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Delaware Court Denies Motions to Dismiss in Two Shareholder Derivative Actions Challenging Timing of Stock Option Grants

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I. INTRODUCTION

On February 6, 2007, Chancellor Chandler of Delaware's Court of Chancery issued two important decisions relating to the purported manipulation of stock option grant dates. In both cases the court denied the defendants' motions to dismiss in large part. Given the prominence of Delaware's Court of Chancery in corporate matters, these decisions deserve careful analysis, and may provide useful lessons and insights in future stock option litigation.

II. RYAN v. GIFFORD

A. Background Facts

Between 1998 and mid-2002, Maxim Integrated Products Inc.'s ("Maxim" or the "Company") board of directors and its compensation committee granted stock options for the purchase of millions of shares of Maxim's common stock to John Gifford, the Company's founder, chairman of the board and chief executive officer, pursuant to shareholder-approved stock option plans filed with the SEC. Maxim's stock option plans provided that the exercise price of all stock options granted would be no less than the fair market value of the Company's common stock, measured by the publicly traded closing price for Maxim stock on the date of the grant.

In 2006, Merrill Lynch published a report analyzing the timing and returns of stock option grants from 1997 to 2002 for a select group of companies, including Maxim, as compared to the market returns for the same period. Merrill Lynch's report concluded that either grants were backdated at these companies or their management was remarkably effective at timing options pricing events. Subsequent to the publication of Merrill Lynch's report, plaintiff, a Maxim shareholder, filed suit against individual members of Maxim's board and the Company's compensation committee, alleging that the defendants breached their fiduciary duties of due care and loyalty by approving or accepting allegedly backdated stock option grants that violated the clear letter of the Company's shareholder-approved stock option plans. All nine grants were dated on unusually low (if not the lowest) trading days of the years in question, or on days immediately before sharp increases in the Company's stock price. The complaint also alleged that the returns for these stock options were approximately ten times higher than the annualized market returns for the same time period.

The plaintiff also contended that defendants purposefully misled shareholders regarding the board's stock option grants and caused Maxim to represent falsely that the exercise price of all the stock options it granted was no less than the fair market value of Maxim's common stock.

B. The Defendants' Motion to Dismiss

Defendants' motion was premised on the following grounds: (1) plaintiff's failure to make demand or to plead particularized facts demonstrating that demand was futile; (2) plaintiff's failure to state a claim for breach of fiduciary duty; (3) expiration of the statute of limitations; and (4) failure to plead a claim for unjust enrichment. The court largely rejected each of these grounds.

1. The "Demand Futility" Defense

Because the action at issue was a shareholder derivative litigation – where the corporation, not the shareholder plaintiff, is the allegedly injured party – the plaintiff was required to show that pre-suit demand

was made on the board to institute the action and was wrongfully refused, or alternatively that such demand should be excused as futile. No pre-suit demand was made, so the issue was whether futility had been adequately pled. Defendants' primary contention was that plaintiff failed to meet his burden of pleading demand futility with particularity because the complaint failed to show either that a majority of the directors faced a "'substantial likelihood' of personal liability for the wrongdoing alleged in the complaint" or that a majority of the Company's directors were "incapable of acting in an independent and disinterested fashion regarding demand." *Ryan v. Gifford*, 2007 WL 416162, at *7 (Del. Ch. Feb. 6, 2007).

The standard for demand futility in Delaware varies depending on whether the challenged action is caused by board action. That was a disputed issue in *Ryan*, as defendants claimed that the compensation committee, not the full board, had approved the challenged option grants. Ultimately, because of the "unique facts" present in the case – the fact that one half of the current board members had served on the compensation committee and had approved each challenged transaction – the court noted that "[w]here at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, the *Aronson* test applies." *Id.* at *8.

Plaintiff alleged, and the court agreed, that "the unusual facts alleged raise a reason to doubt that the challenged transactions resulted from a valid exercise of business judgment." *Id.* As the court went on to explain, "[a] board's knowing and intentional decision to exceed the shareholders' grant of express (but limited) authority raises doubt regarding whether such decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand." *Id.* at *9. In reaching this conclusion, the court relied on allegations of "highly suspicious timing," including that every challenged option grant occurred during the lowest market price of the month or the year in which it was granted. *Id.*

The court rejected the defendants' argument that plaintiff failed to plead demand futility with particularity, noting that plaintiff had "point[ed] to specific grants, specific language in option plans, specific public disclosures, and supporting empirical analysis to allege knowing and purposeful violations of shareholder plans and intentionally fraudulent public disclosures." *Id.* This "empirical" evidence, coupled with the timing of the grants "seem[ed] too fortuitous to be mere coincidence." *Id.* Additionally, the court observed that the fact that the grants were made sporadically, and not at set or designated times, further suggested the appearance of impropriety. *Id.* Finally, the court cited allegations of intentionally fraudulent public disclosures, and found that even if the directors were unaware that their actions violated a duty of loyalty, "[d]irectors of Delaware corporations should not be surprised to find that lying to shareholders is inconsistent with loyalty, which necessarily requires good faith." *Id.* n.35.

In addressing the alternative argument of whether demand would be futile under *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993), even if the compensation committee's decision was not imputable to the entire board, the court stated emphatically:

> A director who approves the backdating of options faces at the very least a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less), and yet satisfy his duty of loyalty. 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.

Id. at *10.

Because plaintiff alleged that three members of the board approved backdated options, and another board member accepted them, the court found that the plaintiff stated "sufficient allegations to raise a reason to doubt the disinterestedness of the current board and to suggest that they are incapable of impartially considering demand." *Id.*

2. *The "Failure to State a Claim" Defense*

Additionally, defendants asserted that plaintiff failed to state a claim for breach of fiduciary duty because

plaintiff failed to rebut the business judgment rule. The court agreed, however, with plaintiff's assertion that the same facts that established demand futility also rebutted the business judgment rule, stating "where plaintiff alleges particularized facts sufficient to prove demand futility under the second prong of *Aronson*, the plaintiff *a fortiori* rebuts the business judgment rule for the purpose of surviving a motion to dismiss." *Id.*

The court's decision goes on to explain that, in any event, even if the business judgment rule were not automatically rebutted by the same allegations that had demonstrated demand futility, because the complaint alleges bad faith, it alleged "a breach of the duty of loyalty sufficient to rebut the business judgment rule and survive a motion to dismiss." *Id.* at *11. Building on Delaware Supreme Court precedent in *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006), which held that acts taken in bad faith breach the duty of loyalty, the court stated that 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." *Id.* Additionally, the court noted that it was "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." *Id.* at *12.

3. *The "Statute of Limitations" Defense*

Defendants also argued that the three-year statute of limitations barred plaintiff's claims and that "tolling" – suspension of the statute of limitations during periods in which defendants conceal the alleged wrongdoing – was not applicable because all relevant information was public. Indeed, Merrill Lynch's report, upon which plaintiff had relied, was prepared using publicly available, disclosed information and historical stock prices. Hence, according to defendants, plaintiff could have discovered the same information that Merrill Lynch used to prepare its report. But the court found this defense "unconvincing," stating that "[s]hareholders may be expected to exercise reasonable diligence with respect to their shares, but this diligence does not require a shareholder to conduct complicated statistical analysis in order to uncover alleged malfeasance." *Id.* at *13.

Moreover, the court agreed with plaintiff's assertion that, because defendants had fraudulently and affirmatively concealed the truth about the Company's stock option grants by misrepresenting in public filings the issue dates of the grants, "prevent[ing] plaintiff from gaining material relevant knowledge in an attempt to put plaintiff off the trail of inquiry," defendants could not rely on the statute of limitations as a defense. *Id.* The court reiterated that "[i]naccurate public representations as to whether directors are in compliance with shareholder-approved stock option plans constitute fraudulent concealment of wrongdoing sufficient to toll the statute of limitations." *Id.*

4. *Plaintiff's Unjust Enrichment Claim*

Finally, defendants argued that, because plaintiff did not allege the manner in which Gifford was unjustly enriched, plaintiff's claim for unjust enrichment must fail. The court rejected this defense as "contrary both to the normal concept of remuneration and to common sense," reasoning that, because Gifford continued to hold the allegedly backdated options and was not precluded from exercising those options, and because the options had not expired, Gifford retained "something of value, at the expense of the corporation and shareholders." *Id.* at *14.

III. IN RE TYSON FOODS

The second of the two cases – *In re Tyson Foods* – did not involve stock options backdating *per se*, but dealt in part with allegations that options granted to key executives were spring-loaded – knowingly granted in advance of announcements of good news to the market – while maintaining in public disclosures that such options were issued at market rates.

Under the circumstances, Chancellor Chandler again held that plaintiffs had adequately pled demand futility and had amply demonstrated that the doctrines of equitable tolling and fraudulent concealment tolled the statute of limitations, given what he characterized as the defendants' "partial, selective disclosure." *In re Tyson Foods, Inc. Sec. Litig.*, 2007 WL 416132, at *17 (Del. Ch. Feb. 6, 2007). He also found that the defendant directors' roles as fiduciaries independently would justify tolling the statute of limitations through the

doctrine of equitable tolling (at least at the pleading stage), because "[i]t is 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." *Id.* (emphasis in original).

In *Tyson*, the court held that the complaint regarding spring-loading should properly be brought only against the members of the compensation committee at the time the options were approved. Finding that plaintiffs had failed to allege sufficient facts to support lack of independence, the court held that plaintiffs were required to demonstrate that the grant of options could not be within the bounds of the compensation committee's business judgment. The court observed that, to meet that standard, the plaintiffs needed to allege facts showing that no person could possibly authorize such a transaction if he or she were attempting in *good faith* to meet their duty, and described the relevant issue as "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 worth more than the exercise price." *Id.* at *18 (emphasis in original).

Chancellor Chandler acknowledged that whether directors may in good faith grant spring-loaded options "is a somewhat more difficult question than that posed by options backdating," because, in his view, "all backdated options involve a fundamental, incontrovertible lie," while spring-loading implicates a "much more subtle deception." *Id.* Thus, to state a claim that issuing spring-loaded options violates the business judgment rule, a plaintiff must allege, first, that options were issued according to a shareholder-approved employee compensation plan, and, second, that the directors who "approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options." *Id.* at *19. The court found that plaintiffs in *Tyson* had adequately met this standard as to the compensation committee members.

IV. THE IMPACT OF THESE DECISIONS

It remains to be seen whether the approach Chancellor Chandler took will be followed in future stock options cases. The facts and pleadings in every case will be different, as will the strength of any inference justifiably drawn from statistical evidence. However, these decisions suggest that directors in some cases may need to prepare to meet substantial challenges to their conduct in connection with option grants and related public disclosures.

It should be noted that an ultimate finding of bad faith, if proven at trial in these and other cases, may have impact beyond the potential loss of the business judgment rule presumption and the potential demonstration of demand futility. Specifically, while section 102(b)(7) of Delaware's General Corporation Law authorizes corporations to adopt a charter provision providing for exculpation of liability to directors in certain circumstances, the statute provides that such a provision may not eliminate or limit liability for, among other things, a breach of loyalty or for acts or omissions not in good faith. Similarly, such a finding may impact the availability of indemnification under Delaware's Section 145.

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