The Delaware Court of Chancery in Contemporaneous Decisions Addresses Backdating and Spring-Loading in Connection With The Award of Employee Stock Options

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On February 6, 2007, the Delaware Court of Chancery issued two decisions prompted by stockholder challenges to alleged backdating of executive stock option awards: *Ryan v. Gifford*, Del. Ch., C.A. No. 2213-N, Chandler, C. (Feb. 6, 2007), and *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, Del. Ch., C.A. No. 1106-N, Chandler C. (Feb. 6, 2007). Each was authored by Chancellor Chandler. These are the first substantive decisions by that influential tribunal to address legal issues surrounding the controversial practices of backdating and the practice commonly known as “spring-loading.” The relevant aspects of each of those holdings is discussed below.


In *Ryan*, a shareholder of Maxim Integrated Products, Inc. advanced a derivative claim on behalf of the company that the compensation committee of the company’s board of directors had issued to Maxim’s founder, chair and CEO, John Gifford, options to acquire additional stock in the company in violation of the terms of the operative shareholder-approved, stock option plan of the company and in violation of the board’s fiduciary duties. In particular, the plaintiff alleged that the grants in question did not comply with the plan requirement that the strike price for all such options be no less than the market price of the company’s stock as of the date of issuance. The complaint asserted that the options instead had been backdated by the committee so as to coincide with trading days on which the price of the company’s stock was unusually low, or that immediately preceded sharp increases in the market price of the stock. Plaintiff alleged that these unfaithful acts had wrongfully deprived Maxim of the higher prices to which it should have
been entitled upon exercise of the options and exposed it to adverse tax consequences and the unhappy effects associated with the need to restate its financials. Defendants responded by moving to stay the action in favor of prior pending litigation and, in the alternative, for dismissal on a variety of grounds.

The Chancellor declined to stay the action, in the process emphatically staking claim to Chancery’s traditional turf. Acknowledging the continuing validity of venerable Delaware precedent[1] to the effect that a stay typically is appropriate where a previously filed and similarly crafted action is pending elsewhere, the Chancellor observed that, in the contest of derivative litigation as to which potential plaintiffs abound, the speed with which one or another may choose a forum is entitled to less judicial deference than in other settings. More relevant factors, the Court held, include the relative quality of the complaints, as well as factors typically considered in a forum non conveniens analysis, among them the ability of the competing tribunals to render justice. As to this factor, the Chancellor was quick to acknowledge that the courts of both federal and sister state jurisdictions were entirely capable of applying Delaware law, but rather pointedly opined that Delaware courts have a particular and substantial interest in resolving controversies that concern the conduct of fiduciaries of Delaware corporations, especially where such issues are presented for the first time. Noting that the issues raised by allegations of backdating are “of great import to the law of corporations.”[2] and that “Delaware courts have not as yet addressed these fundamental issues,”[3] the Chancellor stated:

An answer regarding the legality of these practices plainly will affect not only the parties in other civil and criminal proceedings where Delaware law controls or applies. By directly stating the fiduciary principles applicable in this context, Delaware courts may remove doubt regarding Delaware law and avoid inconsistencies that might arise in the event other state or federal courts, in applying Delaware law, reach differing conclusions.[4]

Turning to the various grounds advanced by defendants to support dismissal of the complaint as a matter of law, the Court made a number of important rulings, among them 1) that a plaintiff stockholder has no standing to challenge derivatively the validity of stock option grants issued prior
to the date on which the plaintiff acquired shares in the corporation;[5] 2) that the applicable statute of limitations period for the initiation of such claims is tolled under the doctrine of fraudulent concealment even when the raw information relevant to the claim could have been teased out of the relevant public filings, since the concept of reasonable diligence for purposes of determining whether one is on inquiry notice for limitations purposes does not require a shareholder to conduct complicated statistical analysis in order to uncover alleged malfeasance;[6] 3) that when the membership of the compensation committee that issued the challenged grants comprises at least one half or more of the entire board, the approval is imputed to the entire board even where the board as a whole took no action on the grants, and the relevant tests for demand futility apply; and 4) the fact that the recipient was not alleged to have exercised any of the challenged options, while perhaps relevant to the appropriate remedy, constitutes no legal defense to a claim of unjust enrichment.

It was in connection with its evaluation of defendants’ argument that plaintiff had improperly failed to make a pre-suit demand, and their parallel assertion that the allegations of the complaint had failed to rebut the threshold presumptions of the business judgment rule, however, that the Court offered its most provocative observations with respect to backdating. As to the former, the Chancellor held that the pre-suit demand requirement imposed under Chancery Court Rule 23.1 was excused both under the second prong of the Aronson test,[7] and under the alternatively applicable test enunciated in Rales v. Blasband.[8] As to the existence of reasonable doubt whether the challenged grants constituted a valid business judgment for purposes of Aronson’s second prong, the Court held that “a board’s knowing and intentional decision to exceed the shareholders’ express (but limited) authority raises doubt regarding such decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand.”[9] In this regard, the court noted plaintiff’s allegations that each of the nine challenged grants issued over a six year period had been granted at the lowest point in the stock’s market price during the month or year in which it was granted, that the average annualized return on the grants at issue was nearly ten times higher than the annualized market returns generally during that period, and that the options were granted sporadically, rather than pursuant to a pre-designated schedule. These allegations, together with the assertion that the board had altered the exercise price by
falsifying the date of the grant in violation of an express provision of the shareholder-approved option plans and that it had issued intentionally fraudulent public disclosures, were held sufficient to raise doubt whether the option awards were the product of a valid business judgment.

Under the alternatively applicable *Rales* test, the question presented is whether a majority of the directors confronted a substantial likelihood of liability in connection with the issuance of the challenged options, thus disqualifying them from objectively evaluating the propriety of a shareholder demand seeking to remedy that conduct on the company’s behalf. In this respect, the Court stated:

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.”[10]

The Chancellor expanded on this point in the course of rejecting defendants’ claim that plaintiff’s complaint failed to plead facts sufficient to rebut the business judgment presumptions, and thus should be dismissed for failure to state a claim. Noting the recent holding of the Delaware Supreme Court that acts of bad faith – including intentional fiduciary conduct having a purpose other than the advancement of the best interests of the company, or intended to violate applicable positive law, or demonstrating a conscious disregard for his duties – constitute a breach of the duty of loyalty,[11] 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.
Well-pleaded allegations of such conduct are sufficient in my opinion, to rebut the business judgment rule and to survive a motion to dismiss. [12]


The Tyson decision has much in common with Ryan; it too addressed (at least in significant part) a stockholder challenge to the validity of certain executive stock option grants, it arose in the context of a motion to dismiss, and of course it was also authored by Chancellor Chandler and issued on the same day as the Ryan opinion. It differs from Ryan in one quite material respect, however. While the complaint in Ryan was a challenge to what was characterized as a classic example of intentional backdating in violation of the express terms of the relevant, shareholder-approved option plan, the Tyson complaint[13] mounted an attack on a far more subtle and understated but, in plaintiff’s view, equally invalid practice commonly known as “spring-loading.” As noted above, this term describes the practice of timing of the award decision to precede immediately the public announcement or disclosure of information by the company that the issuer anticipates will prompt a quickly ensuing increase in the market price of the company’s stock.[14] Because the exercise price is typically determined by reference to the market price for the shares as of the date of the award under the explicit terms of the shareholder-approved option plan, this can be expected to result in a lower strike price for the options than that which would have obtained had the award followed the disclosure and the attending bump in the market price of the stock. “Spring-loading” thus does not involve an outright misrepresentation of the issuance date of the sort alleged to have taken place in the Ryan complaint, but rather a calculated decision to time the award in such a way as to enhance the value of the options for the benefit of the recipient by virtue of the ensuing release of information and the concomitant increase in the spread between the exercise price and the value of the shares that are the subject of the options. The Tyson complaint thus challenged conduct that was far more nuanced and far less obviously in violation of the express terms of the operative stock option plan than was the case in Ryan.

Before turning to the legal sufficiency of the substantive
attack on the practice of spring-loading, the Court took up, as it had in Ryan, the application and effect of the statute of limitations and, predictably, reached the same conclusion. Defendants asserted that the plaintiffs had been placed on inquiry notice with respect to their claims, ultimately instituted well beyond the expiration of the applicable three-year limitations period. They argued that the company’s contemporaneous public disclosures contained all of the raw information necessary to discern the very improprieties now being untimely asserted; the relevant proxy statements had accurately set forth the number of the shares granted, the exercise price and the date of the grant, which the daily business news made clear at the time that the grants themselves had closely preceded important and favorable company announcements. This argument educed little sympathy from the Chancellor:

…it would be manifest injustice for this Court to conclude, as a matter of law, that “reasonably diligence” includes an obligation to sift through a proxy statement, on the one hand, and a year’s worth of press clippings, on the other, in order to establish a pattern concealed by those whose duty is to guard the interests of the investor.[15]

The statute of limitations was thus deemed to have been tolled[16], at least for purposes of resolving the motion to dismiss.

At an earlier point in the opinion, the Court had concluded that the pre-suit demand requirement with respect to all of the derivative claims asserted in the action was excused in this instance under Aronson’s first prong by reason of the combined effects of self-interest and lack of independence on the part of a majority of the relevant board. The Court now turned to defendants’ substantive argument that the complaint failed to state a legally cognizable claim with respect to the issuance of spring-loaded options because it failed to plead facts sufficient to rebut the threshold presumptions of the business judgment rule. Plaintiffs’ complaint in this regard was held to be properly directed only to the specific directors who had served as members of the compensation committee, which had acted on its own pursuant to a grant of exclusive authority from the board. The individual directors in question were not recipients of any of the options in question and they were not deemed to have lacked independence from the recipients of those options. Nor were they accused of having acted in a grossly
negligent fashion (quite to the contrary, in fact). The question posed on the motion to dismiss for failure to state a claim against them therefore was whether the complaint was sufficient to permit a reasonable inference that their decision fell outside the bounds of business judgment because it constituted an act of bad faith and therefore a violation of the duty of loyalty.

As to this, the Court acknowledged that the question whether directors of a Delaware corporation may in good faith approve spring-loaded options was thornier than that presented by an act of premeditated backdating. Reiterating his holding in Ryan, the Chancellor observed that classic backdating always involves a “fundamental and incontrovertible lie” to shareholders with respect to the date on which the grant was actually made, which “against the background of a shareholder-approved stock-incentive program, amounts to a disloyal act taken in bad faith.”[17] While challenges to the practice of spring-loading “implicate a much more subtle deception.”[18] the conduct is rooted in deception nonetheless.

The Court was careful to point out that the problem with spring-loading does not lie in the fact that the options awarded are immediately in the money. To the contrary,

A board of directors might, in an exercise of good faith business judgment, determine that in the money options are appropriate forms of executive compensation. Recipients of options are generally unable to benefit financially from them until a vesting period has elapsed, and thus an option’s value to an executive or employee is of less immediate value than an equivalent grant of cash. A company with a volatile share price, or one that expects that its most explosive growth is behind it, might wish to issue options with an exercise price below current market value in order to encourage a manager to work hard in the future while at the same time providing compensation with a greater present market value. One can imagine circumstances in which such a decision, were it made honestly and disclosed in good faith, would be within the rational exercise of business judgment.[19]

Rather, the Court declared that the root problem with spring-loading is the fact that it is grounded in an implicit deception that conflicts with a director’s fiduciary
responsibility to deal fairly and honestly with shareholders, even when there is no outright violation of the literal terms of the shareholder-approved option plan.

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 worth 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. [20]

The Court concluded its discussion with a summary of the elements that are necessary to plead a legally cognizable claim that the issuance of a spring-loaded (or, presumably, bullet-dodging) options by an admittedly disinterested and independent board or committee constitutes a disloyal act of bad faith that falls beyond the inviolate bounds of business judgment:

1.) the approving directors possessed material non-public information, soon to be released, that would affect the price of the company’s stock; and

2.) that the approving directors issued the options with the intent to circumvent otherwise valid, shareholder-approved restrictions on the exercise price of the stock.

“[I]t is conceivable”’ the Court observed, that a director might show that shareholders have expressly empowered the board of directors (or relevant committee) to use backdating, spring-loading or bullet-dodging as part of employee compensation, and that such actions would not otherwise violate applicable law.” [21] Barring such a showing however, the Tyson decision seems clearly to hold that a complaint that contains the allegations set forth above will survive a motion to dismiss for failure to state a claim upon which relief will be granted, and that a plaintiff that so establishes at trial will succeed in his challenge to invalidate so-called “spring-loaded” stock options.

[1] See McWane Cast Iron Pipe Corp. v. McDowell-


[3] Id.


[5] This holding resulted in the dismissal of seven of the nine stock option grants challenged in the complaint.


[7] Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (failure to make demand may be excused if a plaintiff can raise a reason to doubt that: 1) a majority of the board is disinterested or independent or 2) the challenged acts were the product of a valid exercise of business judgment. Here, a majority of the board, and the entirety of the compensation committee did not receive any of the options in question, thus eliminating the application of Aronson’s first prong.

[8] Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) (where the challenged transaction was not a decision of the board, question is whether complaint creates reasonable doubt that the board in place at the time of the complaint could have properly exercised its independent and disinterested business judgment in responding to a demand).

[9] Ryan, Mem. op. at 22 (referencing the holding in Sanders v. Wang, 1999 WL 1044880 (Del. Ch., Nov. 10, 1999)).


[13] The Tyson opinion in fact addresses a wide array of allegedly self-interested compensation awards and related party transactions. For the limited purposes of this article, we focus solely on plaintiff’s challenge to the validity of the executive stock options grants.
[14] This is to be contrasted with the obverse practice known as “bullet-dodging,” in which options are awarded in the wake of the release of material information that has resulted in a decline of the market price of the stock and, therefore, the applicable strike price as determined on the date of the grant.


[16] This holding was based both upon the theory of fraudulent concealment (defendant by “actual artifice” has fraudulently concealed the facts necessary to put plaintiff on notice of the truth) and the doctrine of equitable tolling (plaintiff reasonably relied on the competence and good faith of a fiduciary). As to the latter, the Chancellor stated that “It is difficult to conceive of an instance, consistent with 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.*, Mem. op. at 49.

[17] *Id.*, Mem. op at 52 and n. 74.

[18] *Id.*

[19] *Id.*, Mem. op. at 53-54, n. 75; see also *Steiner v. Meyerson*, 1995 WL 4419999 at *8 (Del. Ch. July 18, 1995) (“…it is not the case that the grant of a stock option that is immediately exercisable at a profit to the holder necessarily constitutes corporate waste…. Options obviously can be granted as a preferred form of compensation to corporate directors, officers or employees. Compensation can come in a wide range of forms: cash, notes, stock or options are only the most obvious. So long as there is some rational basis for directors to conclude that the amount and form of compensation is appropriate and likely to be beneficial to the corporation, the grant will not constitute waste even if it were immediately exercisable at a profit”).

[20] *Id.*, Mem. op. at 53-54 (*emphasis in original*).