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STOCK OPTION BACKDATING AND SPRING-LOADING: OMINOUS SIGNS FOR DIRECTORS

by
John L. Utz
Utz, Miller & Kuhn, LLC
jutz@utzmiller.com

"The Delaware Court of Chancery has issued its first rulings in connection with the stock option backdating and spring-loading allegations that began circulating in the press in 2006."

The Delaware Court of Chancery has issued its first rulings in connection with the stock option backdating and spring-loading allegations that began circulating in the press in 2006. The first of the option backdating cases is *Ryan v. Gifford*, 2007 WL 1018208 (Del. Ch. 2007). *Ryan* concerned allegations of backdating involving the stock of Maxim Integrated Products, Inc. In a shareholder derivative action, the complaint alleged that members of the company's board of directors and compensation committee breached their duties of due care and loyalty by approving or accepting backdated options that violated the clear letter of two shareholder-approved stock option plans. Those plans allegedly required that the exercise price of all stock options granted be no less than the fair market value of the company's common stock on the date of grant.

The court considered a motion by the defendants to dismiss the action. Although the court did not decide whether the board members had liability, it did say several things that should worry directors of companies that have granted back-dated options. First, the court held that the plaintiff's allegations raised a reason to doubt whether the option grants were a valid exercise of business judgment. The plaintiff claimed that the terms of the stock option plans *required* that the exercise price be not less than 100 percent of the fair market value of the stock on the date the option is granted. The board, therefore, was alleged to have no discretion to contravene the terms of the stock option plans. Altering the actual date of the grant so as to affect the exercise price would, therefore, contravene the plan. As to the business judgment rule that normally protects directors' decisions, the court said:

> 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.'
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> Adding fuel to the fire, the court added in a footnote:
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> Nor do defendant directors' concerns necessarily end with consideration of the duty of loyalty. Were the board to pursue a derivative suit, it might unearth facts that would subject directors to further civil and criminal liability. Four board members . . . were familiar with Maxim's stock option plans. In 1999, they recommended the most recent options plan and submitted it for shareholder approval accompanied by their own directorial stamps of approval. In 2000 and 2001 proxy statements filed pursuant to section 14(a) of the Securities Exchange Act of 1934,

> [three directors], representing half of the board, verified that they bore direct responsibility for granting options and that they granted all options according to the options plan.
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> Further, [the three directors] were also members of the audit committee, and as such, directly responsible for approving any false financial statements that resulted from mischaracterization of these option grants. Thus, they might be exposed to potential criminal liability for securities fraud, tax fraud, and mail and wire fraud.

The court concluded it was "convinced that the intentional violation of a shareholder-approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith." Expanding on this, the court stated:

> I am unable to fathom a situation 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. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary.

The tenor of the opinion in *Ryan* suggests that if the plaintiff is successful in proving the allegations in his complaint, the court will have little difficulty finding that the defendant directors and compensation committee members breached their duty of loyalty.

The same day that the court decided *Ryan* (concerning allegedly back-dated options), the court issued an opinion involving allegations of spring-loaded options. *In re Tyson Foods, Inc.*, 2007 WL 1018209 (Del. Ch. 2007). The plaintiffs in *Tyson* alleged that the compensation committee, at the behest of several board members, "spring-loaded" certain option grants. In particular, plaintiff alleged that days before Tyson would issue press releases that were very likely to drive stock prices higher, the compensation committee would award options to key employees.

The court said whether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than whether a board may grant backdated options. As to the latter, the court said "[a]t their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date the grant was actually made. Allegations of spring-loading implicate a much more subtle deception." In a footnote, the court expanded on its view that the backdating cases seem clearer in terms of their potential for involving violations of directors' duty of loyalty, stating:

> Although similar to spring-loading, the backdating of options always involved a factual misrepresentation to shareholders. Issuance of options in conjunction with such deception, and against the background of a shareholder-approved stock-incentive program, amounts to a disloyal act taken in bad faith.

As with the *Ryan* back-dating case, the court in *Tyson* did not decide whether board members had liability. It did, however, send a message of concern to directors of companies with spring-loaded options when it said:

"The court was 'convinced that the intentional violation of a shareholder-approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation. . ..'"

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

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> Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception. A director's duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary. It is inconsistent with such a duty for a board of directors to ask for shareholder approval of an incentive stock option plan and then later to distribute shares to managers in such a way as to undermine the very objectives approved by shareholders. This remains true even if the board complies with the strict letter of a shareholder-approved plan as it relates to strike prices or issue dates.
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> The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he *knows* those shares are actually wroth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.

Conclusion. The Delaware Chancery Court's decisions in *Ryan* and *Tyson* seem to telegraph the court's sympathy for fiduciary breach claims brought in cases involving the backdating or spring-loading of options. Later decisions will tell us more about directors' liability and the nature of any remedies available to plaintiffs, including whether compensation associated with tainted options must be returned by unknowing executives.

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Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

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emiller@utzmiller.com
Phone: 913.685.8150
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Phone: 913.685.7978
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