Assessing Risk From Options Grants Under Delaware Law

By Peter B. Ladig and Stephen B. Brauerman

In 2007 the Delaware Court of Chancery issued a series of decisions addressing the practice of options granting, specifically backdating and "spring loading" options. These decisions have begun to shape the battlefield on which these claims will be decided, not only in Delaware, but throughout the nation, for years to come.

The Problem With Manipulating Stock Options

By linking executive compensation with company performance, properly issued options grants can help maximize corporate efficiencies by incentivizing management to increase profitability and the corresponding shareholder return. Recently, however, an alarming number of companies have faced public scrutiny from equity holders, the press, and the investment community for allegedly backdating and spring-loading options awarded to directors. Companies caught in the crossfire, and those wishing to avoid it, must understand the problems options manipulation presents and the mechanics by which such actions are challenged.

The case law has identified two primary methods of manipulating stock options: backdating and spring loading.[1] Backdating occurs when a company issues stock options along with falsified documentation that reflects an earlier issuance date. The falsified date often corresponds with an unusually low stock price, which provides corporate executives - often the same executives who approve the stock grants - a windfall because the timing of the issuance inflates the value of the stock options. Not surprisingly, Delaware courts have expressed a strong interest in resolving "all of the intricacies potentially associated with stock options backdating claims" and emphasized Delaware's "sizable interest in resolving such novel issues to promote uniformity and clarity in the law."[2]

Although the deception associated with spring loading is more subtle than with backdating, the practice has nonetheless drawn the watchful eye of the court. With spring loading, a company issues options grants in accordance with a shareholder-approved compensation plan at then-current market values while possessing "favorable, material non-public information that will likely increase the stock price when disclosed."[3] Spring-loading options violates a director's duty to deal fairly and honestly with shareholders because the options are issued at a time when management "knows those shares are actually worth more than the exercise price."[4] As the Court of Chancery explained, "[a] director who intentionally uses inside knowledge not available to shareholders in order to enrich [insiders] while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary."[5]

Companies with spring-loading concerns should take care to investigate the potential for backdating as well, which could adversely color the lens through which the Court reviews the challenged action. Consistent with Delaware's oft-stated deference to the independence of corporate executives to manage their companies free from Court interference, those companies that undertake active investigations and take steps to remedy any wrongdoing discovered will inevitably fare better in the eyes of the Court, even if the remedy falls short of what the Court itself might have awarded.

Procedural Concerns

When assessing potential liability from manipulated options grants, companies should consider several important procedural requirements that may bar shareholder challenges. Companies should consider whether the shareholder bringing the action has standing to do so, whether the jurisdiction in which he brought the action is appropriate, and whether the action can proceed in light of the statute of limitations. While technical in nature, each of these procedural requirements may limit liability for stock options manipulation and should not be overlooked in any risk assessment.

Standing

Section 327 of the General Corporation Law of the State of Delaware requires that a shareholder seeking to assert a derivative action have owned the company's stock when the conduct he seeks to challenge occurred. Although intended to prevent litigious investors from "buying" a lawsuit, the strict application of Section 327 has prevented shareholders from legitimately challenging questionable grants issued before their stock ownership. Although not unique to stock options cases, the surreptitious nature of these grants makes prompt discovery of derivative causes of action more difficult. Indeed, Section 327 limited the number of option grants the shareholder-plaintiff could challenge in almost half of the recent decisions addressing the issue.[6]

Several plaintiffs have sought to escape the formalistic operation of Section 327 using the continuing wrong theory, which permits the challenge a pattern of "continuing wrongs," even if it pre-dated a plaintiff's ownership interest. Despite its appeal, the Court has refused to allow the continuing wrong theory to avoid Section 327 and has clearly held that each options grant is a separate action, which must be challenged separately.[7]

Notwithstanding the rules set forth in Section 327, the Chancery Court has shown that it is uncomfortable allowing the conduct of potentially faithless fiduciaries to go without a remedy. For instance, in Conrad v. Black, the Court conditioned dismissal of the pre-ownership claims on "the receipt of further information from the parties about the possibility of some other stockholder intervening to assert those early claims, or the adoption of some other measure to preserve those claims in the event that they prove to be of value."[8] The Court's willingness to protect derivative interests, especially in light of the company's inaction, could

... continued on page 14

Assessing Risk ... *(continued from page 13)*

lead to creative, equitable remedies if a shareholder with standing cannot be found. Conrad's message notwithstanding, risk assessments should include a consideration of whether Section 327 narrow's liability by limiting the number of grants existing shareholders can challenge.

JURISDICTION

When faced with the expense of overlapping lawsuits in different courts, companies will understandably seek to litigate in only one jurisdiction. Principles of fairness and judicial economy ordinarily persuade courts to accede to the jurisdiction in which the first case was filed for resolution of all common issues. Companies, however, should not, at least in the short-term, expect Delaware courts to follow this practice in the stock options context. Because of Delaware's paramount interest in ensuring that "a corporation's stockholders receive fair and consistent enforcement of their rights" and the need to clarify the novel issues presented by challenges to options granting practices under Delaware law, Delaware courts will likely retain jurisdiction over such actions, even when faced with first-filed cases in sister jurisdictions.[9]

STATUTE OF LIMITATIONS

By analogy, a three-year statute of limitations applies to claims relating to breaches of fiduciary duty associated with stock options manipulation. Ordinarily, the statute begins to run when a defendant commits a harmful act, regardless of the plaintiff's awareness of his potential cause of action. Two primary doctrines, however, may justify tolling the statute of limitations: fraudulent concealment, and equitable tolling. Fraudulent concealment applies where the defendant prevented the plaintiff from gaining knowledge of material facts or led the plaintiff away from the truth. Equitable tolling applies where the plaintiff reasonably relied on the competence and good faith of a fiduciary, so long as the investor did not know or have reason to know of the facts constituting the wrong."[10] The lack of transparency associated with backdating and spring loading increases the likelihood that plaintiffs may successfully toll the statute of limitations.

The Court of Chancery's opinions addressing this issue have focused upon the extent to which public disclosure is necessary to avoid the effects of the tolling doctrines. In Tyson, the Court found disclosure of allegedly spring-loaded grants in the company's proxy statements insufficient to avoid the doctrines of fraudulent concealment and equitable tolling. As the Court explained, "partial, selective disclosure - if not itself a lie, certainly exceptional parsimony with the truth - constitutes an act of 'actual artifice' that satisfies the requirements of the doctrine of fraudulent concealment."[11] The Court also noted that the director defendants' status as fiduciaries would justify tolling the statute even in the absence of fraudulent concealment.

The Court similarly observed in Ryan v. Gifford that a plaintiff "may rely on public filings and accept them as true, and need not assume that directors and officers will falsify such filings."[12] The Court explained that when a company falsifies public filings, it may not rely on the statute of limitations until the plaintiff is placed on inquiry notice that such filings were fraudulent. Nor is the fact a suspicious investor could, with the aid of complicated statistical analysis, discover potential wrongdoing from information contained in a company's public filings sufficient to avoid tolling the statute of limitations.[13] Although these early rulings have narrowed the utility of the limitations defense, it is still viable provided sufficient disclosure has been made in the past.

CONCLUSION

Given Delaware's influence on corporate law and the attention options manipulation suits have already received from investors and the press, the Court of Chancery's early decisions in this area provide helpful insight for corporate management to evaluate the potential liability. Companies can reduce liability by undertaking thorough investigations that yield concrete remedies for the company and its shareholders. Procedural considerations like standing, jurisdiction, and the statute of limitations may minimize liability or form the basis for a company's initial defenses. Corporate actors should continue to monitor developments from the Court of Chancery as Delaware's jurisprudence on stock options manipulation evolves.

Peter B. Ladig is a director and Stephen B. Brauerman is an associate at the law firm of Bayard P.A. in Wilmington, Delaware. The views expressed herein are the authors' own, and do not represent the views of Bayard P.A. or its clients. Mr. Ladig and Mr. Brauerman can be reached at 302-655-5000.

1 An alternative method to manipulate stock options is bullet-dodging, which occurs when a company grants options just after releasing negative information to the market so that the recipient benefits from a lower exercise reflective of the negative publicity. Bullet-dodging has not received much attention, but the concerns implicated by backdating and spring loading apply by analogy.

2 Brandin v. Deason, 2007 WL 2088877, at *3 (Del. Ch.).

3 Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007).

4 In re Tyson Foods Consolidated Shareholder Litigation, 919 A.2d 563, 593 (Del. Ch. 2006) (emphasis in original).

5 Id.

6 See, e.g. Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007); Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007); Conrad v. Black, 2007 WL 2593540 (Del. Ch.).

7 Desimone v. Barrows, 924 A.2d 908, 925 (Del. Ch. 2007).

8 Conrad v. Black, 2007 WL 2593540,at *10 (Del. Ch.).

9 Ryan v. Gifford, 918 A.2d 341, 349 (Del. Ch. 2007); Brandin v. Deason, 2007 WL 2088877, at *3 (Del. Ch.) ("[D]efendants' argument that all legal nuances associated with options backdating are crystalline is a bit sophomoric, considering that only three Delaware cases have dealt substantially with the issue to date.").

10 Id. at 585.

11 Id. at 591.

12 Bryan v. Gifford, 918 A.2d 341, 360 (Del. Ch. 2007).

13 Id.