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Ending Executive Manipulations of Incentive Compensation⁺

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Abstract: In this article, we analyze whether the manipulation of stock options still continues to this day. Our evidence shows that executives continue to employ a variety of manipulative devices to increase their compensation, including backdating, bullet-dodging, and spring-loading. Overall, we find that as a result of these manipulative devices executives are able to increase their compensation by about 6%. We suggest a simple new rule to end all dating games in executive compensation. We propose that all grants of stock options in executive compensation be awarded on a daily pro-rata basis and priced accordingly. This proposal would leave no incentive to game option grant dates or manipulate information flow.

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Introduction

It has been nearly ten years since 2006 when the scandals broke regarding the backdating of executive stock option grants.¹ Stock option packages in executive compensation, once heralded as a simple device to solve the agency problem inherent in the separation of ownership and control to align the interests of management with those of the shareholders,² were found to be too tempting to leave to chance. Executives found ways to manipulate the size of their compensation by fraudulently changing the date of a grant, i.e., backdating or forward-dating, so that options that were meant to be granted “at-the-money” as of the grant date were “in-the-money” instead. This provides top executives and directors with an immediate unearned bonus.³ Researchers have documented that option backdating resulted in an average loss of about eight percent to shareholders, or about \$500 million per firm.⁴ This meant that on average, executives gained over \$500,000 per firm each year.⁵

The Sarbanes-Oxley Act of 2002 (SOX),⁶ which was meant to bring transparency and honesty to financial statements,⁷ was passed in reaction to massive corporate frauds such as Worldcom,⁸ Tyco,⁹ and Enron.¹⁰ With regarding to stopping options backdating, however, SOX has been a spectacular failure. Executives have simply ignored SOX’s two-day reporting requirements and fraudulently manipulated their compensation.¹¹ In addition, SOX has failed to prevent other forms of stock option value manipulation, i.e. spring-loading and bullet-dodging.

¹ Linda Chatman Thomsen, Dir. of Div. of Enforcement, Speech by SEC Staff: Options Backdating: The Enforcement Perspective (Oct. 30, 2006), in <https://www.sec.gov/news/speech/2006/spch103006lct.htm> (discussing the SEC’s ongoing investigation into 100 potential abuses of stock options and enforcement plans).

² See Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There* 1, 24 (Marshall Sch. Of Bus. Working Paper No. FBE 07.12, 2012), (forthcoming in HANDBOOK ECON. FIN. (eds. George Constantinides, Milton Harris, & Rene Stulz)); Jay M. Zitter, *Liability for Backdating of Stock Options Under Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b), and 17 C.F.R. § 240.10b-5*, 32 A.L.R. Fed. 2d 85 (2008).

³ Murphy, *supra* note 2, at 90.

⁴ M.P. Narayanan, Cindy A. Schipani, & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1597 (June 2007) [hereinafter Narayanan et al.].

⁵ *Id.*

⁶ Sarbanes-Oxley Act of 2002, Pub. L. no. 107-204 (2002) (codified as amended in scattered sections of 11, 15, 28, and 29 U.S.C.) [hereinafter SOX].

⁷ See, e.g., *infra* Part I discussing § 302 of SOX requirements. See also Spencer C. Barasch & J. David Washburn, *Decoding the Stock Option Backdating Scandal*, 4 CORP. COUNS. ST. BAR SECTION NEWSL. 1, 5 (Summer 2006).

⁸ See DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. (2003); see also BOB LYKE & MARK JICKLING, CONG. RESEARCH SERV., RS21253, WORLDCOM: THE ACCOUNTING SCANDAL (2002), available at http://www.law.umaryland.edu/marshall/crsreports/crsdocuments/RS21253_08292002.pdf.

⁹ Press Release, Sec. & Exch. Comm’n, SEC Brings Settled Charges against Tyco International Ltd. Alleging Billion Dollar Accounting Fraud (Apr. 17, 2006), <https://www.sec.gov/news/press/2006/2006-58.htm>.

¹⁰ Press Release, Sec. & Exch. Comm’n, SEC Charges Jeffrey K. Skilling, Enron’s Former President, Chief Executive Officer and Chief Operating Officer, with Fraud (Feb. 19, 2004), <https://www.sec.gov/news/press/2004-18.htm>.

¹¹ Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802-12 (2005); M. P. Narayanan & H. Nejat Seyhun, *Do Managers Influence Their Pay? Evidence from Stock Price Reversals Around Executive Option Grants* (Ross Sch. of Bus., Working Paper No. 927, Jan. 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649804 (finding that executive options are backdated); M. P. Narayanan & H. Nejat Seyhun, *Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation* (Nov. 2005), available at <http://ssrn.com/abstract=852964> (again finding that options are backdated and that SOX mandatory grant date reporting decreases, but does not eliminate opportunism); Randall A. Heron & Erik Lie, *Does*

In this study, we show that despite the effect of SOX and all the reforms in response to the backdating scandal of 2006,¹² manipulation of options is still too tempting and continues to this day. Our evidence shows that executives employ a variety of manipulative devices to increase their compensation, including backdating, bullet-dodging, and spring-loading. Although each of these practices in isolation may have a marginal impact on their compensation, together, these manipulative devices unfairly tilt the balance in executives' favor in a meaningful way. Overall, we find that as a result of these manipulative devices executives are able to increase their compensation by about 6%. Further regulation is thus needed to ensure honesty and transparency in corporate financial statements, and promote market fairness.

This paper proceeds as follows. Part I provides an overview of the various ways executives have been found to manipulate option grants to increase their compensation, including backdating, forward-dating, spring-loading, and bullet-dodging. Part II details our empirical study demonstrating that these schemes exist and continue today. In Part III, we analyze these manipulative behaviors and argue that they should be considered violations of § 10(b)¹³ and Rule 10(b)(5)¹⁴ of the 1934 Securities Act. Part IV discusses why these behaviors also violate the fiduciary duties of officers and directors under state laws. Proposals for reform are presented in Part V, followed by our concluding remarks.

I. Stock Options: Potential for Abuse

Including stock options as part of the executive compensation package can have important advantages. For instance, it can lead to an alignment of interests for managers and

Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?, 83 J. FIN. ECON. 271 (2007) [hereinafter Heron & Lie, *Does Backdating Explain*] (finding significantly less abnormal stock returns after the passing of the SOX, and that “in those cases in which grants are reported within one day of the grant date, the pattern has completely vanished, but it continues to exist for grants reporting with longer lags, and its magnitude tends to increase with the reporting delay.”); M.P. Narayanan & Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?*, 21 REV. FIN. STUD. 975-1007 (2008). See also Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 856-57 (2008) (stating that “thousands of firms continued to secretly backdate options by weeks or months after SOX, even though it entailed—in addition to other legal violations—a blatant disregard of the Act’s two-day requirement.”); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1642 (2005) (citing 15 U.S.C. § 7243, 15 U.S.C. § 78m(k) and 15 U.S.C. § 7244) (arguing that executive compensation is indirectly regulated by SOX. Specifically, it forces the CEO and CFO to return “any bonus, incentive, or equity-based compensation” in the previous year if the company has to restate its financial statements due to misconduct; it precludes corporations from giving loans to executives and directors; and outlaws executive trading during “blackout periods.”); Smith, Gambrell & Russell, LLP, *Options Backdating: Scrutinizing Options-Based Compensation Practices*, 18 TRUST THE LEADERS (Spring 2007), available at http://www.sgmlaw.com/resources/trust_the_leaders/leaders_issues/ttl18/817/ (stating that it is widely believed that SOX “short-circuited” options backdating).

¹² Especially, the SEC’s adoption of new disclosure requirements regarding executive compensation including a “Compensation Discussion and Analysis” section and specific requirements for disclosure of option grants. Press Release, Sec. & Exch. Comm’n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), <https://www.sec.gov/news/press/2006/2006-123.htm>.

¹³ 15 U.S.C. § 78j (2015).

¹⁴ 17 C.F.R. § 240.10b-5 (2015).

shareholders.¹⁵ It may also allow firms that want to conserve resources to remain attractive to the best talent.¹⁶ Startups, in particular, find stock options useful because they often have growth potential, but shallow pockets initially.¹⁷ Yet, in executive compensation plans, stock options can be, and have often been, abused.

Professor David Yermack first found irregularities in stock price returns around executive stock option grants in 1997.¹⁸ He argued that the executives accelerated the date of the grants when the corporation is getting ready to release good news.¹⁹ In the early 2000s, researchers provided evidence that managers manipulate the release of information around option grant dates to maximize the value of those grants.²⁰

As the use of stock options increased, so did the interest of the government to restrict the potential for abuse. SOX requires “real-time disclosure of option grants.”²¹ Section 302 of SOX demands that CEOs and CFOs of public corporations state that they have reviewed the company’s quarterly and annual reports and explicitly confirm that “(1) the financial statements and information is materially accurate, (2) disclosure controls and procedures are effective and (3) they have disclosed to the company’s auditors and audit committee any control deficiencies.”²² False statements made under SOX could subject the individual to enforcement by the Securities Exchange Commission (SEC), Department of Justice (DOJ) prosecution, and/or civil litigation instituted by shareholders.²³

Backdating was discovered simultaneously by Professors Lie, Heron, Narayanan and Seyhun and reported in the financial press as early as February 2005.²⁴ Researchers showed that managers falsified grant dates to receive options with lower strike prices.²⁵ The stock price of

¹⁵ Zitter, *supra* note 2. See also Randall S. Kroszner et al., *Economic Organization and Competition Policy*, 19 YALE J. ON REG. 51, 58 (2002).

¹⁶ *Id.*

¹⁷ *Id.* See also David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U.L. REV. 561, 567 (June 2007).

¹⁸ David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcement*, 52 J. FIN. 449, 449-75 (1997).

¹⁹ *Id.*

²⁰ David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON., 73, 73-100 (2000); Keith Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock-option Grants*, 7 J. CORP. FIN. 53, 53-76 (2001).

²¹ SOX, *supra* note 6.

²² Barasch & Washburn, *supra* note 7; see *id.* § 302, 15 U.S.C. § 7241(a).

²³ See SOX § 906 (subjecting CEOs/CFOs to criminal penalties for knowingly certifying inadequate financial statements). While SOX does not explicitly include civil liability provisions on the basis of falsifying financial statements, § 302 violations have had a bearing on civil suits and SEC enforcement actions brought under other provisions. See Jenny B. Davis, *Sorting Out Sarbanes-Oxley: Determining How to Comply with the New Federal Disclosure Law for Corporations Won't Be Easy*, 89 A.B.A.J. 44, 48 (Feb. 2003).

²⁴ See *supra* note 11. See also Jay Ritter, *Forensic Finance*, 22 J. ECON. PERSP. 127, 133 (2008); Mark Hulbert, *Test of Good Corporate Citizenship*, MARKET WATCH (Feb. 18, 2005, 12:15 AM), available at <http://www.marketwatch.com/story/timing-of-managers-option-grants-a-good-litmus-test>.

²⁵ Ritter writes:

On January 19, 2000, when computer manufacturer Apple’s stock closed at \$106.56 per share, Apple announced that one week previously it had granted options to buy 10 million shares to CEO Steve Jobs with an exercise price of the January 12 closing market price of \$87.19. The January 12th close was the

the company would decline right before the exercise of the grant and increase thereafter.²⁶ In 2008 and 2009, research further suggested that managers are likely to make beneficial accounting changes to the CEO prior to option grant dates.²⁷

There are several possible forms of option timing manipulation observed in the empirical literature. First, as described above, options may be backdated.²⁸ Second, executives may alter the exercise date of an option, rather than its grant date.²⁹ Third, executives may manipulate the timing of information release, announcing positive information about the company (i.e. spring-loading) immediately before the grant date or negative information about the company (i.e. bullet-dodging) immediately after the grant date.³⁰ Alternatively, executives may manipulate the timing of stock option awards to occur shortly before an already scheduled release of positive information about the company (again spring-loading) or shortly after the release of negative information about the company (again bullet-dodging).³¹ These manipulative practices are described further below.

A. Options Backdating

Options backdating is a practice whereby the date of the option grant is changed to a date prior to when the option was in fact granted. This practice was possible and easy when the SEC rules did not require reporting of the issuance of stock options until months after the grant date.³² This reporting delay allowed companies to wait until the company's stock price fell low and moved higher before submitting their disclosure forms.³³ The option would then be backdated at

lowest closing price of the two months prior to January 19. Seven years later, Apple admitted that the dates of many options grants had been chosen retroactively, and that documents purporting to show that the board of directors had approved the grants on the dates chosen had in some cases been fabricated. Wealth transfers from option backdating can be large. For the January 2000 grant alone, if there was a 70 percent chance that the options would eventually be exercised, the difference between the January 12th and 19th dates for the exercise price was worth almost \$140 million to Jobs due to the difference between the \$87.19 and \$106.56 exercise prices.

Id. at 131-32. See also Robert M. Daines, Grant R. McQueen, & Robert J. Schonlau, *Right on schedule: CEO Option Grants and Opportunism 2* (Working Paper, revised Mar. 31, 2015) [hereinafter Daines et al.]; Lie, *supra* note 11; Heron & Lie, *Does Backdating Explain*, *supra* note 11; Randall Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, 55 MGMT. SCI. 513-25 (2009)[hereinafter Heron & Lie, *What Fraction*]; Narayanan & Seyhun, *supra* note 11.

²⁶ This is illustrated by a V-shape on a graph.

²⁷ Daines et al, *supra* note 25, at 2 (citing Mary L. McAnally et al., *Executive Stock Options, Missed Earnings Targets, and Earnings Management*, 83 ACCT. REV. 185-216 (2008); Terry A. Baker et al., *Incentives and Opportunities to Manage Earnings around Option Grants*, 26 CONTEMP. ACCT. RES. 649-672 (2009)).

²⁸ See Lie, *supra* note 25; Heron & Lie, *Does Backdating Explain*, *supra* note 12; Heron & Lie, *What Fraction*, *supra* note 25.

²⁹ See Yermack, *supra* note 18.

³⁰ See Aboody & Kasznik, *supra* note 20; Chauvin & Shenoy, *supra* note 20.

³¹ See Daines et al., *supra* note 25, at 3 (finding that there is abnormal price patterns around scheduled CEO grants post-2006).

³² Previously, option grants could be reported on Form 5, which is due 45 days after the end of the fiscal year. Heron & Lie, *Does Backdating Explain*, *supra* note 11, at 272.

³³ Christopher Cox, Chairman of the SEC, Testimony Concerning Options Backdating (Sept. 6, 2006), *available at* <https://www.sec.gov/news/testimony/2006/ts090606cc.htm>.

its lowest point or near that point, so that this lower exercise price could then be reported to the SEC.³⁴ Backdating of stock options thus allows the individual to benefit from larger gains, while the company does not have to report these gains as compensation on its financial statement.³⁵

Shortly after SOX was signed into law, the SEC changed its rule to also require disclosure within two days of the option grant,³⁶ thereby effectively closing the loophole giving rise to backdating.³⁷ This information must be disclosed electronically, allowing shareholders access to the information almost instantly.³⁸ Furthermore, the SEC approved changes to the New York Stock Exchange and the NASDAQ Stock Market listing standards, which mandate that nearly all equity compensation plans be presented to shareholders for a vote.³⁹ The terms of the plan must be disclosed, as well as whether it allows for the exercise price to be less than the fair market value at the time of the grant.⁴⁰ Nevertheless, based on what the backdating studies have discovered,⁴¹ it appears that executives have simply ignored these requirements and continued their backdating practice.

In December 2004, the Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standards (FAS) 123R, which essentially eradicated the accounting benefit of stock options issued at-the-money.⁴² The Standards state that all stock options granted to any employee must be documented as an expense on the financial statements regardless of whether the exercise price is at fair market value.⁴³ In 2006, the SEC began to require all public companies to also report information including: “the grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer); the FAS 123 grant date; the closing market price on the grant date if it is greater than the exercise price of the option; and the date of the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date.”⁴⁴ Companies are also required to explain the goals and policies behind the executive compensation plans.⁴⁵ Reports to investors must discuss whether the company has backdated executive stock options (or utilized “any of the many variations on that theme concerning the timing and pricing of options”) or might do so in the future and, if so, how.⁴⁶ Once again, these changes have been ineffective in stopping executive malfeasance with respect to option grants.

³⁴ Christopher Cox, Chairman of the SEC, Testimony Concerning Options Backdating (Sept. 6, 2006), *available at* <https://www.sec.gov/news/testimony/2006/ts090606cc.htm>.

³⁵ *Id.*

³⁶ See SEC, Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-46421, Sec. II.B (Aug. 27, 2002), <https://www.sec.gov/rules/final/34-46421.htm>.

³⁷ Barasch & Washburn, *supra* note 7.

³⁸ Cox, *supra* note 33.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ See sources cited *supra* note 11.

⁴² Statement of Financial Accounting Standards No. 123, Fin. Acct. Series (revised Dec. 2004), *accessible at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124271&acceptedDisclaimer=true.

⁴³ *Id.*

⁴⁴ Cox, *supra* note 33 (describing the requirements of 17 C.F.R. § 229.402(c)).

⁴⁵ See 17 C.F.R. § 229.402(b), § 229.402(s) (requiring a “Compensation Discussion and Analysis” section, consisting of “material information that is necessary to an understanding of the [company]’s compensation policies and decisions regarding [the executive officers falling within the scope of the rule]”).

⁴⁶ Cox, *supra* note 33.

In addition, in 2007, the SEC enacted rules requiring full disclosure of all aspects of executive and director pay and benefits, including stock options. These rules require the company to disclose the full amount of an executive's compensation in a single number, and whether a stock option was backdated.⁴⁷ If the stock option is backdated, the corporation must provide the reason why. The goal of the rule is to make executive compensation more transparent to the shareholders.

In the wake of the 2006 backdating scandal, many corporations began to award their employee option grants at scheduled times each year.⁴⁸ This practice, has given rise to other forms of options manipulation, as described below. Whether these reforms have finally stopped the practice of backdating and other timing games is the subject of our current study.

B. Manipulation of Exercise Date

There is evidence that some executives have changed the exercise date of their options, without disclosure thereby decreasing their tax liability.⁴⁹ By backdating the exercise date to a date with a lower stock price, executives can transform regular income into capital gains and receive the benefits of a significantly lower marginal tax rate.⁵⁰

C. Spring-Loading and Bullet-Dodging

The most frequently discussed form of option timing manipulation, other than backdating, is "spring-loading:" timing stock option awards to occur just before a positive public announcement by the company.⁵¹ The positive announcement increases the value of the stock, resulting in a "windfall" gain for the recipients of the stock options.⁵² This theory was first put forward by Professor David Yermack, who examined a sample of 620 stock option awards to CEOs of Fortune 500 companies between 1992 and 1994.⁵³ He found that the average abnormal increase in option award value after 20 trading days was \$30,000 and \$48,900 after 50 trading days.⁵⁴

In contrast, executives who engage in bullet-dodging are awarded stock options following a negative public announcement. The negative information may cause a temporary reduction in

⁴⁷ SEC, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A, 34-54302A, IC-27444A, 17-18, <https://www.sec.gov/rules/final/2006/33-8732a.pdf>.

⁴⁸ Daines et al. *supra* note 25.

⁴⁹ Mark Maremont & Charles Forelle, *How Backdating Helped Executives Cut Their Taxes*, WALL ST. J. (Dec. 12, 2006), A1, A13. See also S. Burcu Avci, et al., *Timing of Gifts of Common Stock by Corporate Executives*, Pa. J. Bus. L. (forthcoming) (analyzing timing games of gifts of common stock by executives to increase their tax deductions).

⁵⁰ JAMES M. BICKLEY & GARY SHORTER, CONG. RESEARCH SERV., RL33926, STOCK OPTIONS: THE BACKDATING ISSUE 28 (2008).

⁵¹ *Id.*

⁵² *Id.*

⁵³ Yermack, *supra* note 18, at 449.

⁵⁴ *Id.* at 458.

the market value of the stock, resulting in stock option grants at a low price.⁵⁵ If the stock subsequently restores to its pre-announcement value, recipients of these stock options would have benefited from a favorable exercise price.⁵⁶

Spring-loading and bullet-dodging have been empirically observed in the timing of option repricing.⁵⁷ A statistical analysis of 236 option re-pricings for 166 companies between 1992 and 1997 suggested that executives who expected positive earnings reports repriced their option before the announcement, and alternatively, managers who expected negative earnings reports repriced their options after the announcement of the report.⁵⁸

D. Manipulation of Information Release

SOX, SEC regulations, and increasing public scrutiny curbed the practice of options backdating, to a large extent. But the problem has not been completely resolved. As noted above, many firms began to award options on a specific schedule every year to avoid allegations of illegal options backdating. In 2003, it was found that about 60 percent of all CEO option grants were scheduled.⁵⁹ Although this eradicated most instances of backdating, it has resulted in other agency problems. Executives who know about the upcoming option grants have “an incentive to temporarily depress stock prices before the grant dates to get options with lower strike prices.”⁶⁰ CEOs may use various mechanisms to distort the strike price, such as by changing the substance and/or timing of the company’s disclosures.⁶¹

Substantively, the manipulation of information flow around fixed option grant dates does not diverge very much from spring-loading and bullet-dodging. In spring-loading and bullet-dodging, information flow is fixed but option dates are variable; manipulation of information flow involves variable information flow and fixed option dates, to the same effect.

When the dates for stock option grants are fixed, the timing of corporate announcements can be manipulated in relation to known dates for the granting of options. Executives may induce or accelerate the release of bad news before option grant date in order to set a lower strike price for the options—analogue to bullet-dodging.⁶² The executive could also delay the release of

⁵⁵ BICKLEY & SHORTER, *supra* note 50, at 28.

⁵⁶ *Id.*

⁵⁷ Some companies reprice executive stock options if the exercise price of the options falls significantly below the market value of the company’s stock. This is done in order to restore employee incentives. *Id.*

⁵⁸ *Id.* (discussing the findings in Sandra Renfro Callaghan, P. Jane Saly & Chandra Subramaniam., *The Timing of Option Repricing*, 59 J. FIN. 1651-1676 (2004)).

⁵⁹ Daines et al. *supra* note 25, at 4.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² See Chauvin & Shenoy, *supra* note 20. The authors statistically analyzed a sample of 783 stock option grants from May 1991 to February 1994 issued to 209 CEOs and found “a significant stock price decrease prior to executive stock option grants.” *Id.* See also Aboody & Kasznik, *supra* note 20, at 73. The authors investigated the hypothesis “that CEOs manage investors’ expectations around award dates by delaying good news and rushing forward bad news.” *Id.* at 98. They analyzed 2,039 stock option grants between 1992 and 1996 to the CEOs of over 500 firms and concluded that “CEOs of firms with scheduled awards make opportunistic voluntary disclosures that maximize their stock option compensation. *Id.*”

good news until after the grant is made – analogous to spring-loading.⁶³ Thus, for purposes of our study, we include manipulation of information flow as an aspect of spring-loading and bullet-dodging. Additionally, the executive could delay projects until after an options grant, or otherwise manipulate the timing of the corporation’s investments.⁶⁴ An executive may also change the firm’s profit trajectory or accounting options to move earnings from before the grant to after.⁶⁵ All these actions transfer wealth from the shareholders to management and may impact the corporation’s value by influencing investment choices.⁶⁶

Empirical evidence suggests that to manage investors’ expectations around fixed dates of scheduled awards for their stock options, management may delay good news and accelerate the release of bad news.⁶⁷ The bad news may be disclosed in a public announcement, or managers may “put a more negative ‘spin’ on information than otherwise, speak ‘off the record’ to analysts, or strategically use rumor and innuendo to ‘leak’ information.”⁶⁸

Evidencing this behavior, the data shows “abnormal stock returns surrounding SEC Form 8-K filings (which report material corporate events) tend to be negative in the months immediately before a scheduled CEO option grant and then positive in the months after the grant.”⁶⁹ Executives also tend to move earnings to after the grant period. Scholars have found that scheduled options may result in executives making disclosures, accounting, and investment decisions based on their own self-interest rather than increasing shareholder value.⁷⁰ These actions may be even worse than backdating because they distort stock prices and may decrease firm value if significant projects are postponed as a result.⁷¹ Unlike the backdating practice which has been mostly curbed, this is an ongoing concern.

Empirical research has also demonstrated that corporations with scheduled options tend to show the same pattern associated with backdating.⁷² This pattern was not found in grants made prior to the SEC’s 2002 regulations.⁷³ CEOs with significant compensation in scheduled options have more incentive to disrupt the company’s stock price and research shows they have earned an average three percent abnormal return on the option.⁷⁴ This trend is even more striking the more options the CEO holds and the more difficult the corporation is to value.⁷⁵

Our empirical study, described in Part II below, provides further evidence of this practice and adds valuable current data. Most studies on the topic of stock option grant manipulation in executive compensation have focused primarily on pre-2006 backdating of stock options. Once the excitement of the backdating scandal simmered, and the regulatory changes of the early

⁶³ Daines et al. *supra* note 25, at 4.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.* at 5.

⁶⁷ Chauvin & Shenoy, *supra* note 20, at 59. *See also* Aboody & Kasznik, *supra* note 20, at 74.

⁶⁸ BICKLEY & SHORTER, *supra* note 50, at 37 (citing Chauvin & Shenoy, *supra* note 20, at 59).

⁶⁹ Daines et al. *supra* note 25, at 5.

⁷⁰ *Id.* at 7.

⁷¹ *Id.* at 8.

⁷² *Id.*

⁷³ *Id.* *See also* Heron & Lie, *What Fraction*, *supra* note 25.

⁷⁴ Daines et al. *supra* note 25, at 6.

⁷⁵ *Id.*

2000s were implemented, research turned to the other forms of manipulation (i.e. spring-loading and bullet-dodging). Even now, however, there is very limited research on these topics analyzing information in the last decade, after these important regulatory changes took effect. Our research adds to the empirical studies on the issues of stock option grant manipulation, with a more comprehensive dataset than previous studies. Importantly, as we look at the period between 2008 and 2014, our information encompasses the effects of the regulatory changes of the mid- and late-2000s, concluding that these changes have not prevented the unfair manipulation of stock option grants. Notably, as our earliest data is in 2008, our evidence is not explained by backdating of options. Finally, our study takes prior studies further by considering manipulation of data flow around scheduled grants as well as manipulation of grant dates.⁷⁶

Spring-loading and bullet-dodging in the context of executive stock options are difficult to address because the tactics employed may differ year to year. Executives could make strategic disclosures, use accruals, or act in a number of different ways to impact stock price.⁷⁷ It is also easy to rationalize and justify the timing of disclosures because executives are given discretion about these decisions.⁷⁸

To reduce the risk of this type of distortion, scholars have suggested that boards and analysts stay aware of the incentives established by scheduled options and closely monitor disclosures.⁷⁹ Furthermore, it has been suggested that boards decouple stock and exercise prices, as well as spread out at-the-money option grants over months to dilute the size of the grant per period.⁸⁰ In addition, the directors could set the strike price at an average of stock prices over a period, restrict the period of time in which executives can sell stock to the month the options are granted, and/or give officer and directors options at separate times from the CEO.⁸¹ We further suggest regulatory changes to close the opportunities giving rise to these manipulative behaviors by requiring options awards to be awarded on a pro-rata daily basis, as discussed in Part V below.

II. Current State of Options Manipulation: The Empirical Evidence

A. Hypotheses and Data

This section presents our hypotheses, methodology, and empirical findings relating to executive behavior with regard to stock option manipulation. We show that manipulative behavior continues despite the aftermath of the backdating scandal and the corresponding heightened disclosure requirements.

⁷⁶ See Part II.A., *infra*.

⁷⁷ Daines et al. *supra* note 25, at 44.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* at 42 (citing Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-term Performance*, 159 U. PENN. L. REV. 1915-1959 (2010)).

⁸¹ *Id.* at 42.

Following the work of Professors Narayanan and Seyhun,⁸² we investigate two hypotheses involving dating and timing games. Our first hypothesis is that executives are continuing to backdate option grant dates (the backdating hypothesis). Our second hypothesis, denoted the timing hypotheses, is linked to spring-loading and bullet-dodging activities. We thus analyze whether executives continue to manipulate either the dating of their options and/or the flow of information to increase their compensation.

These hypotheses can be tested empirically. First, our backdating hypothesis suggests that if executives change the date of their option awards to an earlier date resulting in a higher compensation award, then these awards will necessarily appear to be reported with delays. Furthermore, the greater the reporting delay, the greater will be the level of unfair compensation.

To explain this further, an example may be useful. Suppose that executives receive an option award on March 2, when the stock price is \$50. This implies that without backdating the exercise price of the option would have been set at \$50. Also suppose that the stock price started about \$50 per share and over the past year began to rise, before it fell to \$25 on January 2, and then increased back to \$50 at the time of executive option award. In order to maximize their compensation, suppose that executives backdate their option award to January 2nd and they report that they received their option award on January 2 when the stock price was \$25. Executives then immediately report their option award on Form 4 to the SEC without any further delays.

At this point, anyone examining Form 4 who is unaware of the fraud committed by the executive will deduce the following: 1) executives received an option award on January 2nd when the stock price was \$25; and 2) executives reported this award on March 2nd with a two month delay.

Thus, to the extent executives go back into stock price history and backdate their option awards, these awards will be necessarily associated with reporting delays. Furthermore, to the extent executives go further back into history to find even lower stock prices in the past, those with greater delays will have higher price rises (ex-post). Thus, the greater the reporting delays, the greater will be the degree of compensation.

The timing hypotheses, on the other hand, do not necessarily imply reporting delays. Here, managers do not change the option grant date, rather they change the date the information is publicly revealed. In spring-loading, executives with good information, delay its release until after their options are granted. In bullet-dodging, executives with negative information accelerate the release of information to a date before their options will be granted. These actions have the effect of minimizing the stock price on the option grant date. Consequently, the exercise price of the options is also minimized, thereby increasing the compensation to the executives.

To test these hypotheses, we obtain option grant data. Our data comes from the Thomson Reuters database and contains all option grants to executives in all publicly listed firms in the United States. The database includes the date of the grant, the reporting date, number of shares granted, and underlying security on which options are granted, in addition to firm name, firm

⁸² Narayanan & Seyhun, *supra* note 11, at 1907.

identification information, and the executive's name and title. Although the database starts in 1986, we limit our attention to the January 1, 2008 to December 31, 2014 period to contrast from previously documented evidence of abuse. Our main objective is to understand whether executives continue to abuse their privilege and manipulate their option grants to unfairly increase their compensation.

Table 1 provides sample characteristics of executive option grants by firm size. Option grants are grouped into three firm-size categories. Firm size is measured as market capitalization of firms (number of shares outstanding multiplied by stock price per share). The first group contains stocks with less than \$1 billion market capitalization, we call this group small-cap firms (3,574 firms). The second group, mid-cap firms, contains stocks with market capitalization between \$1 billion and \$5 billion (926 firms). The largest firm size group contains stocks with more than \$5 billion market capitalization; we call this group large-cap firms (375 firms).

Table 1

Sample Characteristics of Executives' Option Grants, 1/1/2008-12/31/2014

Firm Size	Small- Cap Firms	Mid-Cap Firms	Large-Cap Firms	All firms
Firm Definition	Market Capitalization is less than \$1 Billion	Market Capitalization is between \$1 Billion and \$5 Billion	Market Capitalization is more than \$5 Billion	
	Executive Option Awards			
Number of Firms	3,574	926	375	4,875
Number of Option Awards	964,175	251,404	143,176	1,358,755
Average Award Size (Number of shares)	11,907.9	18,272.3	25,389.1	14,506.0
Total Awards to Officers (million shares)	3,976.34	2,581.24	1,313.73	7,871.31
Total Awards to Directors (million shares)	2,550.87	927.64	1,101.62	4,580.13
Total Awards to Top Executives (million shares)	4,954.09	1,084.86	1,219.77	7,258.71

Average number shares awarded per firm (million shares)	3.21	4.96	9.69	4.04
Total Shares Awarded (in Million)	11,481.30	4,593.74	3,635.12	19,710.15

Each individual grant is an observation and the dataset includes a total of 1,358,755 option grants. Table 1 shows that options are granted mostly by small-cap firms. The number of companies and the number of awards are highest for small-cap firms and lowest for large-cap firms. Small-cap firms granted 964,175 separate awards to managers, while mid-cap and large-cap firms granted 251,404 and 143,176 separate awards to managers, respectively.

The average award size is positively related to firm size: large-cap firms grant the largest awards to their managers. The average award size is 25,389.15 shares for large-cap firms. For small and mid-cap firms, the average award size is 11,908 and 18,272 shares, respectively. The average total shares awarded also rises with firm size: in small-cap firms, the average total shares awarded equals 3.2 million shares. This value rises to 5.0 million and 9.7 million shares for mid-cap and large-cap firms, respectively.

Overall, our sample contains about 20 billion share awards. This is distributed as 11.5 billion in small-cap firms, 4.6 billion in mid-cap firms and 3.6 billion in large-cap firms.

We use event-study methodology as described below to measure the abnormal returns around event dates. Event dates are defined as option grant dates. We measure 90 days of cumulative abnormal returns (CAR) before the event date and 90 days of cumulative abnormal returns after the event date.

To explore whether executives still time their options, we compute abnormal returns by subtracting the return to the value weighted index of the New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and the National Association of Securities Dealers Automated Quotations (NASDAQ) stocks from the returns for firms with the option awards to executives. This approach controls for market movements and implicitly assumes that average beta or risk-exposure is one. Given that our sample contains over 9,000 firms, this assumption is satisfied. Hence, abnormal return $AR_{i,t}$ for stock i and day t is computed as:

$$AR_{it} = (R_{it} - R_{mt}) \quad \text{for each firm } i \text{ and day } t,$$

where R_{it} is the simple daily return on the stock option i awarded to insiders on day t . R_{mt} is the daily return to the value-weighted index of NYSE, AMEX, and NASDAQ stocks on day t . For each event date t , these returns are first averaged across all option granting firms i to compute average abnormal returns:

$$AAR_t = \frac{1}{n_t} \sum_{i=1}^{n_t} AR_{it}$$

The average abnormal returns are then cumulated across the event dates as follows:

$$CAR_T = \sum_{t=1}^T AAR_t$$

These cumulative abnormal returns are then graphed to examine the behavior of abnormal returns around gifting dates.

Figure 1 shows the overall pattern of abnormal returns. Stock returns are relatively flat until about day -30 (30 trading days before the option grant date). From that point they begin to increase. During the 90 days following the option grant date, stock prices rise abnormally by more than 6%. This finding establishes that executives are still timing their option awards.

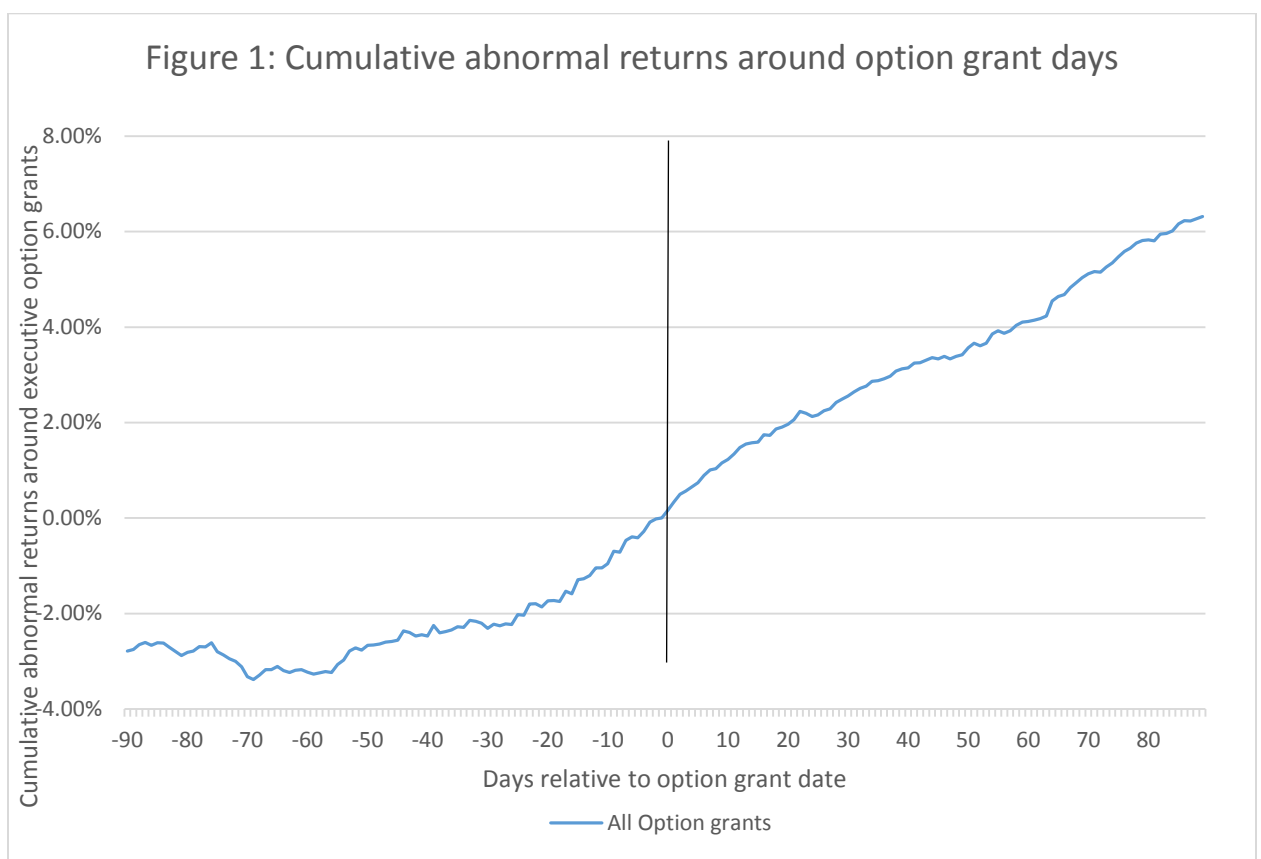


Figure 1: Cumulative abnormal returns around executives' option grant dates. Abnormal returns are computed using market adjusted model. Day 0 refers to the grant day. Day 10 refers to the 10th trading day after the grant date, while day -10 refers to the tenth trading day before the grant date. Executives have the title of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair and members of the various board committees.

Next we examine abnormal stock returns grouped by the number of shares granted. These results are shown in Figure 2. First, Figure 2 shows that post-grant abnormal returns line up positively with shares granted. The largest share-grant group has the largest post-grant abnormal returns, while the smallest share-grant group has the smallest post-grant abnormal returns. For the small share-grant group (1000 shares or fewer) the abnormal returns reach about 2%. This value jumps to 4% for the middle group (between 1,000 and 500,000 shares granted) and about 9% for the largest grant-size group (more than 5000,000 shares granted). These findings further corroborate the conclusion that the post-grant returns are not due to random noise. Instead, this evidence indicates very clearly that the greater the benefits to executives (greater shares granted), the greater is the manipulation of stock returns.

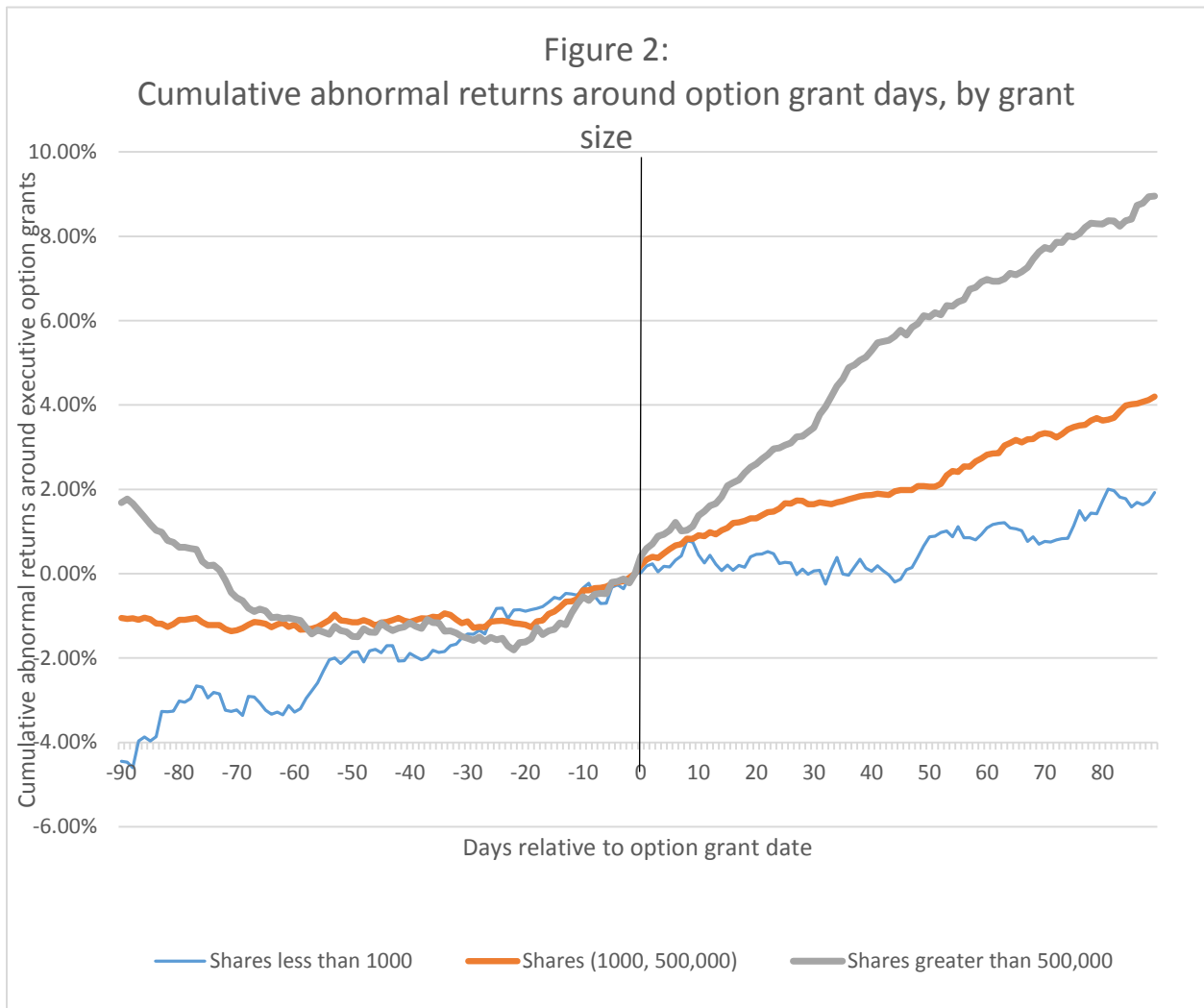


Figure 2: Cumulative abnormal returns around executives' option grant dates. Abnormal returns are computed using market adjusted model. Day 0 refers to the grant day. Day 10 refers to the 10th trading day after the grant date, while day -10 refers to the tenth trading day before the grant date. Executives have the title of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair and members of the various board

committees.

Next we examine the abnormal stock return patterns grouped by the relation of the executives. Figure 3 displays 180 days of abnormal returns around grant date for officers, directors, and top executives.⁸³ One hypothesis is that because top executives have access to all private information about the company, they should have the most ability to influence stock prices. Another hypothesis is that manipulations originate from the board of directors. Using this logic, directors' options should show the largest evidence of manipulations. The evidence shown in Figure 3 however indicates the stock price patterns are the same for all three groups. This finding indicates that options are typically granted on the same day to all executives and directors, and thus it is not possible to distinguish between subgroups of insiders.

⁸³ We define top executives to include CEOs, CFOs, CI, CO, CT, Chairmen of the Board, Presidents, officers and owners of more than 10% of the outstanding shares.

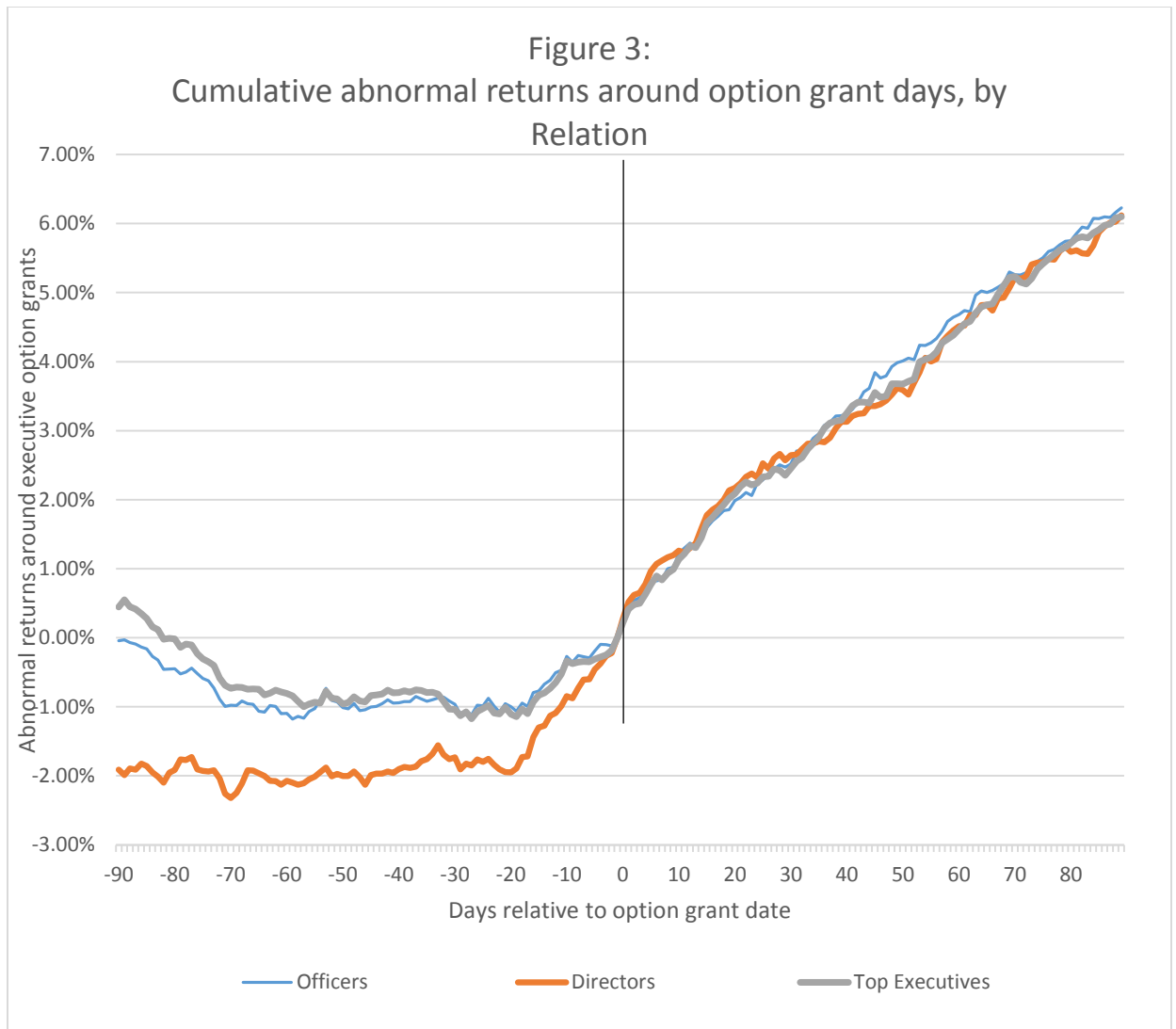


Figure 3: Cumulative abnormal returns around executives' option grant dates. Abnormal returns are computed using market adjusted model. Day 0 refers to the grant day. Day 10 refers to the 10th trading day after the grant date, while day -10 refers to the tenth trading day before the grant date. Executives have the title of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair and members of the various board committees. Top executives include CEO, CFO, CI, CO, CT, President, and Chairman of the Board,

Next we examine the manipulation of option awards for scheduled and unscheduled awards. Managers' ability to influence stock prices on the grant or exercise date is limited for scheduled awards. Managers can influence the stock price of a scheduled award only if they have timely and relevant information before the scheduled date. They can release the good news after the grant date or release the bad news before the grant date. To the contrary, it is easier for managers to influence the stock price of an unscheduled award. However, if executives backdate their options, they can backdate all options with equal ease, regardless of the scheduled or

unscheduled status.

Figure 4 shows the 180 day abnormal returns around the grant date for scheduled and unscheduled awards. An award is defined as scheduled if there is another grant within plus or minus two days of the prior calendar year. Otherwise, the grant is defined as unscheduled. Figure 4 shows that the average abnormal returns are the same for scheduled and unscheduled awards. This finding suggests that executives use a variety of manipulative games to time the stock option grants.

The evidence in Figure 4 thus suggests that manipulation involves more than timing games. Yet, if some of the option grants are backdated, these price patterns would be possible for both scheduled as well as unscheduled awards. Next we examine the evidence for potential backdating of executive options.

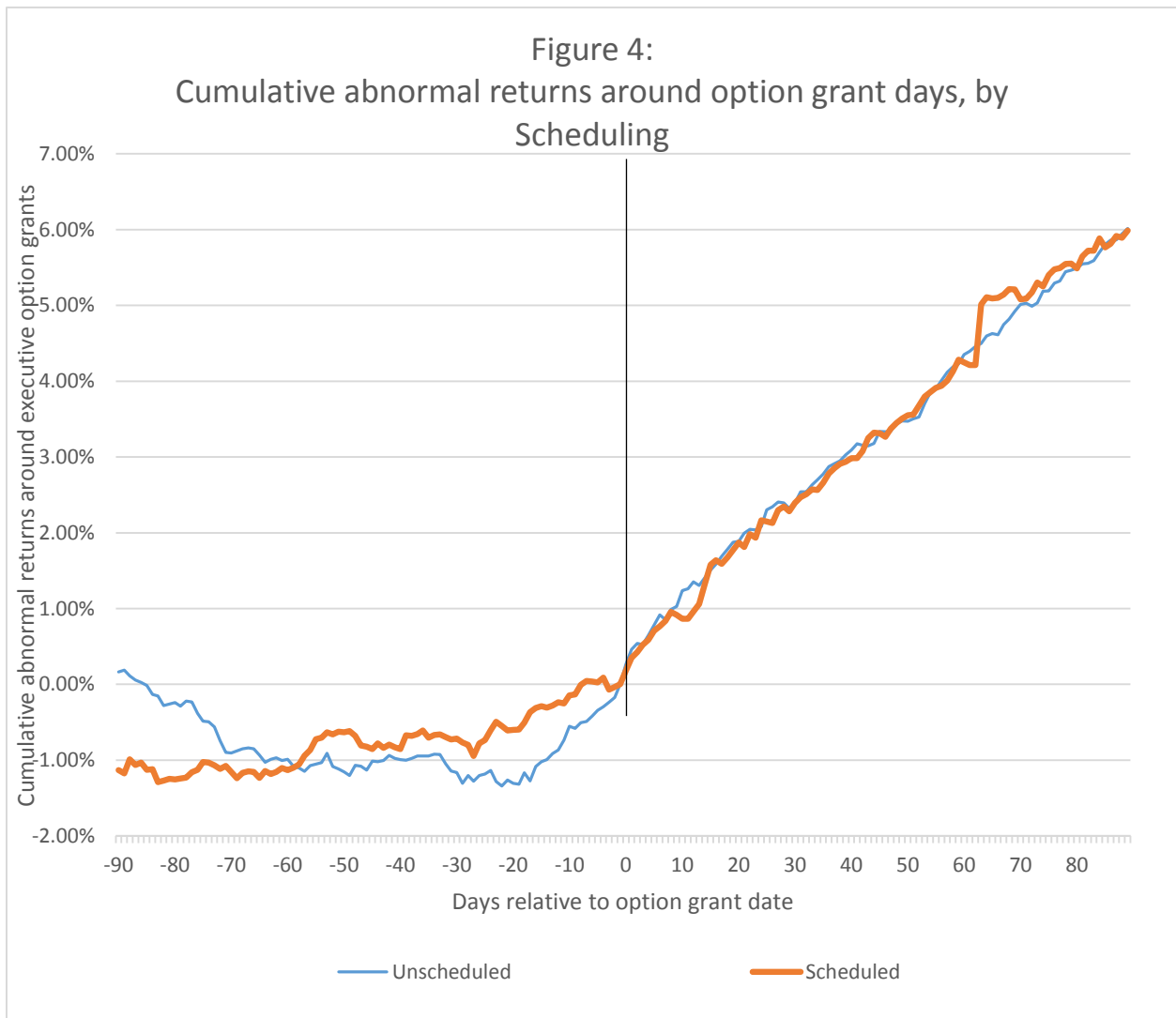


Figure 5: Cumulative abnormal returns around executives' option grant dates. Abnormal returns are computed using market adjusted model. Day 0 refers to the grant day. Day 10 refers to the 10th trading day after the grant date, while day -10 refers to the tenth trading day before the grant date. Executives have the title of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair and members of the various board committees. Reporting delays are measured from the grant date to the SEC receipt date.

As an additional test of backdating, we also classify the options by the abnormal stock returns around the grant date. Since backdating involves picking a date with the lowest stock price, we group options into two categories, one group showing an abnormal stock price decline 10 days before the grant date, and the other showing an abnormal stock price increase during the 10 days before the grant date. The backdating hypothesis predicts that the group with a stock price decline should show a greater subsequent rise in stock price.

The evidence is shown in Figure 6. Consistent with the backdating hypothesis, the group with a prior 10-day stock price drop shows about a 7% rise during the next 90 days. In contrast, the group with a prior 10-day stock price increase before the grant date shows only a 5% increase during the next 90 days. Once again, this evidence corroborates the finding that at least some options grants are still being backdated.

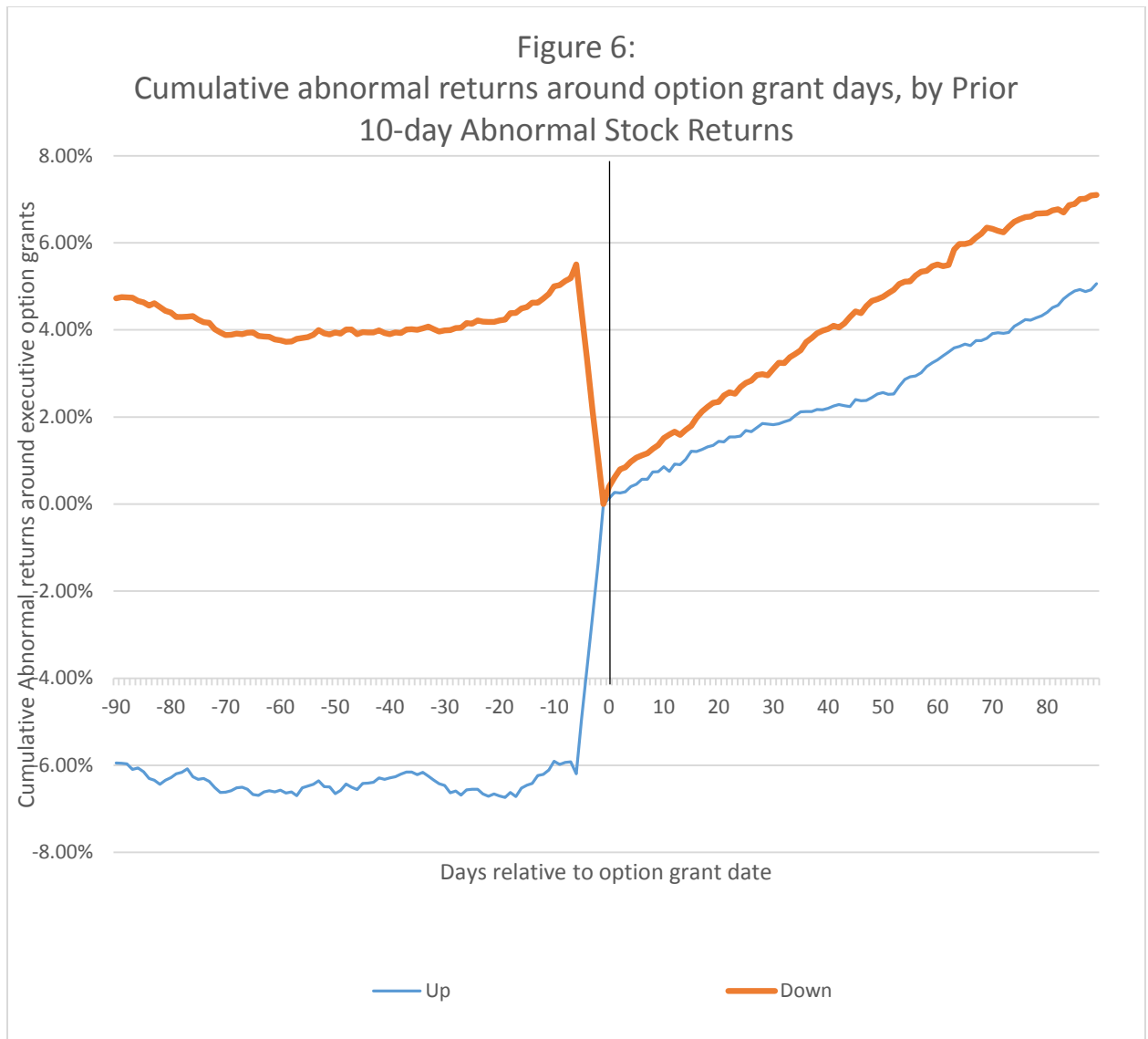


Figure 6: Cumulative abnormal returns around executives' option grant dates. Abnormal returns are computed using market adjusted model. Day 0 refers to the grant day. Day 10 refers to the 10th trading day after the grant date, while day -10 refers to the tenth trading day before the grant date. Executives have the title of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair and members of the various board committees. If the 10 day cumulative abnormal return from day -10 to day -1 is positive, then prior return is classified as "Up." If the 10 day cumulative abnormal return from day -10 to day -1 is negative, then prior return is classified as "Down."

Overall, the evidence presented in this section indicates that option grants are still being manipulated. Abnormal stock returns rise about 6% during the 90 days following the option grants. Large volume grants show a greater amount of manipulation. Similarly, late reported option grants also show a greater amount of subsequent abnormal returns consistent with backdating. Option grants where stock price drops during the 10-days before the grant date show

a large bounce back after the grant date. This evidence is consistent with both timing and backdating games.

III. Federal Securities Laws Implicated in Stock Option Manipulations

Section 10(b) of the Securities Act of 1934 makes it illegal for anyone to “use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.”⁸⁴ Under SEC Rule 10b-5, it is unlawful for anyone “(a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,” in connection with a purchase or sale of securities.⁸⁵

To establish a violation of these federal securities laws, the SEC must show that there was “(1) a material misrepresentation, (2) connection with the purchase or sale of a security, (3) scienter, and (4) use of the jurisdictional means.”⁸⁶ Material misrepresentation exists where there is “a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁸⁷ The determination of the materiality depends on both questions of law and fact.⁸⁸ Courts entertain factors such as whether the disclosure in question impacted stock price,⁸⁹ as well as the degree to which the earnings or losses were misstated.⁹⁰ The SEC has resisted establishing a quantitative standard for determining materiality⁹¹ and emphasized qualitative factors, such as the intent of the misstatement or omission, in the analysis.⁹²

A. Options Backdating and Forward-Dating

Between 2003 and 2010, the SEC brought charges against 32 companies and/or their executives for options backdating.⁹³ Upon discovery of options backdating, corporations may be

⁸⁴ 15 U.S.C. § 78j.

⁸⁵ 17 C.F.R. § 240.10b-5.

⁸⁶ SEC v. C. Jones & Co., 312 F. Supp. 2d 1375, 1379 (D. Colo. 2004).

⁸⁷ Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

⁸⁸ SEC v. Todd, No. 03CV2230, 2006 U.S. Dist. LEXIS 41182, at 13 (S.D. Cal. May 23, 2006).

⁸⁹ *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424-25 (3rd Cir. 1997).

⁹⁰ Narayanan et al. *supra* note 4, at 1608.

⁹¹ The Second Circuit adopted the SEC’s 1999 Staff Accounting Bulletin in dismissing quantitative benchmarks in *Ganino v. Citizens Utilities Co.* (228 F.3d 154, 163-64 (2nd Cir. 2000)) (stating SEC staff accounting bulletins are “a body of experience and informed judgment” (citing *Skidmore v. Swift & Co.*, 323 U.S. 134, 140), well-reasoned, and consistent with law.)

⁹² Narayanan et al. *supra* note 4, at 15 (citing SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45, 150, 45, 150 (1999)).

⁹³ The SEC charged the following companies and/or their officers/directors in the following chronological order: Peregrine Systems, Inc. (June 30, 2003); Symbol Technologies, Inc. (June 3, 2004) (resulting in a \$37 million fine

required to restate financial statements and could face significant penalties. The board of directors may also be implicated in this wrongdoing, particularly if they knew or should have known about the practice.⁹⁴ The former CFO and member of the board of Brocade Communication Systems, Inc. (Brocade), for example, was implicated under allegations that he had knowledge of the practice and did not address it.⁹⁵

Undisclosed options backdating and forward-dating violate §10(b) of Securities Exchange Act of 1934⁹⁶ and SEC Rule 10b-5.⁹⁷ First, undisclosed backdating and forward-dating satisfy the material misrepresentation requirement. It is likely that a reasonable investor would find this information to be significant in making investment decisions, especially because executive compensation is a major focus for shareholders.⁹⁸ When backdating and forward-dating ensues, corporate financial statements are inaccurate and tax laws are violated.⁹⁹

In its first action in 2003, for example, the SEC alleged that Peregrine Systems, Inc. understated its expenses by about \$90 million, when it “fail[ed] to record any expense for compensation when it issued incentive stock options.”¹⁰⁰ Next, the SEC charged Symbol Technologies, Inc. for manipulating exercise dates of stock options at the cost of \$229 million.¹⁰¹ In one prominent case, the SEC required Brocade to restate six years of financial statements.¹⁰² The civil fraud action filed by the SEC against three former executives of Brocade alleged that the backdating of stock options caused the inflation of the company’s net income by

for the company); Brocade (July 20, 2006) (resulting in a \$7 million penalty); Comverse Technology, Inc. (Aug. 9, 2006); Engineered Support Systems, Inc. (Feb. 6, 2007) (resulting in a \$886,557 payment for the former controller of the company); Take-Two Interactive Software, Inc. (resulting in the company settling for \$3 million in civil penalties and the former CEO/Chairman settling for over \$6 million in civil penalties, disgorgement, etc.) (Feb. 14, 2007); Monster Worldwide, Inc. (Feb. 15, 2007); McAfee, Inc. (Feb. 28, 2007); Apple (Apr. 24, 2007) (resulting in the settlement of \$2.2 million against former General Counsel); Mercury Interactive (May 31, 2007); Engineered Support Systems, Inc. (second allegations; July 12, 2007); KLA-Tencor (July 25, 2007); Brooks Automation (July 26, 2007); Integrated Silicon Solution (Aug. 1, 2007); Safe-Net, Inc. (Aug. 1, 2007); Brocade (additional executive; Aug. 17, 2007); Juniper (Aug. 28, 2007); Maxim Integrated Products (Dec. 4, 2007) (former CEO accepts penalty of \$800,000); UnitedHealth Group (Dec. 6, 2007) (former CEO/Chairman settles for \$468 million-largest settlement to date); Marvell Technologies (May 8, 2008); Analog Devices (May 30, 2008); Microtune, Inc. (July 1, 2008); Sycamore Networks (July 9, 2008); HCC Insurance Holdings, Inc. (July 22, 2008); Embarcadero Technologies, Inc. (Sept. 9, 2008); KB Home (Sept. 15, 2008) (resulting in a \$7.2 million settlement against former Chairman and CEO); Blue Coat Systems (Nov. 12, 2008); Research in Motion (Feb. 17, 2009); Pediatrix Medical Group (Mar. 5, 2009); Quest Software (Mar. 12, 2009); Ulticom (June 18, 2009); The Hain Celestial Group, Inc. (Sept. 3, 2009); Black Box Corporation (Dec. 4, 2009); Trident Microsystems, Inc. (July 16, 2010). *See* SEC, Spotlight on Stock Options Backdating: Enforcement Actions Related to Options Backdating (last updated Jul. 19, 2010), <https://www.sec.gov/spotlight/optionsbackdating.htm>.

⁹⁴ Narayanan et al. *supra* note 4, at 1614.

⁹⁵ SEC v. Reyes, Complaint No. 06-4435, 2 (N.D. Cal. July 20, 2006).

⁹⁶ 15 U.S.C. § 78j.

⁹⁷ 15 U.S.C. § 78j(a)(2)(b). For a full and comprehensive analysis of the illegality of options backdating and forward-dating, as well as the economic impact of the practices, *see* Narayanan, et al. *supra* note 4.

⁹⁸ Narayanan et al. *supra* note 4. *See infra* Part III (B) (2) (discussing how shareholders want clearer and more comprehensive disclosures on executive compensation).

⁹⁹ *Id.* at 1610.

¹⁰⁰ Cox, *supra* note 33. *See also* SEC v. Peregrine Systems, Inc., Complaint No. 03 CV (S.D. Cal. June 2003).

¹⁰¹ Cox, *supra* note 33. *See also* SEC v. Symbol Technologies, Inc., Complaint (E.D.N.Y. June 3, 2004).

¹⁰² *Id.* (citing SEC v. Alexander, Complaint No. 1:06-CV-03844 (E.D.N.Y. Aug. 9, 2006)).

approximately \$1 billion in just 2001.¹⁰³ Even when the amount has a minor effect on financial statements, research shows that it has a significant impact on shareholder earnings.¹⁰⁴

Second, the fraud must have occurred in connection with the purchase or sale of securities. This requirement is met when the “scheme to defraud and the sale of securities coincide.”¹⁰⁵ The courts consider press releases, quarterly reports, or any documents that investors may rely on as evidence.¹⁰⁶ Because backdating of stock options almost always results in misrepresentations in financial statements, the element can generally be satisfied.¹⁰⁷

In its most recent charges for option backdating, the SEC charged Trident Microsystems and the company’s former CEO and CAO with stock option backdating in 2010.¹⁰⁸ The SEC alleged that executives in the corporation backdated stock options from at least 1993 to May 2006, thereby, concealing millions of dollars in expenses from its shareholders. The company filed a restatement in 2007 showing about \$37 million in compensation expenses that were not accurately recorded with the SEC over a thirteen year period.¹⁰⁹ By not accounting for these grants, Trident overstated its pre-tax income by as much as 113 percent in each fiscal year during the period.¹¹⁰

The third element requires that the defendant had “a mental state embracing intent to deceive, manipulate, or defraud.”¹¹¹ The standard for meeting this requirement varies depending on the jurisdiction. The Ninth Circuit, for example, requires “deliberate recklessness” or conduct that shows “extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”¹¹² As with the previous elements, the third element is fairly easily satisfied with options backdating practice due to the deception inherent in changing the date of a previously granted stock option.¹¹³ The mental state required by this third element would not be present, however, in cases of simple procedural mistake.¹¹⁴

The last element mandates that the fraud is conducted “by the use of any means or instrumentality of interstate commerce, or of the mails.”¹¹⁵ This element is also easily satisfied, as it requires a link to either mail or interstate commerce, which the courts have historically

¹⁰³ Cox, *supra* note 33.

¹⁰⁴ Narayanan et al. *supra* note 4, at 1611.

¹⁰⁵ *Id.* (quoting SEC v. Zandford, 535 U.S. 813, 822 (2002)).

¹⁰⁶ SEC v. C. Jones & Co., 312 F. Supp. 2d 1375, 1380 (D. Colo. 2004 (citing SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1933))).

¹⁰⁷ Narayanan et al. *supra* note 4, at 1612.

¹⁰⁸ SEC, Litigation Release No. 21593, SEC v. Trident Microsystems, Inc. et al., Civil Action No. 1:10-CV-01202 (JDB) (D.D.C.) (July 16, 2010).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* Trident and the two executives settled the matter without admitting or denying the SEC’s allegations.

¹¹¹ Narayanan et al. *supra* note 4, at 1612 (citing Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976))).

¹¹² *Id.* at 1613 (citing SEC v. Dain Rauscher, Inc., 254 F.3d 852, 856 (9th Cir. 2001)).

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 1613-14 (citing 17 C.F.R. §240.10b-5 (2006)).

interpreted very broadly.¹¹⁶ Importantly, the SEC filing required of executive compensation plans “satisfies the jurisdictional means requirement.”¹¹⁷

B. Spring-Loading

The legality of spring-loading under Rule 10(b)(5) has been hotly debated.¹¹⁸ Even the SEC Commissioners do not agree on whether spring-loading should be considered a violation of insider trading laws.¹¹⁹ SEC Commissioner Paul Atkins argued that it is unclear if “there is a legitimate legal rationale for pursuing any theory of insider trading in connection with option grants.”¹²⁰ Former SEC Chief Accountant Lynn Turner, on the other hand, has testified that non-disclosure of spring-loading is a “false and misleading” statement in the context of securities laws.¹²¹ In addition, former Chairman Christopher Cox has remarked that the Commission is just as “concerned with misbehavior in using inside information to time the granting of options” as with backdating and expressed interest in the practice of spring-loading.¹²² The SEC’s approach is further complicated by its initial pursuit of Analog Devices, Inc. for spring-loading, where the Commission alleged the company “failed to adequately disclose that it priced stock options before the release of favorable financial results.”¹²³ Although the initial investigation and complaint included both backdating and spring-loading allegations, the settlement for \$3 million only addressed backdating. The SEC reportedly did not charge the company with spring-loading because the conduct in question took place prior to the adoption of the 2006 express disclosure rules.¹²⁴

¹¹⁶ See, e.g., *United States v. Kunzman*, 54 F.3d 1522, 1527 (10th Cir. 1995); *Dupuy v. Dupuy*, 511 F.2d 641, 643-44 (5th 1975) (“We align ourselves with the great majority of courts which have considered this issue, and hold that intrastate use of the telephone may confer federal jurisdiction over a private action alleging violation of 10 of the Securities Exchange Act of 1934 and SEC Rule 10b-5.”)

¹¹⁷ Narayanan et al. *supra* note 4, at 1614 (citing *SEC v. Todd*, No. 03CV2230, 2006 U.S. Dist. LEXIS 41182, at 9 (S.D. Cal. May 30, 2006)).

¹¹⁸ See, e.g., Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 9, n.27 (Univ. of Colo. Legal Studies Working Paper Series, Working Paper No. 06-38, 2006), available at:

<http://ssrn.com/abstract=939914>; Stephen Bainbridge, *Spring-loaded Options and Insider Trading*, PROFESSORBAINBRIDGE (July 10, 2006), http://www.professorbainbridge.com/2006/07/springloaded_op_1.html (describing Professor Iman Anabtawi’s argument that spring-loaded options constitute a form of insider trading or breach of fiduciary duty); Larry E. Ribstein, *Options and Insider Trading*, IDEOBLOG (July 11, 2006), http://busmovie.typepad.com/ideoblog/2006/07/options_and_ins.html (refuting Anabtawi’s insider trading argument).

¹¹⁹ For a discussion about the differing views of SEC Commissioners on the legality of spring-loading, see William Hughes, *Stock Option “Springloading”: An Examination of Loaded Justifications Rules*, 33 J. CORP. L. 777, 788-89 (Spring 2008); Matthew Orso, “Spring-loading” *Executive Stock Options: An Abuse in Need of a Federal Remedy*, 53 SLU L.J. 628, 637-38 (2009).

¹²⁰ Hughes, *supra* note 119, at 788 (quoting Paul S. Atkins, Comm’r of SEC, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), <http://www.sec.gov/news/speech/2006/spch070606psa.htm>).

¹²¹ *Id.* (citing Former SEC Chief Accountant Lynn Turner’s remarks in Hearing on Stock Options Backdating Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 2-4 (2002)).

¹²² Orso, *supra* note 119, at 637 (citing Jonathan Peterson, *SEC Broadens Stock Option Investigation*, L.A. TIMES (June 20, 2006) at C1).

¹²³ *Id.* (citing Kara Scannell, Charles Forelle & James Bandler, *Can Companies Issue Options, Then Good News?*, WALL ST. J. (July 8, 2006) at A1).

¹²⁴ Kara Scannell & John Hechinger, *SEC, Analog Settle Case*, WALL ST. J. (May 31, 2008).

These 2006 SEC disclosure requirements also do not take a position on spring-loading. The SEC's release adopting the final rules in August 2006 states:

The Commission does not express a view as to whether or not a company may or may not have valid and sufficient reasons for such timing of option grants, consistent with a company's own business purposes. Some commentators have expressed the view that following these practices may enable a company to receive more benefit from the incentive or retention effect of options because recipients may value options granted in this manner more highly or because doing so provides an immediate incentive for employee retention because an employee who leaves the company forfeits the potential value of unvested, in-the-money options. Other commentators believe that timing option grants in connection with the release of material non-public information may unfairly benefit executives and employees.¹²⁵

The current rules simply require disclosure that a company grants stock options when in possession of material nonpublic information, rather than the disclosure of that information.¹²⁶ Yet, we argue spring-loading and the practice of manipulating information flow to convert at-the-money options into in-the-money options violates at least the spirit of § 10(b) of the Securities Act of 1934 and SEC Rule 10b-5, if not the statute and the rule, and is contrary to the congressional intent behind federal securities regulation. We further argue in Part IV that such self-interested manipulation of information flow also violates state fiduciary duty laws.

Although the SEC has not taken a clear stand on the issue, the legality or illegality of spring-loading, specifically relating to insider trading rules, has been debated by scholars. Professor Iman Anabtawi, for example, argues that spring-loaded options can be considered as discounted options.¹²⁷ She states that "granting a stock option with an exercise price that does not reflect favorable inside information is substantively equivalent to granting a discount option; that is, an option with an exercise price below the market price on the date of the grant. The upward price adjustment that results from the release of the inside information is the size of the discount."¹²⁸ Therefore, spring-loading and backdating may be different in form, but are largely the same in substance.¹²⁹ Anabtawi further argues that "[w]hile it is true that using discount options may be efficient compensation policy, doing so without adequate disclosure to shareholders involves making materially misleading statements in connection with a securities transaction – in other words insider trading."¹³⁰

The purpose and policy considerations of § 10(b), which will be discussed in greater detail below, strongly weigh in favor of making the grant of spring-loaded options a disclosure-inducing event.

¹²⁵ 71 Fed. Reg. at 53159, 53163.

¹²⁶ See 17 C.F.R. § 229.402(b)(2)(iv).

¹²⁷ See Iman Anabtawi, *Secret Compensation*, 82 N.C.L. REV. 835, 843 (2004).

¹²⁸ Brainbridge, *supra* note 118 (describing *id.* at 855-57).

¹²⁹ *Id.*

¹³⁰ *Id.* (describing Anabtawi, *supra* note 127, at 875-86).

1. Disclosure requirements

Executive compensation reporting requirements promulgated by the SEC in 2006, mandate that a company disclose “all material elements of . . . compensation of . . . named executive officers.”¹³¹ The material elements may include “[h]ow the determination is made as to when awards are granted, including awards of equity-based compensation such as options.”¹³² Although these disclosure requirements appear broad, the release adopting the final rules expressly states that the SEC takes no position on whether a company has “valid and sufficient reasons” for “timing option grants in connection with the release of material non-public information,” and would require only the “plan or practice” of spring-loading or bullet-dodging be disclosed.¹³³ While remarking that a spring-loading plan “would be material to investors and thus should be fully disclosed,” the SEC only requires that “the company should disclose that the board of directors or compensation committee may grant options at times when the board or committee is in possession of material non-public information.”¹³⁴ Thus, even the more strict disclosure rules only require a company that grants stock options while in possession of material nonpublic information to disclose that fact to its shareholders.¹³⁵

Yet, the federal courts have articulated a “disclose or abstain rule” under Rule 10b-5, which establishes that an insider holding material nonpublic information must either disclose this information before trading or not trade until the information has been released to the public.¹³⁶ The case that provides the strongest precedent for the illegality of manipulation of information flow and spring-loading is *SEC v. Texas Gulf Sulphur Co.*¹³⁷ In this case, the defendants, company executives, possessed material inside information that their company had found valuable mineral deposits in Canada.¹³⁸ While knowing of this new discovery, the defendants accepted stock option grants from an unknowing board of directors.¹³⁹ After the company made a public announcement of discovery, the corporate stock price soared, increasing by over 140 percent from the date of the stock options grant.¹⁴⁰ According to the *Texas Gulf Sulphur* court, in order to comply with Rule 10b-5, the option recipients would have either had to disclose the inside information in their possession to the company’s stock option committee or reject the options.¹⁴¹ The executives failed to make the required disclosure, and the court rescinded the option grants.¹⁴²

¹³¹ Orso, *supra* note 119, at 638 (quoting 17 C.F.R. § 229.402(b)).

¹³² *Id.* (quoting 17 C.F.R. § 229.402(b)(2)(iv)).

¹³³ 71 Fed. Reg. at 53159, 53163.

¹³⁴ *Id.*

¹³⁵ Orso, *supra* note 119, at 639.

¹³⁶ Anabtawi, *supra* note 127, at 860.

¹³⁷ 401 F.2d 833 (2d Cir. 1968).

¹³⁸ *Id.* at 843-44.

¹³⁹ Orso, *supra* note 119, at 640 (citing *Texas Gulf*, 401 F.2d at 844).

¹⁴⁰ *Id.* (citing *Texas Gulf*, 401 F.2d at 847).

¹⁴¹ *Texas Gulf*, 401 F.2d at 856-57.

¹⁴² *Id.* at 857.

Texas Gulf Sulphur provides an early articulation of the “disclose or abstain rule,” which forms the basis of classical insider trading theory¹⁴³ and requires that “an insider possessing material inside information must either disclose such information prior to trading or abstain from trading until the information has been disclosed.”¹⁴⁴ This rule was initially based on the ground that all members of the open market were “entitled to equal access to material information.”¹⁴⁵ The Supreme Court, however, later limited the scope of the rule. In *Chiarella v. United States*,¹⁴⁶ the Court adopted the SEC’s argument from *In re Cady, Roberts & Co.*¹⁴⁷ and held that the defendant must have an established duty arising from a “fiduciary or other similar relation of trust and confidence” before the “disclose or abstain” rule applies.¹⁴⁸ The Court further confirmed this requirement in *Dirks v. SEC*.¹⁴⁹

The question then arises as to whether, by spring-loading and manipulating the timing of information flow, executives and directors might be in breach of a pre-existing duty. Under *Dirks*, not every breach of fiduciary duty in relation to a securities transaction is a violation of Rule 10b-5;¹⁵⁰ the breach must come from “some manipulation or deception.”¹⁵¹ *Dirks* followed *Santa Fe Industries v. Green*, which held that only conduct that “can be fairly viewed as ‘manipulative or deceptive’ within the meaning of [Section 10(b)]” could be the source of liability.¹⁵²

The Supreme Court has not clarified the source of the fiduciary duty within the context of federal securities law.¹⁵³ In fact, the Court explicitly argued against a federal common law fiduciary duty in *Santa Fe*, as it would “bring within [Rule 10b-5] a wide variety of corporate conduct traditionally left to state regulation.”¹⁵⁴ Despite this reluctance, however, the Court has implied a federal source of the fiduciary obligation in key cases following *Santa Fe*.¹⁵⁵

Professor Anabtawi argues that the difficulty is in determining whether spring-loading satisfies the “fraud or deception” element as the source of the fiduciary duty is uncertain.¹⁵⁶ The

¹⁴³ Anabtawi, *supra* note 127, at 873-76 (discussing the inadequacy of extending misappropriation theory to classical insider trading cases). An alternative theory of liability for insider trading is the misappropriation theory, which imposes liability under Rule 10b-5 when an individual “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.” *United States v. O’Hagan*, 521 U.S. 642, 652 (1997). The misappropriation theory is not applicable to the manipulation of stock option grants or information flow, because misappropriation theory imposes liability on corporate outsiders, and the parties involved in the contexts discussed here are corporate insiders. *Id.* at 652-53.

¹⁴⁴ Anabtawi, *supra* note 127, at 859.

¹⁴⁵ *Id.* (citing *Texas Gulf*, 401 F.2d at 848).

¹⁴⁶ 445 U.S. 222 (1980).

¹⁴⁷ 40 S.E.C. 907 (1961).

¹⁴⁸ *Chiarella*, 445 U.S. at 228.

¹⁴⁹ 463 U.S. 646 (1983).

¹⁵⁰ Anabtawi, *supra* note 127, at 860 (citing *id.* at 654).

¹⁵¹ *Id.* (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

¹⁵² *Id.* (citing *Santa Fe Industries v. Green*, 430 U.S. 462, 473-74 (1977)).

¹⁵³ Anabtawi, *supra* note 136, at 862.

¹⁵⁴ *Id.* (citing *Santa Fe*, 430 U.S. at 478).

¹⁵⁵ See Anabtawi, *supra* note 136, at 861-62 (discussing the implications of *Chiarella*, 445 U.S. 222 (1980), *Dirks*, 463 U.S. 646 (1983) and *U.S. v. O’Hagan*, 521 U.S. 642 (1997) on the possible existence of a federal common law fiduciary duty).

¹⁵⁶ *Id.*

courts have held that the “fraud or deceit” element is satisfied by evidence of material misrepresentation on the part of the defendants.¹⁵⁷ The information that is being traded on in the context of spring-loading is likely to be material to the extent that the public information released after option grant significantly affects the price of the company’s stock¹⁵⁸ and to the extent that investors would find the information important in making their investment decisions.

Some commentators disagree with Professor Anabtawi finding that there is both a federal and state common law source of the fiduciary duty. Matthew Orso argues that under the true interpretation of the “disclose or abstain” rule, the disclosure of material insider information must be provided to the shareholders prior to the granting of the stock option.¹⁵⁹ Without such disclosure, there is a violation of Rule 10b-5. He finds that the Delaware Chancery has established that spring-loading is a breach of a fiduciary duty in *Tyson I* and *Tyson II*, further discussed in Part IV below. Orso concludes that “if the federal securities laws are ‘designed to protect shareholders from trading on incomplete or inaccurate information,’ then the SEC is failing this goal in regard to spring-loading.”¹⁶⁰

Assuming that a federal common law fiduciary duty exists, *Dirks* and *Chiarella* imply that a fiduciary relationship between corporate insiders and shareholders gives rise to a duty imposed on insiders to either abstain from trading or disclose to shareholders “material nonpublic information,” that is, “information intended to be available only for a corporate purpose and not for the personal benefit of anyone.”¹⁶¹ The difficulty in applying the disclose-or-abstain rule to stock option grants is that most other cases to which the rule applied involves open market transactions.¹⁶² Option grants, in contrast, are “intra-corporate transactions” which do not involve a direct trade with a shareholder.¹⁶³ The holding in *Texas Gulf Sulphur* would indicate that in the context of insider trading on option grants, disclosing the inside information to the compensation committee would absolve insider-executives of liability.¹⁶⁴

2. Insufficiency of disclosure

Although there are no federal cases addressing the disclosure requirements for spring-loading or manipulation of the timing of information release, two principles can be extracted from the cases applying the disclose-or-abstain rule. First, insider trading is a breach of the fiduciary duties owed to shareholders,¹⁶⁵ and second, using material nonpublic information that

¹⁵⁷ *Id.*

¹⁵⁸ See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424-25 (3rd Cir. 1997).

¹⁵⁹ Orso, *supra* note 119, at 628.

¹⁶⁰ *Id.* at n. 36 (“[t]here is much language in the debates prior to passage of those statutes and in later case law to the effect that the federal securities laws were designed to prevent the kinds of abuses of naïve investors that took place during that period.”) (citing Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 92 (2000)).

¹⁶¹ *Id.* at 654 (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

¹⁶² Although *Texas Gulf* has not been overturned, that case can be distinguished by the fact that the directors had no knowledge of the relevant inside information when issuing the options.

¹⁶³ Anabtawi, *supra* note 127, at 870.

¹⁶⁴ *Id.*

¹⁶⁵ Orso, *supra* note 119, at 647 (citing Theresa A. Gabaldon, *State Answers to Federal Questions: The Common Law of Federal Securities Regulation*, 20 J. CORP. L. 155, 198 (1995)). There exists a “relationship of trust and

is, intended for business purposes for the insider's own self-interest is intrinsically unfair.¹⁶⁶ According to *Dirks*, the duty of corporate insiders to disclose to shareholders is not a general duty, but one arising from a fiduciary relationship.¹⁶⁷ Although the Court has suggested that adequate disclosure requires a broader, more public release of information in some circumstances,¹⁶⁸ it is shareholders who are owed the duty of disclosure.¹⁶⁹

We contend that allowing spring-loading for the sole purpose of increasing the value of executive options, even if the practice is disclosed, is inconsistent with the purposes of § 10(b) of promoting investor confidence and protecting investors. First, a company “in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them.”¹⁷⁰ This reasoning implies that a company cannot trade its own stock through the use of material nonpublic information.¹⁷¹ Professor Anabtawi argues that “[a]llowing a company to time option grants around inside information can be analogized to allowing a company to engage in insider trading in the open market and then use the profits to pay its executives.”¹⁷² Furthermore, disclosure to the board only may not be enough to satisfy the duty of disclosure under § 10(b) because standard disclosure relating to executive compensation is usually considerably delayed.¹⁷³

Furthermore, although disclosure is the preferred method of the SEC and Congress in curbing potential abuses of executive compensation, there is little evidence to suggest that higher disclosure results in fewer abuses. Many shareholders simply do not read every disclosure, or cannot digest effectively what these disclosures state. According to a recent study, almost half of institutional investors think that disclosures about executive compensation need to be clearer and more comprehensive.¹⁷⁴ As the Director of Governance Research at Equilar simply states, “it is more important than ever that companies explain to their shareholder base why the compensation packages they offer are appropriate in size and structure.”¹⁷⁵ The study found that investors are highly dissatisfied with the compensation disclosure and that the proxies are unmanageably long and difficult, forcing them to rely on a small percentage of the information when making

confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.” *Chiarella v. United States*, 445 U.S. 222, 228. =

¹⁶⁶ *Id.* (citing *Gabaldon*, *supra* note 165, at 198-99). “This relationship [of trust and confidence] gives rise to a duty to disclose because of the ‘necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders.’” *Chiarella* 45 U.S. at 228–29 (alteration in original) (quoting *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951)).

¹⁶⁷ 463 U.S. 646, 654.

¹⁶⁸ *See id.* at 653 n.12 (citing *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973)).

¹⁶⁹ *Id.* at 653 n.10.

¹⁷⁰ *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994).

¹⁷¹ Anabtawi, *supra* note 127, at 871 (citing William K.S. Wang & Marc I. Steinberg, *Insider Trading* § 5.2.3.3, at 297–98 (1996)).

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ DAVID F. LARCKER ET AL., 2015 INVESTOR SURVEY: DECONSTRUCTING PROXY STATEMENTS-WHAT MATTERS TO INVESTORS (2015), available at https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements_0.pdf. For a summary of key points of the study see *Even the experts are frustrated: Stanford research finds shareholders dissatisfied with CEO pay disclosure*, STAN. G.S.B. NEWSROOM (Feb. 17, 2015), <https://www.gsb.stanford.edu/newsroom/school-news/even-experts-are-frustrated-stanford-research-finds-shareholders-dissatisfied>.

¹⁷⁵ *Id.* at 1.

decisions. In addition, investors are dissatisfied with the structure and amount of pay of the executives and only 21 percent think that CEO pay is linked to performance.¹⁷⁶ Therefore, it is unreasonable to expect SEC disclosure rules as they stand today to result in shareholders clearly understanding the details of the executive compensation plan they are approving. There is a real need to further regulate these disclosures to ensure that the information is comprehensible to the average shareholder and that the executive compensation adequately correlates to performance. Mere disclosure of a practice of spring-loading does neither.

3. Legislative intent

The legislative policy considerations behind the Securities Acts imply that disclosure should be extensive. The 1933 Act was intended to “‘substitute’ . . . ‘a philosophy of full disclosure for the philosophy of caveat emptor.’”¹⁷⁷ Moreover, Congress passed the 1934 Act in hopes that it would “[renew]investors’ confidence” through “a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations.”¹⁷⁸ The 1934 Act was the answer to the public concern of the “unscrupulous insider . . . [using] inside information for his own advantage.”¹⁷⁹ The legislative history, which takes account of the concerns giving rise to the need for and the popularity behind the Acts, suggests that “an executive must disclose material nonpublic information in some manner prior to an option grant, or refuse the options, in order to discharge the federal duty to disclose or abstain.”¹⁸⁰

Professor Anabtawi argues that the 1934 Act promotes full disclosure and requires the board of directors to “avoid making materially misleading statements in connection with a securities transaction.”¹⁸¹ The legislative intent behind the Acts also supports the argument that, the “disclose or abstain” rule ought to also bar materially misleading omissions.¹⁸² As shareholders often base their investment decisions on corporate communications, it is imperative that these board disclosures are both honest and full.¹⁸³ Moreover, there is an expectation that stock option grants are part of the executive compensation plan to incentivize officers to make decisions that raise the company’s stock price. When stock options are spring-loaded, but this fact is omitted from corporate disclosures to shareholders, the shareholders are misguided about the extent of the incentive device.¹⁸⁴

¹⁷⁶ DAVID F. LARCKER ET AL., *supra* note 174, at 2.

¹⁷⁷ Orso, *supra* note 119, at 648 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)).

¹⁷⁸ *Id.* (quoting H.R. Rep. No. 73-1383, at 13 (1934)).

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 649.

¹⁸¹ *Id.* (quoting Anabtawi, *supra* note 136, at 880 (citing Steve Thel, *The Original Conception of Securities 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 415 (1990)).

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.* (citing Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 820 (2002)).

In *In re Cady, Roberts & Co.*,¹⁸⁵ the SEC considered factors that are just as powerful in arguing against insider trading, as they would be in relation to spring-loading.¹⁸⁶ The court focused on two factors in analyzing whether there is an affirmative duty to disclose material information. First, the SEC looked for a relationship that provides access to information that is “intended to be available only for a corporate purpose and not for the personal benefit of anyone.”¹⁸⁷ Second, the SEC analyzed whether allowing one party to take advantage of that information is unfair.¹⁸⁸ This interpretation was used in *Texas Gulf Sulphur*, where the court found that “the purpose of the Securities Exchange Act was to prevent unfairness and inequalities in securities transactions.”¹⁸⁹ The court also noted in a footnote that the Act was envisioned to “eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.”¹⁹⁰ The themes of unfairness and inequality are focal points in analyzing whether spring-loading and the manipulation of the timing of information flow should be considered illegal.

Furthermore, gaming release of information contradicts the economic purpose of insider trading prohibitions. In *Texas Gulf Sulphur*, the court found that Rule 10b-5 was Congress’ attempt to level the risks in the financial market among insiders and outsiders, so that all have equal access to potential profits.¹⁹¹ Mandatory disclosure and insider trading prohibitions affect the way that investors act. Investors are usually risk-averse, and disclosure of information gives them a higher level of trust and confidence in the market. This reduction in risk means lower cost of capital for the firm because investors agree to a lower rate of return during time of public disclosures.¹⁹² This goal is undermined by the use of spring-loaded stock option grants.

4. Nature of the harm

Some scholars disagree with Commissioner Paul Atkins’ arguments alleging the legality of spring-loading, finding both that a party is harmed by the practice and that the decision to award loaded options does not fall within the discretion of the corporate board of directors under the business judgment rule.¹⁹³ Professor Hughes argues that there is a counterparty that is harmed by spring-loading, specifically as (1) spring-loaded options represent a cost to the corporation and its shareholders,¹⁹⁴ and (2) the benefits that may be intended for shareholders cannot compensate for the costs of the practice.¹⁹⁵ Therefore, spring-loading is not a victim-less.

First, options represent real value and cost to the corporation as they dilute the value of current stock. The practice also “conceals from investors the full scope of the costs attributed to

¹⁸⁵ 40 S.E.C. 907 (1961).

¹⁸⁶ Hughes, *supra* note 119, at 793.

¹⁸⁷ *Id.* at 786 (citing *In re Cady*, 40 S.E.C. at 912).

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 787 (citing 401 F.2d 833, 851-52 (2nd Cir. 1968)).

¹⁹⁰ *Id.* (quoting *Texas Gulf*, 401 F.2d at 848, n.9).

¹⁹¹ *Id.* at 787 (citing *Texas Gulf*, 401 F.2d at 851-52).

¹⁹² *Id.* (citing Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1118 (1985)).

¹⁹³ *Id.* at 789.

¹⁹⁴ *Id.* at 789-90.

¹⁹⁵ *Id.*

management compensation.”¹⁹⁶ Before 2005, the options awarded to employees were included as compensation expenses only if the exercise price on the date of the award was less than the market price.¹⁹⁷ Therefore, spring-loading “conceal[ed] from investors the full scope of the costs attributed to management compensation.”¹⁹⁸ Spring-loading prior to 2005 was in fact “artificially inflating corporate profits.”¹⁹⁹ Furthermore, even though all employee stock option awards create diluted costs for shareholders, spring-loaded options aggravate the problem. The practice increases the chance that a manager would exercise the option because timing the option award with the release of good news places the option at a more favorable position than the market price.²⁰⁰

5. Role of incentives

It has also been argued that spring-loading does not result in compensation incentives that align officer incentives with the incentives of the shareholders.²⁰¹ After all, the higher the increase of the stock price vis-à-vis the option’s exercise price, the greater the compensation for the officer. Hence, spring-loading “destroys the performance benefit that stock options are intended to provide shareholders,”²⁰² because “[f]rom the outset of the grant, a spring-loaded option immediately provides the officer with an unrealized profit.”²⁰³ Moreover, the possibility of spring-loading would presumably lead investors to question the effectiveness of the option grants in promoting long-term company performance because spring-loading allows corporate officers to unfairly profit without the intended incentive to act to maximize shareholder value. It would be virtually impossible under these circumstances to predict the incentive effects of the adoption of an option plan or of individual grants. While the practice does not completely eliminate the incentive to perform (the higher the eventual stock price, the more wealth to the officer) the practice decreases the performance incentive stock options were intended to provide in exchange for compensation.²⁰⁴ Thus, it may be appropriate to require disclosure by executives who are granted options while in possession of inside information similar to that required of insiders in their open market dealings, that is, substantive disclosure of the inside information to shareholders before the grant is made or abstention from accepting the grant.

C. Bullet-Dodging

Although spring-loading and bullet-dodging achieve the same result – the grant of stock options at a price lower than what they would have been otherwise – and are essentially mirror images of each other, courts differ on whether bullet-dodging raises the same legal issues as spring-loading. In *Desimone v. Barrows*,²⁰⁵ the court distinguished spring-loading (which it

¹⁹⁶ Hughes, *supra* note 119, at 790 (citing Anabtawi, *supra* note 136, at 852).

¹⁹⁷ *Id.* at 789.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 790.

²⁰¹ *Id.* at 791.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ 924 A.2d 908, 944.

likened to an in-the-money option grant) from bullet-dodging, noting that in the latter case the market has already absorbed the negative information and thus bullet-dodging involves a strike price at the stock's actual market price.²⁰⁶ That is, bullet-dodging does not involve trading on non-public material information because the relevant information will already have been released by the time of grant.

Moreover, *Dirks* states that “an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes ‘secret profits.’”²⁰⁷ Because the relevant non-public information that the insider-executive has about the company is already public by the time the grant is made, liability must be established by some other means. Yet, the practice of bullet-dodging itself, if not disclosed, would seem to constitute material, non-public information. To the extent that bullet-dodging influences executive compensation, bullet-dodging practices are likely to be considered material.

IV. Corporate Governance Implications: Fiduciary Duties

In addition to potentially violating federal securities laws, manipulation of stock options more clearly violate the fiduciary duties of the executives and directors. Corporate officers and directors owe the corporation and its shareholders the fiduciary duties of care and loyalty, and imbedded in these duties is the obligation to act in good faith.²⁰⁸ In addition, these individuals may also be violating their duties of disclosure when participating in the manipulation of stock options.

A. Overview of Fiduciary Duties

Corporate officers and directors are primarily obligated to uphold their fiduciary duties of care and loyalty, and breaches of these duties may give rise to liability for damages to shareholders. These duties are discussed below.

1. Duty of Care

The duty of care imposes a “reasonable person” standard on officers and directors, requiring that they inform themselves “prior to making a business decision, of all material information reasonably available to them,”²⁰⁹ and to play an active role in protecting the interests of the corporation and its stockholders.²¹⁰ Whether a fiduciary was informed of “all material information” is a fact-specific question as to the quality of the information, the advice

²⁰⁶ *Id.*

²⁰⁷ 463 U.S. 646, 654 (citing *In re Cady, Roberts, & Co.*, 40 S.E.C., at 916, n. 31.)

²⁰⁸ Narayanan et al. *supra* note 4, at 1622.

²⁰⁹ William M. Lafferty, Lisa A. Schmidt & Donald J. Wolfe, Jr., *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 PENN. ST. L. REV. 837, 842 (2012) [hereinafter Lafferty et al.] (citing *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984))).

²¹⁰ *See id.*

considered, and whether the fiduciary had “sufficient opportunity to acquire knowledge concerning the problem before acting.”²¹¹

Delaware courts consider a variety of factors related to the fiduciary’s actions and knowledge in determining the fiduciary’s compliance with the duty of care.²¹² The standard with respect to the duty of care is gross negligence, which in this context has been judicially defined as “reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”²¹³ Delaware statutory law, however, permits corporations to include in their articles of incorporation a provision exculpating directors from monetary liability to the corporation and shareholders for breach of the duty of care.²¹⁴ Most Delaware corporations have adopted a provision exculpating their fiduciaries to the extent possible under § 102(b)(7). Notably, this exculpation provision does not apply to violations of the duty of loyalty or the obligation of good faith.²¹⁵

The duty of care also implies a duty to monitor the behavior of management. In *In re Caremark International, Inc. Derivative Litigation (Caremark)*, the Delaware Court of Chancery indicated (in dicta) that directorial liability may attach for failure to implement adequate reporting systems.²¹⁶ The court stated that because “relevant and timely information is an essential predicate for satisfaction of the board’s supervisory and monitoring role,”²¹⁷ “a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists.”²¹⁸ The court further defined a multi-factor test to determine when directors breached their duty of care. To establish a violation of the duty of care, plaintiffs would need to show that (1) the directors knew or should have known that the violation of law was occurring, (2) the directors took no steps in a good faith effort to prevent or remedy that situation, and (3) the failure to take steps proximately resulted in the losses complained of by the plaintiffs.²¹⁹

2. Duty of Loyalty

²¹¹ Lafferty et al., *supra* note 209 (quoting *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1075 (Del. Ch. 1985), *aff’d*, 500 A.2d 1346 (Del. 1985)).

²¹² For a list detailing some of these factors, see Lafferty et al., *supra* note 209, at 842-843. *See also* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989).

²¹³ Lafferty et al., *supra* note 209, at 843 (quoting *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005) (quoting *Tomczak v. Morton Thiokol, Inc.*, No. 7861, 1990 WL 42607, at 12 (Del. Ch. Apr. 5, 1990))).

²¹⁴ *Id.* at 844 (citing 8 DEL. C. § 102(b)(7) (2005)). “The Delaware legislature amended § 102 of the General Corporation Law in 1986, in part, to address the concerns of directors following decisions of the Delaware Supreme Court in the mid- 1980s holding directors liable for breaches of the duty of care (such as *Van Gorkom*) and the concomitant rise in the cost of directors’ and officers’ insurance.” *See Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001).

²¹⁵ *Id.*

²¹⁶ *In re Caremark Int’l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

²¹⁷ *Id.* at 970.

²¹⁸ *Id.*

²¹⁹ *Id.* at 971.

The duty of loyalty requires that corporate officers and directors act in the best interest of the corporation and prioritize the interests of the corporation over their own self-interests.²²⁰ Corporate fiduciaries must “affirmatively protect the interests of the corporation,” in addition to “refrain[ing] from doing anything that would work injury to the corporation” or depriving it of profit or advantage that the fiduciary might otherwise lawfully have brought to it.²²¹ Therefore, a fiduciary “must not have disabling conflicts of interest.”²²² If there is such a conflict, the board must take affirmative steps to ensure the decision-making process is not tainted by the conflicts.²²³

The Delaware courts will find corporate officers or directors to be in breach of the duty of loyalty if they: “(i) cause the corporation to engage in an interested transaction which is not entirely fair to the corporation;”²²⁴ “(ii) profit from the use of confidential corporate information;”²²⁵ “(iii) take any action solely or primarily to entrench themselves in office;”²²⁶ or “(iv) otherwise place benefits to themselves or to affiliated entities ahead of benefits of the corporation.”²²⁷ The Delaware courts have generally considered a director fully independent only when his or her decision is solely based on the business merits of the transaction.²²⁸ The traditional example of a breach of the duty of loyalty is when a fiduciary either appears on both sides of the transaction or collects a personal benefit that the corporation does not.²²⁹

3. Acting in Good Faith

There has been much debate about whether there is a separate duty of good faith.²³⁰ Regardless, the duty of care and loyalty imbed the fiduciary duty of good faith.²³¹ It also goes

²²⁰ Lafferty et al., *supra* note 209, at 844 (citing *In re Walt Disney S'holder Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005)) (“[t]o act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation”).

²²¹ *Id.* at 845 (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)).

²²² Lafferty et al., *supra* note 209, at 845; Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 683 (2009).

²²³ *Id.*

²²⁴ *Id.* (citing *Cinemara, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167-68 (Del. 1995); *Cede & Co.*, 634 A.2d 345, 362-63).

²²⁵ *Id.* (citing *Brophy v. Cities Serv. Co.*, 70 A.2d 5, 7-8 (Del. Ch. 1949)) (“A fiduciary is subject to a duty to the beneficiary not to use on his own account information confidentially given him by the beneficiary or acquired by him during the course of or on account of the fiduciary relation or in violation of his duties as fiduciary, in competition with or to the injury of the beneficiary . . . unless the information is a matter of general knowledge.”)

²²⁶ *Id.* (citing *Polk v. Good*, 507 A.2d 531, 536-37 (Del. 1986); *Unocal v. Mesa Petroleum*, 493 A.2d 946, 954-56 (Del. 1985)).

²²⁷ *Id.* (citing *Gantler v. Stephens*, 965 A.2d 695, 706-08 (Del. 2009); *Aronson v. Lewis*, 473 A.2d 946, 954-56 (Del. 1985)).

²²⁸ *In re Walt Disney S'holder Derivative Litig.*, 907 A.2d 693, 751 (Del. Ch. 2005).

²²⁹ *Cede Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 2005) (citing *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984)).

²³⁰ See *In re Walt Disney*, 907 A.2d (the court discusses the issue of good faith as separate of the duty of care and loyalty); see also *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003):

It does no service to our law's clarity to continue to separate the duty of loyalty from its essence; nor does the recognition that good faith is essential to loyalty demean or subordinate that essential requirement. There might be situations when a director acts in subjective good faith and is yet not

beyond those duties, as it requires the fiduciary to take “all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.”²³² The good faith requirement generally requires an “honesty of purpose” and genuine respect and care for the interests of the fiduciary’s constituents.²³³ The Delaware courts, however, presume that directors are acting in good faith,²³⁴ thus the corporate law jurisprudence tends to focus on the components of a claim of bad faith.²³⁵

The Supreme Court of Delaware has held that bad faith may be shown where the fiduciary 1) intentionally acts with a purpose other than that of advancing the best interests of a corporation, 2) acts with the intent to violate applicable positive law,²³⁶ or 3) intentionally fails to act in the face of known duty to act, demonstrating a conscious disregard for his duties.²³⁷ Other actions taken in bad faith “include any action that demonstrates a faithlessness or lack of true devotion to the interests of a corporation and its shareholders.”²³⁸ Furthermore, the reason for the failure to act in good faith does not matter.²³⁹

4. Duty of Disclosure

Although the Delaware courts have stated that there are no other fiduciary duties outside of the recognized duties of care, loyalty, and perhaps good faith, some applications of these duties may include the duty of candor or disclosure.²⁴⁰ Therefore, if there is a federal duty of

loyal (*e.g.*, if the director is interested in a transaction subject to the entire fairness standard and cannot prove financial fairness), but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally. . . . For example, one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.

Id. See also *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. 1988) (finding that even if the directors acted in good faith, their actions “constituted an unintended violation of the duty of loyalty that the board owed to the shareholders” as it thwarted the franchise.); *Dana M. Muir & Cindy Schipani, Fiduciary Constraints: Correlating Obligation With Liability*, 42 Wake Forest L. Rev. 697, 717- 22 (2007); *cf.* IHS, 2004 Del. Ch. LEXIS 122, *3, 2004 WL 1949290, at *9 (discussing good faith arguments under both the duty of care and loyalty, and not as a separate duty).

²³¹ *Stone v. Ritter*, 911 A.2d 362, 362 (Del. 2006).

²³² *In re Walt Disney*, 907 A.2d at 755.

²³³ E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U.J.L. & POL’Y 1, 9 (2003).

²³⁴ See *Allaun v. Consolidated Oil Co.*, 147 A. 257 (Del. Ch. 1929); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

²³⁵ Delaware courts have been reluctant to include well-defined contractual standards of good faith and fair dealings into the corporate fiduciary duty context. *In re Walt Disney*, 907 A.2d at n. 449.

²³⁶ *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1051 n.2 (citing *Miller v. AT&T*, 507 F.2d 759 (3rd Cir. 1974)). See also Veasey, *supra* note 223, at 448 (stating that intentional violations of law implicate good faith).

²³⁷ *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006).

²³⁸ *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. Ch. 2007).

²³⁹ See *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (“The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious actions not in the corporation’s best interest does not make it faithful, as opposed to faithless.”). See also *Nagy v. Bistricher*, 770 A.2d 43, 48 n.2 (Del. Ch. 2000).

²⁴⁰ The duties may also include an analysis of the “Revlon” duties. *In re Walt Disney S’holder Derivative Litig.*, 907 A.2d 693, n. 400 (Del. Ch. 2005).

disclosure, it must be understood in the context of the other fiduciary duties.²⁴¹ The duty of disclosure requires fiduciaries to disclose material information to shareholders.²⁴² This duty has been specifically articulated by the Delaware courts in cases where the board requests a shareholder vote on the matter at hand. For example, in *Turner v. Bernstein*, the court drew on a long list of cases and stated:

The fiduciary duty of disclosure flows from the broader fiduciary duties of care and loyalty. That disclosure duty is triggered (*inter alia*) where directors . . . present to stockholders for their consideration a transaction that requires them to cast a vote and/or make an investment decision, such as whether or not to accept a merger or demand appraisal. Stockholders confronted with that choice are entitled to disclosure of the available material facts needed to make such an informed decision.²⁴³

This judgment and reasoning were recently affirmed by the Delaware Supreme Court in *Skeen v. Jo-Ann Stores, Inc.*,²⁴⁴ where the court stated “[d]irectors must disclose all material facts within their control that a reasonable stockholder would consider important in deciding how to respond to the pending transaction.”²⁴⁵ Determining whether information is material is a fact-specific inquiry, wherein “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”²⁴⁶

Although the responsibility to disclose all material information is generally applied in the context of mergers and acquisitions of companies, it could have an impact on executive compensation grants insofar as they are approved by the shareholders. In this context, a director or officer may be in breach of the duty to disclose, as well as a duty of care, loyalty or to act in good faith, when the shareholders vote on the compensation plan and are not provided with all material information to make an informed decision. In either case, this duty to disclose sheds light on a general policy that shareholders should not be misguided about information that they must approve through a vote.

B. Standard of Review

²⁴¹ See *Cinerama, Inc. v. Technicolor*, 663 A.2d 1156, 1163 (Del. 1995) (“A combination of the fiduciary duties of care and loyalty gives rise to the requirement that ‘a director disclose to shareholders all material facts bearing upon a merger vote. . . .’”); see also *Stroud v. Grace*, 606 A.2d 75, 84-88 (Del. 1992) (noting that the duty of candor “represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board’s control when it seeks shareholder action”); cf. *Arnold v. Soc’y for Sav. Bancorp*, 650 A.2d 1270, 1287 (Del. 1994) (“[c]laims alleging disclosure violations that do not otherwise fall within any exception are protected by Section 102(b)(7) and any certificate of incorporation provision . . . adopted pursuant thereto”).

²⁴² Lafferty et al., *supra* note 209, at 849; Hilary A. Sale, *Monitoring Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719, 744 (2007)..

²⁴³ *Turner v. Bernstein*, 1999 Del. Ch. LEXIS 18, 19-20 (Del. Ch. Feb. 9, 1999). See also *Stroud*, 606 A.2d at 84.

²⁴⁴ 750 A.2d 1170, 1171 (Del. 2000).

²⁴⁵ Lafferty et al., *supra* note 209, at 849.

²⁴⁶ *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

Delaware courts apply two primary standards of review to cases involving fiduciary duties in corporate transactions: the business judgment rule and the entire fairness standard. The business judgment rule is a court-established default presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.”²⁴⁷ Therefore, the doctrine²⁴⁸ protects the ability of corporate directors to make business decisions on behalf of the corporation without facing personal liability. The rule fights against the risk-averse nature of directors and pushes them to make difficult calls that they believe in good faith to be beneficial for the corporation and its shareholders, albeit potentially risky.

The rule is a deferential standard of review. The Delaware courts will generally refrain from imposing their judgment upon the business and affairs of a corporation when the board’s decision can be attributed to a rational business purpose.²⁴⁹ The rule establishes a presumption that the business decision made by the directors should not be substantively reviewed by the courts, so long as certain preconditions exist.²⁵⁰ A plaintiff may overcome the business judgment rule by demonstrating that the directors breached their fiduciary duties of care or loyalty.²⁵¹ If the plaintiff is not able to do so, he or she is not entitled to any remedy, unless the action is considered to be waste.²⁵²

Traditionally, the rule applies to directors that are reasonably informed, disinterested and independent, as well as acting in good faith.²⁵³ The presumption applies to cases where there is no evidence of “fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment” by the directors.²⁵⁴ The rule does not apply, however, to directors who made an

²⁴⁷ Ryan v. Gifford, 918 A.2d 341, 357 (Del. Ch. 2007) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). See also, e.g., Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Unitrin, Inc. v. American Gen. Corp. (In re Unitrin, Inc.), 651 A.2d 1361 (Del. 1995); Gagliardi v. Trifoods Int’l, Inc., 683 A.2d 1049, 1051 n.2.

²⁴⁸ The doctrine has been defined as “the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.” *Van Gorkom*, 88 A.2d at 872.

²⁴⁹ Cede & Co., 634 A.2d 345, 361 (Del. 2005). *In re Walt Disney S’holder Derivative Litig.*, 907 A.2d 693, 746 (Del. Ch. 2005) (It is generally understood that “courts are ill equipped to engage in post hoc substantive review of business decisions”).

²⁵⁰ The business judgment rule is a complicated doctrine, and is often expressed in vague terms. The Delaware courts often explain the rule as “a *presumption* that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.” *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812) (emphasis added). In fact, however, the courts often use it as “both a procedural guide, dictating the terms of the plaintiff’s first move, and, if the plaintiff fails to meet evidentiary burden, a substantive rule of law, protecting the substantive merits of the board’s decision from judicial review.” D. Gordon Smith, *The Modern Business Judgment Rule*, COLUMBIA LAW SCH. BLOG ON CORP. AND THE CAPITAL MKT. (Aug. 6, 2015), <http://clsbluesky.law.columbia.edu/2015/08/06/the-modern-business-judgment-rule/>.

²⁵¹ *Cinerama, Inc. v. Technicolor*, 663 A.2d 1156, 1162 (Del. 1995). Additionally, it is worth noting that “[f]rom a procedural perspective, the breach of any *one* of the board’s fiduciary duties is enough to shift the burden of proof to the board to demonstrate entire fairness.” *Id.* at 1164 (emphasis in original).

²⁵² *In re Walt Disney*, 907 A.2d at 747 (citing *In re J.P. Stevens & Co. S’holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988)). It should be noted that waste is very rarely found in Delaware courts. *Id.* at 748.

²⁵³ *Van Gorkom*, 488 A.2d.

²⁵⁴ *In re Walt Disney*, 907 A.2d at 747 (quoting *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988)).

“unintelligent or unadvised judgment.”²⁵⁵ Furthermore, directors who have not exercised business judgment due to inaction are also not protected by the rule.²⁵⁶

Modern jurisprudence regarding the business judgment rule also includes cases where the independence of the board is questionable.²⁵⁷ Specifically, a board’s decision will not receive the benefit of deference under the business judgment rule where self-interested directors (1) constitute a majority of the board;²⁵⁸ (2) control or dominate the board as a whole;²⁵⁹ or (3) fail to disclose their interest in the transaction to the whole board, an interest which a reasonable board member would regard as having a significant effect on those directors’ evaluation of the transaction.²⁶⁰ Even under these circumstances, however, the business judgment rule is applied where procedural formalities and safeguards are utilized, such as special committees, stockholder approval, or even partial review of the action by a court.²⁶¹

Compensation decisions are generally afforded the protection of the business judgment rule. Yet, in *Weiss v. Swanson*,²⁶² for example, the court acknowledged that the rule “applies to the directors’ grant of options pursuant to a stockholder-approved plan only when the terms of the plan at issue are adhered to.”²⁶³ Therefore, when there is evidence to support an “inference that the directors intended to violate the terms of stockholder-approved option plans,” the business judgment rule is rebutted.²⁶⁴

The entire fairness standard may apply to both directors and officers. For directors, this standard only comes into play if the plaintiff demonstrates facts sufficient to overcome the

²⁵⁵ *Mitchell v. Highland-Western Glass Co.*, 167 A. 831, 833 (Del. Ch. 1933); *Van Gorkom*, 488 A.2d at 872.

²⁵⁶ *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) (noting that “a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment.”)

²⁵⁷ *Id.*

²⁵⁸ In controlling stockholder transactions, the directors may also face a conflict of interest. Until recently, the courts treated the transaction under the “entire fairness” standard, which does not receive the benefit of the business judgment rule. In a 2014 case, however, the Delaware Supreme Court held that the business judgment rule may apply in the context of controlling stockholder transactions, “if and only if” a number of conditions were met: “(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.” *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014)

²⁵⁹ This is especially true in relation to takeovers, as the board members may be self-interested in maintaining their positions to the disadvantage of the shareholders’ interests. *See Bennett v. Propp*, 187 A.2d 405, 409 (Del. 1962) (“We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.”). For example, the Delaware Supreme Court held that the business judgment rule may be available in the context of hostile takeovers, but the burden of proof shifts to the defendants to show that the directors reasonably perceived the threat to the company and that the directors’ responses were proportionate to that threat. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (discussing *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964)).

²⁶⁰ *See Lafferty et al.*, *supra* note 209, at 846.

²⁶¹ *Id.*

²⁶² 948 A.2d 433, 441 (Del. Ch. 2008) (citing *In re 3COM Corp.*, 25 DEL. J. CORP. L. 1060, 1999 WL 1009210, 3 (Del. Ch. 1999)).

²⁶³ *Id.*

²⁶⁴ *Id.*

business judgment rule. Executives and directors engaging in related-party transactions – where, for example, a majority of the directors approving the transaction are interested parties – may be subject to the entire fairness standard of review.²⁶⁵ In the absence of arms-length bargaining, executives are obligated to disclose such transactions and seek approval by an independent committee of the board.²⁶⁶ If the executive fails to obtain independent approval, the burden is to show that the transaction is entirely fair.²⁶⁷ To satisfy this burden, the executive must demonstrate “to the court’s satisfaction that the transaction was the product of both fair dealing (i.e., process) and fair price (i.e., substance).”²⁶⁸

Notably, a major obstacle in all derivative actions is the “demand” requirement, under which a shareholder must first make demand on the corporation's board of directors before challenging a decision, giving it the opportunity to determine whether pursuing the action is in the best interest of the corporation.²⁶⁹ In Delaware, a plaintiff may overcome a failure to make demand under Rule 23.1 by pleading with particularity why demand would be futile.²⁷⁰ The courts apply two different tests depending on who made the decision being challenged. If the plaintiff’s challenge is to a decision made by the board, the plaintiff must satisfy the *Aronson* test.²⁷¹ When a plaintiff challenges a decision not made by the board of directors, however, a different test (known as the “*Rales* test”) applies.²⁷²

C. Fiduciary Duty Implications of Options Manipulation

1. Backdating

²⁶⁵ Narayanan, *supra* note 4, at 1623.

²⁶⁶ See, e.g., *Stegemeier v. Magness*, 728 A.2d 557, 562 (Del. 1999); *Schock v. Nash*, 732 A.2d 217, 225 n.21 (Del. 1999); *Oberly v. Kirby*, 592 A.2d 445, 466-67 (Del. 1991).

²⁶⁷ See, e.g., *Oberly*, 592 A.2d, at 466-67; *Stegemeier*, 728 A.2d at 562; *President & Fellows of Harv. Coll. v. Glancy*, 2003 Del. Ch. LEXIS 25, 69 (Mar. 21, 2003).

²⁶⁸ *Cede Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 2005).

²⁶⁹ See generally Carole F. Wilder, *The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits*, 3 PACE L. REV. 633 (1985).

²⁷⁰ MARC J. LANE, REPRESENTING CORPORATE OFFICERS, DIRECTORS, MANAGERS, AND TRUSTEES 3-118 (2nd ed. 2013). A majority of states have this futility exception to the demand requirement, but a growing number of “universal demand” states have abolished this exception. See *Ariz. Rev. Stat.* 10-742; *Conn. Gen. Stat.* 33-722; *Fla. Stat. Ch.* 607.07401(2); *Ga. Code Ann.* 14-2-742; *Haw. Rev. Stat.* 414173; *Idaho Code* 30-1-742; *Me. Rev. Stat. Ann. Tit.* 13-C 753; *Mich. Comp. Laws* 450.1493a; *Miss. Code Ann.* 79-4-7.42; *Mont. Code Ann.* 35-1-543; *Neb. Rev. Stat.* 21-2072; *N.H. Rev. Stat. Ann.* 293-A:7.42; *N.C. Gen. Stat.* 55-7-42; *Tex. Bus. Corp. Act. Ann. Art.* 5.14C; *Utah Code. Ann.* 16-10a-740(3); *Va. Code Ann.* 13.1-672.1; *Wis. Stat.* 180.0742.42; *Wyo. Stat. Ann.* 17-16-742; see also *Model Bus. Corp. Act* 7.42.

²⁷¹ The plaintiff satisfies this test by alleging facts that raise a reasonable doubt that (1) a majority of the board is disinterested or independent, or (2) the challenged action was otherwise the product of the board’s valid business judgment. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

²⁷² The situation may arise in three ways: when a plaintiff challenges a decision made by directors who no longer sit on the board; where the decision at issue was made by a body or committee other than the board, and where the decision at issue was made by the board of a different corporation. In these circumstances, a plaintiff must “create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” The *Rales* test may be satisfied when “the potential for liability is not a mere threat but instead may rise to a substantial likelihood.”

Options backdating does not comply with the abovementioned fiduciary duties due to the dishonest, manipulative, and self-serving nature of the act. Especially considering this practice is meant to enrich the executive at the expense of the company as a whole and shareholders in particular, it stands in complete contrast to the ideal expressed through these fiduciary duties. It is not surprising that a number of scholars have suggested that options backdating is a result of weak corporate governance practices in corporations.²⁷³

The board of directors may be implicated in breaching this duty. Increasing or decreasing executive compensation, including through options backdating is within the board's right, so long as it is disclosed properly to the shareholders.²⁷⁴ The board is protected by the business judgment rule, which will shield these decisions against liability in most cases, unless it can be proven that the board acted in bad faith or there was conflict of interest.²⁷⁵ The business judgment rule does not apply, however, where the board violates its fiduciary duties through deception to the company and shareholders.²⁷⁶ Additionally, board members may be implicated if they knew of or should have known that executives were changing the dates of the option grants without approval and took no action.²⁷⁷

In *Ryan v. Gifford*, the plaintiff contended that the board of directors of Maxim Integrated Products, Inc. (Maxim), a California computer chip manufacturer, actively approved Maxim's compensation committee's backdating of option grants issued to the former Chairman and CEO.²⁷⁸ The complaint alleged that these approvals contravened the Maxim shareholder-approved stock option plan, which prohibited the granting of options at exercise prices below the closing price on the date of the grant, and that the directors made false representations regarding the option dates in public filings.²⁷⁹ Notably, the plaintiff had not alleged specific facts showing actual backdating by the committee, relying instead on a report by Merrill Lynch which stated that each of the challenged grants was made on a date on which Maxim's stock traded at unusually low trading days of the year in question, or on days immediately preceding sharp increases in the market price of the stock.²⁸⁰

In denying the defendants' motion to dismiss in *Ryan*, the court held 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."²⁸¹ The court further held that allegations of such intentionally misleading conduct is sufficient to rebut the business judgment rule.²⁸²

²⁷³ John M. Bizjak et al., *Option Backdating and Board Interlocks*, 22 REV. FIN. STUD. 4821 (2009); D. Collins et al., *Corporate Governance and Backdating of Executive Stock Options*, 26 CONTEMP. ACCT. RES. 403 (2009); Narayanan et al. *supra* note 4.

²⁷⁴ Narayanan et al. *supra* note 4, at 1617.

²⁷⁵ *Id.*

²⁷⁶ *Id.*

²⁷⁷ *Id.* (Citing *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959, 970-71 (Del. Ch. 1996)).

²⁷⁸ *Ryan v. Gifford*, 918 A.2d 341, 341 (Del. Ch. 2007).

²⁷⁹ *Id.* at 342.

²⁸⁰ Milbank Client Alert, *Delaware Chancery Court Takes On Stock Option "Backdating" and "Spring-Loading,"* <http://www.milbank.com/images/content/7/0/706/022807-DEChancery-Backdating-and-Springloading.pdf>, [hereinafter Milibank].

²⁸¹ *Ryan*, 918 A.2d at 358.

²⁸² *See id.*

Importantly, the *Ryan* case indicated that evidence of options backdating would overcome the demand futility requirement. The court held that making demand clearly would have been futile on directors who knowingly violated the company's stock option policy and then issued false disclosures to shareholders and the SEC concealing such practices.²⁸³ According to the court, “[b]ackdating 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.’”²⁸⁴

In *Desimone v. Barrows*, the Delaware Chancery Court dismissed backdating claims against the directors in a shareholder derivative suit for, among other reasons, failing to meet the “demand” requirement and, as to grants made to outside directors, for failure to state a claim.²⁸⁵ The corporation, Sycamore Networks, Inc., had “essentially admitted” in public filings that options had been backdated, and “the options were represented to the public as having been issued at fair market value, when in fact they were issued at a price lower than the fair market value that prevailed as of the dates of the Grants.”²⁸⁶ Three categories of grants were made: grants to non-officer employees, grants to executive officers, and grants to outside directors.²⁸⁷

With respect to non-officer employee option grants, the court found that the complaint failed to allege facts relating to “the key issues of who approved the Employee Grants and whether any of the directors knew that options were being backdated,” and thus, there was insufficient basis to conclude that the Sycamore board “faces a substantial threat of liability” with respect to this category of demands, so the plaintiff’s failure to make a demand was not excused.²⁸⁸ Notably, the “stockholder-approved option plans contemplated delegation of the option-granting function to non-director executive officers,” and most of the backdating was done by a single executive officer and actively hidden from the board and auditors.²⁸⁹ Unlike the shareholders in *Ryan*, the plaintiff could not allege that any of the directors knowingly approved improperly-backdated options, and thus demand was not excused.²⁹⁰ Thus, in order for a backdating claim to succeed against directors, it is necessary for the plaintiffs to show that the board was either complicit in the behavior or should have known what was going on, under a *Caremark* analysis.

Scholars have suggested that boards implement controls to monitor stock option backdating and other manipulative practices of stock prices. Some ways to safeguard against these practices is to prohibit unanimous written consent for approval of option grants and single-

²⁸³ *Id.* at 354-356.

²⁸⁴ *Id.* (quoting *Aronson v. Lewis*, 473 A.2d 946, 954-56 (Del. 1985)).

²⁸⁵ 924 A.2d at 914.

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ *Id.*

²⁹⁰ The court stated that demand could be excused if the allegations created “a rational inference that the directors knowingly approved backdated grants of options, realizing that the corporation would deceptively account for them to investors and regulatory authorities as having been made at fair market value on the date of issuance, demand would be excused, consistent with the *Ryan* decision.” *Id.* at 915.

person compensation committees.²⁹¹ In addition, conflicts of interest should be avoided.²⁹² We provide further proposals in Part V below.

2. Spring-Loading and Bullet-Dodging

It has been argued that the business judgment rule should not apply to spring-loading decisions because the high potential for abuse ought to warrant “a less deferential stance to protect shareholder interests.”²⁹³ The business judgment rule presumes that directors make informed decisions, however, officers are usually better informed about corporate performance. Hence, officers have a conflict of interest in disclosing certain information to the directors, including timing of stock option grants.²⁹⁴ If plaintiffs show that the directors were not independent and well-informed when making these decisions, the rule does not prohibit judicial review.

In *Weiss v. Swanson*,²⁹⁵ the plaintiff alleged that certain former and current directors of a company issued 22 spring-loaded and bullet-dodged option grants. The options were granted in accordance with the stockholder-approved option plans, but the majority of the grants “were made in conjunction with quarterly earnings releases” and “the director defendants approved grants before positive releases and after negative releases.”²⁹⁶ Therefore, the court could infer that these particular directors granted spring-loaded and bullet-dodged options.²⁹⁷ The court stated that “it is reasonable to infer that stockholders would consider the practice of timing options described in the complaint to be important in deciding whether to approve the option plans or to reelect board members.”²⁹⁸ Furthermore, because the defendants did not disclose the practice in the plans, subsequent proxy statements, or SEC filings, “the allegations ... give rise to an inference that the Director Defendants, in violation of their fiduciary duties, intended to circumvent the restrictions found in the plans.”²⁹⁹ Hence, the court found the plaintiff succeeded in establishing reasonable doubt that the option grants were a product of a business judgment exercise.³⁰⁰

The *Weiss* court also noted that “[a] director does breach his duty of loyalty if he knows that the company has been defrauded and does not report what he knows to the board or to an appropriate committee of the board, at the very least when he is involved in the fraud and keeps silent in order to escape detection.”³⁰¹ Thus, spring-loading, where the executive knows material nonpublic information, while keeping the board in the dark, amounts to fraud and breach of duty of loyalty.³⁰²

²⁹¹ Narayanan et al., *supra* note 4, at 1619.

²⁹² *Id.*

²⁹³ Hughes, *supra* note 119, at 792.

²⁹⁴ *Id.*

²⁹⁵ 948 A.2d 433, 441 (Del. Ch. 2008).

²⁹⁶ *Id.*

²⁹⁷ *Id.* at 442-444.

²⁹⁸ *Id.*

²⁹⁹ *Id.* at 443.

³⁰⁰ *Id.*

³⁰¹ Hoover Industries, Inc. v. Chase, 14 DEL. J. CORP. L. 332, 1988 WL 73758 (Del. Ch. 1988).

³⁰² Justin Fox, *Dodging bullets, loading springs, and backdating options*, TIME (Oct. 31, 2006), http://business.time.com/2006/10/31/dodging_bullets_loading_spring/.

In *In re Tyson Foods, Inc. (Tyson I)*, the Delaware Chancery Court held that spring-loading can give rise to a breach of fiduciary duty claim.³⁰³ The *Tyson I* shareholders alleged that the directors approved the compensation committee's spring-loading of option grants in violation of the shareholder-approved stock option plan.³⁰⁴ The complaint alleged that, on several occasions, the compensation committee had awarded options shortly before the corporation issued press releases containing favorable information, foreseeably leading to increases in the price of the company's stock.³⁰⁵ The court first observed that "[w]hether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating; " whereas "all backdated options involve a fundamental, incontrovertible lie" in falsifying the date of option grant, "[a]llegations of spring-loading implicate a much more subtle deception" because the spring-loaded options are set at the market price on the date of the grant, which does not explicitly violate stock option plans.³⁰⁶

Nevertheless, the court concluded that "[g]ranting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception," and a board of directors breach their duty of loyalty when they distribute shares to managers "in such a way as to undermine the very objectives approved by shareholders" in a shareholder-approved option plan.³⁰⁷ In effect, the court focused on the purpose of the shareholder-approved plan, rather than the technical requirements. According to the court, even if a director authorized options with a market-value strike price in compliance with a shareholder-approved incentive option plan, the director may have acted in bad faith if at the time he knew that the shares were worth more than the exercise price.³⁰⁸ Furthermore, if the directors, at the time of the grants, were aware of material non-public positive information, then they would have known that they were granting options with exercise prices that were less than the actual value of the underlying shares on the date of grant.³⁰⁹ The court observed that in spring-loading cases, the impropriety is not simply in granting an option that is, in practical effect, immediately in the money (an action that, in some circumstances, could be a legitimate exercise of business judgment) but, rather, in the accompanying deception of shareholders.³¹⁰

³⁰³ See *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 592 (Del. Ch. 2007).

³⁰⁴ See *id.*

³⁰⁵ *Id.*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.* at 593.

³⁰⁹ Milbank, *supra* note 270.

³¹⁰ According to the *Tyson I* court,

The touchstone of disloyalty or bad faith in a spring-loaded option remains deception, not simply the fact that they are (in every real sense) "in the money" at the time of issue. A board of directors might, in an exercise of good faith business judgment, determine that in the money options are an appropriate form 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 the 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,

The court concluded that the grant of spring-loaded options may, under certain limited circumstances, constitute a breach of fiduciary duty.³¹¹ Such a grant is beyond the protection of the business judgment rule if the awards are made pursuant to a shareholder-approved plan and if the directors who approved the allegedly spring-loaded grants: (a) possessed material information soon to be released that would affect the company's share price; and (b) issued the options intending to circumvent shareholder-approved restrictions on their exercise price.

The complaint in *Desimone v. Barrows*,³¹² discussed above regarding the implications for backdating, also alleged claims against the board of directors for spring-loading and bullet-dodging by the executive officers.³¹³ Although the court noted the size of the grants and the identities of the recipients indicated that decisions about the officer grants were less likely to have been delegated to non-director executive officers, the allegations did not support an inference that "the board or even the Compensation Committee was likely to have driven details like the precise date of issuance of the Grants."³¹⁴ With respect to the spring-loading allegations, the court sought to distinguish *Tyson I* by focusing on the differences in the directors' knowledge of and involvement in the timing of the option grants in the two cases. According to the court, although both *Tyson I* and *Desimone* involved officers receiving options just before a positive announcement, the plaintiff in *Desimone* did not "plead facts that suggest that members of the Sycamore board approved the Officer Grants with knowledge of corporate information that, if made public on the date of the Grants, would have increased the fair market value of the corporation's stock."³¹⁵ In *Tyson I*, "the plaintiffs pled a multi-year pattern of large grants occurring at random times of year that preceded large, market-moving announcements," whereas the plaintiff in *Desimone* only pled that the corporation made officer grants two weeks before a far less impactful positive announcement.³¹⁶ Furthermore, the grants in *Desimone* "were subject to a three-year vesting schedule with sharp restrictions on pledging the options received."³¹⁷ Finally, two of the officers on Sycamore's board of directors owned a significant portion of the company, yet received none of the options in dispute, a fact that "powerfully undercut[s] any inference that the board itself had a motive to make its executive officers fat at the expense of the stockholders."³¹⁸

The *Desimone* court also pointed out that, in contrast with the facts in *Ryan*, the stockholder-approved plan under which the officer and employee grants had been made explicitly permitted the issuance of in-the-money stock options.³¹⁹ As to bullet-dodging, the court opined that insofar as bullet-dodging did not violate the terms of the stockholder-approved

were it made honestly and disclosed in good faith, would be within the rational exercise of business judgment.

In re Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 592 n. 75 (Del. Ch. 2007).

³¹¹ 919 A.2d at 593.

³¹² 924 A.2d 908, 944 (Del. Ch. 2007).

³¹³ *Id.*

³¹⁴ *Id.* at 914-15.

³¹⁵ *Id.* at 916.

³¹⁶ *Id.*

³¹⁷ *Id.*

³¹⁸ *Id.* at 916-17.

³¹⁹ *Id.* at 930-31.

agreement, such allegations are unlikely ever to support a claim for relief, other than, in extreme circumstances, a claim for corporate waste (if approved by independent and disinterested directors) or self-dealing (if approved by interested or controlled directors).³²⁰

A third category of option grants was made to Sycamore's outside directors. As to the claims relating to grants to interested directors, the court noted that demand was excused and the pivotal issue was whether the complaint stated a claim upon which relief could be granted.³²¹ Those grants had been made under a shareholder-approved plan setting the amounts and dates of option grants to directors over a multiyear period.³²² Because the allegations of the complaint raised no inference of manipulation or impropriety, the court dismissed the claims relating to the outside director grants for failure to plead facts upon which relief could be granted.³²³

The *Desimone* court also addressed directors' oversight obligations under the *Caremark* standard. The court refined the requirement of cognitive culpability by saying that "directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care."³²⁴ According to the court, *Caremark* "plainly held that director liability for failure to monitor required a finding that the directors acted [in bad faith] because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance."³²⁵ This is a very high burden of persuasion, and liability will not reach the director who simply fails to use due care in attending to her business and responsibilities.

In ruling on a subsequent motion in the *Tyson* litigation (*Tyson II*),³²⁶ the court sharpened the distinction with *Desimone*. The *Tyson II* decision, issued August 15, 2007, denied the motion by outside director defendants for summary judgment.³²⁷ The court examined its earlier refusal to dismiss the claim in *Tyson I*, and in light of the "more clearly delineated" allegations with respect to the current motion,³²⁸ altered the basis for allowing plaintiffs' claim to proceed.

In their motion for judgment on the pleadings, defendants argued that the allegedly spring-loaded options were "nonqualified stock options," which *Tyson I*'s compensation committee could make exercisable at any price, as authorized under the company's shareholder-approved stock option plan (in contrast to plaintiffs' previous claims).³²⁹ The court accepted this assertion, finding it confirmed by a review of the stock option plan and *Tyson I*'s proxy

³²⁰ See *Desimone*, 924 A.2d at 916 ("[a]lthough stockholders might quibble with the decision whether to give large slugs of options to officers after a disappointing quarter, no deception on the stockholders, the market, or regulatory authorities is involved and the officers have the intended incentive to perform well in order to help the corporation's stock price improve from its level on the date of issuance, a level that reflects the negative information released").

³²¹ *Id.* at 917.

³²² *Id.*

³²³ *Id.* at 916-917.

³²⁴ *Id.* at 935.

³²⁵ *Id.*

³²⁶ *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 2007 Del. Ch. LEXIS 120 (Del. Ch. Aug. 15, 2007).

³²⁷ *Id.* at *13.

³²⁸ *Id.* at *3.

³²⁹ *Id.* at *2.

statements.³³⁰ The assertion appeared to invalidate the premise upon which the defendant's motion to dismiss had been denied: that the options "may have been issued with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options."³³¹ Rather than compel the granting of defendants' motion, however, the absence of such restrictions shifted the analysis to broader ground.

According to the court, the question addressed in *Tyson I* was the relatively narrow one of "whether a grant of spring-loaded options could be within the bounds of the Compensation Committee's business judgment in the face of a shareholder-approved agreement explicitly requiring a market value strike price."³³² But in light of the "more clearly delineated" allegations in *Tyson II*, the court indicated that the test stated in *Tyson I* for determining whether spring-loading is beyond the protection of the business judgment rule was possibly "couched in too limited a manner."³³³ To overcome the business judgment rule, it may not be absolutely necessary to allege an implicit violation of a shareholder-approved stock incentive plan with respect to spring-loading; rather, a reasonable inference "that a board of directors later concealed the true nature of a grant of stock options" suffices to find a fiduciary breach of loyalty.³³⁴ Thus, under *Tyson II*, the adequacy of company disclosures about the award of spring-loaded options is key in determining whether fiduciary duty was breached. In the instant case, the court found the defendants' disclosures regarding the challenged options "did nothing to rebut the pleading stage inference that the defendants intended to conceal a pattern of unfairly stocking up insiders' larders with option grants shortly before the announcement of events likely to increase the Company's stock price."³³⁵ In fact, the magnitude and timing of the grants, in the absence of "disclosure of the reasons motivating the grants, is suggestive ... of a purposeful subterfuge."³³⁶

The court also insisted that the *Tyson I* defendants' persistent failure to disclose the motivations for the stock option grants made the case distinguishable from *Desimone*. The *Tyson II* court found that its conclusions were consistent with two hypothetical scenarios discussed by the *Desimone* court³³⁷ because both hypotheticals "assume[d] that the board of directors has revealed their strategy to shareholders in complete and utter candor. In the absence of a shareholder-approved plan, the board clearly discloses in the merger proxy that these grants are rewards for exemplary service."³³⁸

IV. Proposal for Reform

Our evidence shows that executive option grants continue to show distinct signs of manipulation during the 2008-2014 period. It has been nearly ten years since 2006 when the

³³⁰ *See id.* at *6-7.

³³¹ *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 2007 Del. Ch. LEXIS 120, at *2.

³³² *Id.* at *8.

³³³ *Id.* at *14.

³³⁴ *Id.* at *14-15.

³³⁵ *Id.*

³³⁶ *Id.* at *18.

³³⁷ *Id.* at *16.

³³⁸ *Id.* at *17.

scandals broke regarding the backdating of executive stock option grants.³³⁹ As discussed above, numerous firms have been sued in civil and criminal courts, with settlements amounting to millions of dollars. In addition, the SEC has instituted new reporting requirements to prevent any future manipulations. Despite all this effort, corporate executives appear to be still benefiting from manipulating their option grants.

To prevent any future manipulations of executive option grants, we suggest a simple but extremely effective remedy through the SEC's rule-making authority. We recommend that the SEC institute a new rule that automatically requires daily allocation of executive option grants. To explain this further, suppose that firm A awarded 365 options to its executives on January 1. Under our proposed new rule, the firm would be required to spread these options through the course of the entire year, enabling the executive to earn just one option for each day worked. The simplest way of implementing our new rule is to use the average stock price over the entire year from January 1 through December 31 as the exercise price for all these options.

The net effect of our suggested rule is that executives will no longer be able to benefit from any of the dating and timing games documented in our study. Any backdating, spring-loading, bullet-dodging or any other game that benefits one option will necessarily hurt the other options, thereby cancelling its effects. Furthermore, our rule is easy to understand and easy to implement.

Conclusion

In this study, we found that executives still continue to manipulate their option grants. We show that despite all the reforms in response to the backdating scandal of 2006,³⁴⁰ manipulation of options is still too tempting and continues to this day. Our evidence shows that executives employ a variety of manipulative devices to increase their compensation, including backdating, bullet-dodging, and spring-loading. Although each of these practices in isolation may have a small marginal impact on their compensation, together, these practices unfairly tilt the balance in executives' favor in a meaningful way. Overall, we find that as a result of these manipulative devices executives are able to increase their compensation by about 6% in the 2008-2014 period.

To date, these behaviors have eluded meaningful regulation. This may be due, in part, to the difficulty in proving motivation and intent. Inadvertent backdating does not give rise to securities fraud. Furthermore, in hindsight, executives may be able to construct plausible reasons for the timing of information releases and option dates, although analysis of the data suggests otherwise. Current rules against securities fraud have not addressed options manipulation in an effective way.

Our recommendation calling for daily allocation of option grants is a simple regulatory reform that should put an end to executive option dating and timing games, once and for all. As discussed above, option dating and timing games raise serious issues under federal securities

³³⁹ See Thomsen, *supra* note 1.

³⁴⁰ See Thomsen, *supra* note 1.

laws and state fiduciary duties. Under our proposal, executives would no longer benefit from any of the dating and timing games documented in our study. Any backdating, spring-loading, bullet-dodging or any other game that benefits one option will necessarily hurt the other options, thereby cancelling its effects. This modest proposal, if implemented, should go a long way toward eradicating this illicit, self-serving behavior, in accordance with the intent of federal securities laws and state fiduciary duty obligations.