Vice Chancellor Strine held that an alleged cover-up is not sufficient to invoke the continuing wrong theory. (pp. 26-28.)

More importantly, Vice Chancellor Strine emphasized that "[m]ere notice pleading is insufficient to meet the plaintiff's burden to show demand excused" under Delaware's seminal case in this area, *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). He emphasized that the terms of the plans at issue here did not explicitly require that options be granted at fair market value on the date of grant and even noted that it could be a legitimate exercise of a board's business judgment to issue options at a trading low point in that circumstance, as long as there was no misrepresentation that the options were granted at fair market value. Noting, however, that contravention of the express terms of the plans at issue was not the only potential cause for concern in the *Tyson* and *Ryan* cases, Vice Chancellor Strine explained:

That point highlights the second important difference between this case and *Ryan* and *Tyson*. In contrast to the plaintiff in *Ryan*, plaintiff . . . has pled no facts to suggest even the hint of a culpable state of mind on the part of any director. Likewise, [plaintiff] has not, as was done in *Tyson*, pled any facts to suggest that any director was incapable of acting independently of the recipients of any of the Employee or Officer Grants. The absence of pled facts of these kinds underscores the utility of a cautious, non-generic approach to addressing the various options practices now under challenge in many lawsuits. The various practices have jurisprudential implications that are also diverse, not identical, and the policy purposes of different bodies of related law (corporate, securities, and tax) could be lost if courts do not proceed with prudence. Indeed, within the corporate law alone, there are subtle issues raised by options practices.

. . .

In this same vein, the importance and utility of the Delaware Supreme Court's recent decision in *Stone v. Ritter*, reinforcing the vitality of this court's decision in *In re Caremark Int'l Inc. Deriv. Litig.* should not be ignored. Some respected scholars seem to fear that *Stone* opens directors to new kinds of claims foreclosed by *Caremark*, while others read it as taking away a non-scienter based claim *Caremark* supposedly seems to suggest. Neither position seems entirely consistent with the decision itself. *Stone* clarified one of the most difficult questions in corporate law—when directors with no motivation to injure the firm can be held responsible if the corporation incurs serious harm as a result of its failure to obey the law. What *Stone* makes clear is that *Caremark* and its progeny, such as *Guttman v. Huang*, are still good law. For reasons *Caremark* well-explained, to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care. *Caremark* itself encouraged directors to act with reasonable diligence, but plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director—bad faith—because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance. By reinforcing that a scienter-based standard applies to claims in the delicate monitoring context, *Stone* ensured that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded. *Stone* has obvious implications for cases like this, when a plaintiff seeks to hold directors accountable for failing to prevent backdating by corporate officers. (pp. 36-44.)

In short, Vice Chancellor Strine believes that all measurement date cases are not alike, and that substantial knowledge of wrongdoing must be credibly and specifically pled to support a demand-excused complaint:

> In order to state a viable *Caremark* claim, and to predicate a substantial likelihood of director liability on it, a plaintiff must plead the existence of facts suggesting that the board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed. (p. 52.)

As such, in order to maintain a valid demand-excused complaint, "a derivative complaint must plead facts *specific* to *each director*, demonstrating that at least half of them could not have exercised disinterested business judgment in responding to a demand." (pp. 58-59; emphasis in original.)

While *Desimone* isn't a panacea for all measure date cases, it's crystal clear that Vice Chancellor Strine was trying to send a strong message. We think he succeeded.

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