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Analysis

Option Backdating and Independent Directors: An Analysis of Litigation Trends

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Over the last two years, allegations of stock option pricing manipulation at a number of public companies have generated a wave of private securities lawsuits and regulatory investigations. This litigation has enhanced scrutiny of executive compensation practices, and the roles of outside directors and management who oversee them.

The U.S. Department of Justice has also pursued high-profile criminal prosecutions in several cases involving CEOs and other senior executives at companies like Brocade, Comverse, and Broadcom, and some matters may still remain under investigation. In separate investigations or enforcement actions, the Securities and Exchange Commission announced significant civil settlements with a number of companies and individual defendants, including Brocade, the former CEO of United Health, the former general counsels of Apple and Monster Worldwide, and the former CEO of Take-Two Interactive Software, Inc.

Outside, independent directors—especially directors who serve on compensation committees—play an integral role in supervising corporate decisions on executive pay and their conformity with internal governance requirements. Civil litigation in the stock option backdating area has renewed focus on the fiduciary standards to which courts hold such corporate directors accountable when they oversee executive compensation practices. While most of the law in this context has been generated fairly early pin the leading stage, it nonetheless has provided useful insight into the analyses used by courts to judge directors' accountability for compensation-related misconduct occurring on their watch.

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Potential Consequences

Stock option grants have traditionally served as an important component of corporate executive pay packages, providing both rewards for past performance and, theoretically, an incentive for future positive performance.

Option backdating typically involves a practice of using hindsight when making an option grant to select from prior dates' stock prices an exercise price lower than the fair market value existing on the measurement date, while failing to disclose that the date being used to price the grant is not in fact the date on which the pricing decision was made—the true measurement date. When charted in the context of surrounding historical stock prices, such option exercise prices can often be found at or near the bottom of V-shape or ''trough'' patterns.

Backdating of stock options granted to management creates a number of potential consequences. Numerous companies have faced claims that a practice of backdating options, while admittedly not illegal *per se*, raises corporate governance issues where, for example, shareholder-approved stock plans prohibited any pricing of options at less than the prevailing fair market value, or where the backdating resulted from a delegation of key option decisions to management despite requirements in the stock plans that directors retain exclusive discretion over the pricing of option awards.

Failure to disclose backdating could lead to incorrect accounting for expenses, and could arguably affect executives' entitlement to an exemption from the short swing profits rule of Rule 16b-3(d) of the Securities Exchange Act of 1934 under the terms of that rule requiring disclosure to shareholders.[1]

Adverse tax implications could also follow from a practice of backdating. Internal Revenue Code § 162(m) and related regulations, for example, require fair-market-value pricing of options by a compensation committee of the board in order to qualify an issuer for a deduction for performance-based compensation paid to the issuer's CEO and certain highly compensated executive officers, to the extent that any such individual's aggregate compensation exceeds $1 million.[2] Below-market pricing or control of option decisionmaking by management, as opposed to a compensation committee of outside directors, would raise issues of disqualification under § 162(m).[3] Further, Internal Revenue Code § 409A imposes interest penalties and a 20 percent additional tax (over and above ordinary income taxes) on a recipient of nonqualified deferred compensation, and Treasury guidance indicates that below-fair-market-value pricing may cause an option to lose its exempt status.[4]

Director Liability

Delaware law provides a useful starting point for understanding the contours of director liability primarily because of the large number of corporations incorporated in Delaware and the resulting deference of other jurisdictions to Delaware law as a result of the ''internal affairs'' doctrine recognized by most courts, which requires application of the state law of incorporation in adjudication of intracorporate claims (including derivative claims for breach of fiduciary

[1] *See* 17 C.F.R. § 240.16b-3(d).

[2] 26 U.S.C. § 162(m)

[3] 26 U.S.C. § 162(m); 26 C.F.R. § 1.162-27(e)(2)(vi).

[4] 26 U.S.C. § 409A; 26 C.F.R. § 1.409A-1(b)(5)(i).

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duties).[5] Under Delaware law standards, directors can be held liable under fiduciary duty standards for affirmative actions that breach the duties of care and loyalty where the action is not otherwise entitled to the protections of the business judgment rule. In cases where directors at most failed to detect and prevent misconduct, however, a derivative plaintiff cannot typically make out a fiduciary duty claim against a director without pleading facts to suggest that the director exhibited more than gross negligence, i.e., an intentional and bad faith refusal to exercise oversight by utterly failing to ensure that reasonable internal reporting and controls system existed.[6] Facts showing the directors ignored specific ''red flags,'' for example, would be required to show liability.[7]

Fiduciary Duties

Motions to dismiss derivative complaints alleging backdating or other options-related misconduct have given courts occasion to analyze the fiduciary duties of directors as applied to supervision of executive compensation practices. Under federal law and the law of most state jurisdictions, shareholders seeking to pursue derivative claims against directors and officers on behalf of the corporation without first making a formal demand on the board of directors are required to plead particularized facts showing that such a demand would have been futile based either on a risk of director partiality – ''interestedness'' or ''dependence''– or a risk that the director decisionmaking will ultimately fall outside of the protections of the business judgment rule where affirmative board action is at issue. In either case, courts assess this question by judging preliminarily whether the plaintiff has adequately pleaded what is in essence a claim for breach of fiduciary duty.

Intentional backdating of stock options can implicate the fiduciary duties of good faith and loyalty where it is done in knowing contravention of shareholder-approved stock plans and concealed from shareholders.[8]

While several Delaware option timing decisions have suggested a critical view of director accountability in the context of alleged backdating or other problematic pricing practices, other Delaware and federal caselaw have reflected a more nuanced view. Three Delaware Chancery Court cases – *Ryan v. Gifford*, *In re Tyson Foods*, and *Conrad v. Blank*[9] – declined to dismiss breach of fiduciary duty claims against directors for failure to plead demand futility based on allegations of options backdating or ''springloading.'' In the *Ryan* and *Conrad* backdating decisions, the courts did so where plaintiffs alleged that grant exercise prices consistently hit monthly or yearly lows and company stock plans required pricing of options at fair market value on the date of the grant.[10]

A number of federal cases, however, while acknowledging this Delaware jurisprudence, have nonetheless declined to assume such liability without a greater pleading of actual director involvement in the mechanics of pricing decisions.[11] A fourth Delaware case involving Sycamore Networks, *Desimone v. Barrows*[12] also appears to diverge somewhat from the *Ryan*/*Tyson*/*Conrad* approach by holding that compensation committee membership itself does not presumptively generate a likelihood of liability for alleged backdating without greater specificity as to what directors actually did. Thus, *Desimone* and these federal decisions appear to suggest a judicial awareness that at many companies management may in fact control proposals for grant allocations, recipients, and timing, and the role of the board may be limited to mere ratification (or less) of some or all of these proposals.

The weight of demand futility cases in the backdating area suggest, therefore, that courts will not reflexively view outside directors, even those serving on compensation committees, as presumptively responsible for options-related misconduct occurring on their watch.

Federal Securities Laws

As with fiduciary liability, director liability under the federal securities laws in backdating cases has generally depended upon the clarity of director's roles and knowledge regarding problematic compensation practices. As the type of acts triggering a violation under federal securities laws – specific fraud, or misrepresentations or omissions – is a narrower subset of the more generalized activities that might compromise the duties of care and loyalty for fiduciary liability purposes, courts appear willing to apply the same rigorous scrutiny to allegations of director involvement in options-related misconduct and to dismiss securities claims, especially where specifics are not pleaded in accordance with the requirements of the Private Securities Litigation Reform Act. [13]

When the discretion afforded to directors regarding permissible option pricing under the terms of stock plans is restricted, courts may be more receptive to allegations of knowledge and participation in option backdating if such restrictions were not followed. Courts have, on occasion, declined to dismiss § 10(b) claims against compensation committee directors in backdating cases where stock plans required fair-market-value pricing for options, on the theory that the stock plan terms implied greater responsibility and opportunity to monitor exercise dates of options.[14] One flaw in the analysis of such decisions is the assumption that directors are necessarily in a position to know or verify the ultimate pricing of options where management con-

[5] *See First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983); *In re Sagent Technology, Inc. Deriv. Litig.*, 278 F. Supp. 2d 1079, 1086-87, 1090-93 (N.D. Cal. 2003); *Ryan v. Gifford*, 918 A.2d 341, 356-58, (Del. Ch. 2007).

[6] *See Stone v. Ritter (AmSouth Bancorporation)*, 911 A.2d 362, 369-71 (Del. 2006).

[7] *See Guttman v. Huang*, 823 A.2d 492, 506-07 (Del. Ch. 2003) (discussing *Caremark* standard for director liability); *see also In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (recognizing that pleading director liability based on failure to detect wrongdoing is ''possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment'').

[8] *Ryan*, 918 A.2d at 341.

[9] *Ryan*, 918 A.2d 341; *Conrad v. Blank*, 940 A.2d 28, (Del. Ch. 2007); *In re Tyson Foods*, 919 A.2d 563 (2007).

[10] *Ryan*, 918 A.2d at 357-58; *Conrad*, 940 A.2d at 28.

[11] *See, e.g.,In re Finisar Corp. Deriv. Litig.*, 542 F. Supp. 2d 968, 977-78 (N.D. Cal. 2008); *In re MIPS Technologies, Inc. Deriv. Litig.*542 F. Supp. 2d 980, 995 (N.D. Cal. 2008);*In re F5 Networks, Inc.*2007 U.S. Dist. LEXIS 57464, at *40-41 (W.D. Wash. 2007)*See, e.g., In re CNET Networks, Inc. Deriv. Litig.*, 483 F. Supp. 2d 947, 963-66 (N.D. Cal. 2007); *In re Linear Technology Corp. Deriv. Litig.*, 2006 WL 3533024, at * 3, (N.D. Cal. 2006).

[12] 924 A.2d 908(Del. Ch. 2007).

[13] *See In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142 (C.D. Calif. 2007).

[14] *See, e.g., In re Comverse Tech., Inc. Sec. Litig.*, 543 F. Supp. 2d 134, 142-43 (E.D.N.Y. 2008).

trols the mechanics of options awards. Given that directors are typically entitled to rely in good faith upon records and representations of management in performing their duties,[15] an argument could be made that outside directors should not be presumptively charged with knowledge of backdating on option awards carried out by company management unless specific facts show that the practice was made apparent from discussion or records presented to the board or compensation committee.[16]

Moreover, under *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*,[17] the Supreme Court held that liability under § 10(b) requires a specific false or misleading statement or omission attributable to each defendant. Thus, arguably under *Stoneridge*, directors who are merely alleged to have participated in backdating by virtue of compensation committee membership, but who did not exercise specific control over financial statements or accounting, should not face liability under § 10(b). As a result, plaintiffs' attempts to utilize the fact of directors' compensation committee membership in itself as a basis for pleading actionable conduct under § 10(b) should be foreclosed by *Stoneridge*.

Conclusion

Legal developments in the option backdating area have highlighted and clarified the standards of independent director liability where executive compensation practices are at issue. In the fiduciary duty and securities la context, courts have shown care in recognizing the limitations on director accountability for options-related misconduct occurring at companies, although the more narrowly defined the parameters of their authority and the more egregious the alleged misconduct, the less likely directors are to receive the benefit of the doubt when irregularities occur. As the law in this area continues to develop, it seems clear that courts will continue to be called upon to rationalize normative ideals of director behavior with the positive realities within which directors must operate in the corporate world.

[15] *See, e.g.*, DEL. CODE ANN. tit. 8 § 141(e); *In re CNET Networks,483 F. Supp. 2d at 963-64.*

[16] *See In re CNET Networks*, 483 F. Supp. 2d at 965 (holding that compensation committee directors might not have known dates on which management finalized the grants where stock plans permitted some delegation).

[17] 128 S. Ct. 761 (2008).

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