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THE SHAREHOLDER DERIVATIVE SUIT AS A RESPONSE TO STOCK OPTION BACKDATING

INTRODUCTION

Brocade Communications Systems, Inc. recently came under investigation for backdating employee stock options and then attempting to conceal this practice from shareholders, regulators, and the public.[1] Brocade, a company that creates products to connect computer servers with data-storage systems,[2] restated its earnings, reducing income by over $300 million to reflect that its stock options had been accounted for improperly.[3] Former chief executive officer Gregory Reyes and Stephanie Jensen, the head of the human resources department, were convicted of criminal charges in federal court for regularly backdating stock options from 2000 to 2004 and concealing millions of dollars in related expenses.[4] The Securities and Exchange Commission (SEC) brought civil charges against the company and both executives individually.[5] In May 2007, the company settled the SEC's securities fraud suit by agreeing to pay a seven million dollar penalty.[6]

The SEC and the United States Department of Justice are not the only ones taking action. Many of the company's shareholders have responded by filing

1. *See* Therese Poletti & Scott Duke Harris, *Firms to Pay Fines on Options: Brocade, Mercury Settle Backdating Charges with SEC*, SAN JOSE MERCURY NEWS, June 1, 2007, at A1.

2. Jordan Robertson, *Ex-CEO Convicted of Options Fraud: Brocade's Reyes Guilty on All Counts in First Backdating Case to Go to Trial*, SEATTLE TIMES, Aug. 8, 2007, at C1.

3. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1610 (2007).

4. *Brocade Ex-Official Convicted*, WALL ST. J., Dec. 6, 2007, at C7; Press Release, U.S. Dep't of Justice and SEC, U.S. Attorney's Office and SEC Separately Charge Former Brocade CEO and Vice President in Stock Option Backdating Scheme (July 20, 2006), *available at* http://www.sec.gov/news/press/2006/2006-121.htm. The two were accused of falsifying company documents to cover up the backdating practice. *See* Press Release, U.S. Dep't of Justice and SEC, *supra*. Reyes was convicted of ten felony counts in the first backdating case to reach a jury. *See* Robertson, *supra* note 2. He was sentenced to twenty-one months in prison and ordered to pay a $15 million fine, but his sentence has been stayed pending appeal. Pete Carey, *21 Months for Reyes*, SAN JOSE MERCURY NEWS, Jan. 17, 2008, at C1. Jensen was convicted of conspiracy and falsifying corporate records. *Brocade Ex-Official Convicted*, *supra.* She was sentenced to four months in prison and ordered to pay a $1.25 million fine. *Brocade Ex-Employee Gets 4 Months in Prison*, WALL ST. J., Mar. 20, 2008, at A13.

5. *See* Poletti & Harris, *supra* note 1.

6. *Id.*

derivative suits against Brocade's directors based on allegations of a corporate-wide practice of backdating stock options.[7] The parties in one of the derivative actions actually reached a settlement agreement involving significant corporate governance changes for Brocade as well as payment of the plaintiff's legal fees, but the judge was critical of the terms and refused to approve the agreement.[8] Another derivative suit was recently dismissed for failing to state a claim,[9] but at least one such suit is still pending.[10] Other shareholders joined together to bring a class action suit against Brocade and its directors, asserting violations of Rule 10b-5 of the Securities and Exchange Act of 1934.[11] The action survived an early motion to dismiss.[12]

The Brocade case is not unique. Studies suggest that the practice of backdating employee stock options in corporate America may have been widespread.[13] In the last few years, well over one hundred companies have conducted internal inquiries, issued restatements, or come under investigation by the SEC and the United States Department of Justice based on claims of

7. *See* Roth v. Reyes, No. C 06-02786 CRB, 2007 WL 2470122, at *1 (N.D. Cal. Aug. 27, 2007).

8. *See* Julie Creswell, *One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal*, N.Y. TIMES, Sept. 5, 2006, at C4 ("You have item after item after item of malfeasance by all these defendants—then it's sort of a Roseannadanna situation: 'Oh, never mind,' Judge Breyer told lawyers at a hearing."). Judge Breyer's Saturday Night Live reference confuses Gilda Radner's Roseanne Roseanadanna character with her Emily Litella character, who regularly ended her Weekend Update segments with "never mind."

9. *Roth*, 2007 WL 2470122, at *6–7 (explaining that plaintiffs based their theory of liability on inapplicable provisions of the insider trading statutes).

10. *Id.* at *1.

11. *See* Amended Consolidated Class Action Complaint at 1, Smajlaj v. Brocade Commc'ns Sys., Inc., No. 3:05-CV-02042-CRB, 2007 WL 2457534 (N.D. Cal. Aug. 27, 2007) (citing 17 C.F.R. § 240.10b-5 (2008)).

12. Smajlaj v. Brocade Commc'ns Sys., Inc., No. 3:05-CV-02042-CRB, 2007 WL 2457534, at *2 (N.D. Cal. Aug. 27, 2007) (holding that it could be reasonably inferred from the complaint's detailed allegations that the directors bringing the motion knew, "or were reckless in not knowing," that backdating was occurring).

13. Eric Dash, *Study Charts Broad Manipulation of Options*, N.Y. TIMES, Nov. 17, 2006, at C2; Charles Forelle & James Bandler, *The Perfect Payday*, WALL ST. J., Mar. 18, 2006, at A1; *see also* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997); Lucian Bebchuk et al., *Lucky CEOs* (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 566, 2006) [hereinafter *Lucky CEOs*], *available at* http://ssrn.com/abstract=945392; Lucian Bebchuk et al., *Lucky Directors* (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 573, 2006) [hereinafter *Lucky Directors*], *available at* http://ssrn.com/abstract=952239.

stock option backdating.[14] Some companies have faced civil penalties,[15] and in other cases former executives have been charged criminally.[16]

As the Brocade case illustrates, there are a number of avenues available for addressing the misconduct associated with the practice of backdating stock options. The possibilities include criminal charges, civil suits by the SEC against companies, civil suits by the SEC against individuals within the companies, and actions brought by the shareholders against the companies and directors. Shareholders could bring direct suits, often in the form of class actions, alleging that backdating constituted a securities law violation, particularly of Rule 10b-5 which prohibits deceptive nondisclosures or misstatements.[17] Shareholders could also bring derivative suits, asserting that by backdating directors breached their fiduciary duties.[18] A main difference between these two shareholder suits is that a derivative suit is brought by the shareholder on behalf of the corporation, so any recovery goes to the corporation, while damages in a direct suit are awarded directly to the shareholders.[19] Damages awarded in a 10b-5 action would equal the amount the stock's market value declined due to the deception.[20] Since a majority of companies' stock was not greatly affected by revelations of backdating, direct damages may be difficult to prove.[21] This has led many shareholders to bring derivative suits instead of direct actions in backdating cases.[22]

This Comment analyzes the shareholder derivative action based on allegations of stock option backdating. It examines whether such suits will be successful and whether a derivative action is an appropriate forum for

14. *See Corporate Crime in America: Collared*, ECONOMIST, Aug. 11, 2007, at 54; *Perfect Payday Options Scorecard*, WALL ST. J. ONLINE, Sept. 4, 2007, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

15. *See Backdated Options Cost Tech Firms Millions in Fines*, CHI. TRIB., June 1, 2007, § 3, at 5.

16. *Corporate Crime in America: Collared*, *supra* note 14.

17. *See* 17 C.F.R. § 240.10b-5 (2008).

18. *See* Daniel S. Kleinberger & Imanta Bergmanis, *Direct vs. Derivative, or "What's a Lawsuit Between Friends in an 'Incorporated Partnership?,'"* 22 WM. MITCHELL L. REV. 1203, 1215–16 (1996) (explaining that in a derivative suit, "the underlying transaction or conduct . . . is alleged to have caused some harm or breached some duty to the corporation").

19. *See id.* at 1213–15; Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1734 (1994).

20. Jeffrey M. Goldman, *Avoiding Blurred Lines: The Computation of Damages in Rule 10b-5 Securities Class Action Lawsuits in the Ninth Circuit and a Proposal for a More Sensible System*, 2 HASTINGS BUS. L.J. 261, 265 (2006).

21. *See* Ashby Jones, *Firms Settle Backdating Suits: Some Private Cases End in Agreements; More Deals Ahead?*, WALL ST. J., Nov. 19, 2007, at A15 ("[W]ord of options backdating typically didn't lead to significant drops in share prices . . . .").

22. *See id.* (noting that only about thirty class actions suits were filed in the wake of backdating revelations).

addressing corporate backdating. Part I explains stock options in general and the process of backdating options. Part II describes shareholder derivative actions and the obstacles the shareholder-plaintiff must overcome to bring a successful claim. Part III examines the two Delaware cases that have laid the framework for future decisions in shareholder derivative suits filed in response to allegations of corporate backdating. Finally, Part IV follows with an analysis of the somewhat conflicting results of those decisions and looks at the future of derivative actions based on backdating claims, concluding that if a shareholder can meet the challenge of showing the company's directors knowingly issued backdated options, a derivative suit is the best forum for addressing and resolving the problem.

I. STOCK OPTIONS AND THE PRACTICE OF BACKDATING

Stock options are a form of employee compensation.[23] An option allows the holder to purchase company stock at a specified price, referred to as the strike or exercise price.[24] Many employee stock options have a vesting period, after which employees can exercise the option.[25] Exercising the option essentially requires that the issuing company sell, at the set strike price, a specified number of shares of its stock to the employee holding the option.[26] The strike price is agreed upon when the options are issued, and it is often equal to the current selling price of the stock, although there are other ways of setting the price.[27]

When an employee exercises an option whose strike price equaled the stock's selling price on the date the option was issued, the employee makes a profit if the stock's selling price has since increased.[28] The employee pays less to buy the stock than what it is currently worth in the market. If the stock was selling for $50/share when the option was issued, the employee may purchase shares for $50, even if the stock is now selling for $60/share, giving the employee a $10/share profit. It is possible that the strike price and market

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

24. *Id.*

25. *See* Subcomm. on Executive Comp. of the Comm. on Employee Benefits and Executive Comp., A.B.A., *Executive Compensation: A 1987 Road Map for the Corporate Advisor*, 43 BUS. LAW. 185, 275 (1987) (stating that most options are subject to holding periods ranging from a few months to several years before the options can be exercised).

26. Melissa A. Chiprich & Phillip J. Long, Empirical Study, *Is Midnight Nearing for Cinderella? Corporate America Faces Reality with Stock Option Accountability*, 39 WAKE FOREST L. REV. 1033, 1033–34 (2004).

27. Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209, 209 (2000).

28. *See* Narayanan et al., *supra* note 3, at 1602 (explaining that if "stock price at the time of exercise exceeds the exercise price" the difference is a payoff to the employee).

price remain equal when the option is exercised, in which case the option holder gains nothing. The market price might also drop below the strike price, which makes the option worthless because it could only be exercised at a loss. These options, where the strike price equals the fair market value of the company's stock on the date of issuance, are referred to as "at-the-money."[29] The common rationale for granting options of this kind is to align employee interests with shareholder interests by giving employees personal incentives to increase the value of the company's stock.[30]

Stock options may also be issued "in-the-money."[31] This means the agreed upon strike price is lower than the stock's selling price on the date the option is issued.[32] If the company's stock is currently trading for $50/share and on the same day the strike price is set at $40/share, the option is in-the-money. The option holder essentially has a $10/share paper profit without the stock increasing in value.[33]

When a company backdates the stock options it issues, it sets the strike price at the stock's selling price from an earlier date.[34] When backdating, companies assign the grants prior dates where the stock price was lower than on the date the option was actually issued, creating an in-the-money option, because the option can be exercised at a price lower than the stock's current fair market value.[35] Companies may legally grant in-the-money options, but

29. Walker, *supra* note 23, at 567.

30. John D. Shipman, Comment, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C. L. REV. 1194, 1199 (2007) ("Because equity option grants inherently link an executive's compensation to the value of the company's underlying stock, public companies generally adopt executive stock option plans to improve the performance of management and create a proprietary interest in the company to better align shareholder and management interests. Properly structured equity option packages provide top executives with 'a great incentive to raise the company's share price, which increases both the value of his or her options and shareholder returns.'" (footnotes omitted) (quoting TED ALLEN & SUBODH MISHRA, INSTITUTIONAL S'HOLDER SERVS., AN INVESTOR GUIDE TO THE STOCK OPTION TIMING SCANDAL 1 (2006))).

31. *See* Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 148 n.31 (2000) (citing Roy F. Price, Note, *Options, Waste and Agency Costs*, 4 S. CAL. INTERDISC. L.J. 391, 395 n.13 (1995)).

32. *Id.* (explaining that this type of option would allow an employee to purchase stock below the present market value).

33. *See* Mark Maremont, *Authorities Probe Improper Backdating of Options*: *Practice Allows Executives to Bolster Their Gains; A Highly Beneficial Pattern*, WALL ST. J., Nov. 11, 2005, at A1.

34. Ashwini Jayaratnam, Recent Development, *Prosecuting Stock-Option Backdating: The Ethics of Enforcement Techniques*, 20 GEO. J. LEGAL ETHICS 755, 755–56 (2007).

35. *Stock Options Backdating: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) [hereinafter *Backdating Hearing*], *available at* http://banking.senate.gov/public/_files/ACFB067.pdf (testimony of Christopher Cox, Chairman, SEC).

they must record a related compensation expense.[36] Unfavorable tax consequences accompany in-the-money options, while at-the-money options qualify for more advantageous tax treatment.[37] Until recent revisions to the rules came about, companies were not required to record any compensation expense when at-the-money options were granted, leading companies to prefer them over in-the-money options.[38] Companies frequently adopted shareholder-approved compensation plans restricting option pricing in order to avoid the negative tax and accounting consequences of in-the-money options.[39]

Problems arose when companies attempted to disguise the fact that by backdating they were issuing in-the-money options.[40] Companies tried to make it appear as though the options were actually granted on the prior date with the lower price. Sometimes those issuing the options would falsify corporate records to give the appearance that the options were issued on the

36. *See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 863 (2002); *see also* ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, Opinion of the Accounting Principles Bd. No. 25, ¶ 10 (Am. Inst. of Certified Pub. Accountants 1972), *reprinted in* FIN. ACCOUNTING STANDARDS BD., FINANCIAL ACCOUNTING STANDARDS, ORIGINAL PRONOUNCEMENTS AS OF JULY 1, 1979, at 329 (1979) (requiring that "a corporation recognize[] compensation cost for stock issued through compensatory plans unless the employee pays an amount . . . equal to the quoted market price of the stock at the measurement date"). FASB eventually replaced this APB opinion, and in 2004 it issued a pronouncement requiring all companies to record the services received in exchange for option grants. *See* SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123R, ¶ 9–10 (Fin. Accounting Standards Bd. 2004), *available at* http://www.fasb.org/pdf/aop_FAS123R.pdf.

37. *See* Walker, *supra* note 23, at 569 (explaining that in-the-money options do not allow the employee to be taxed at the lower long-term capital gains rate available for at-the-money options and that companies can only take limited deductions for in-the-money options, unlike at-the-money options, which qualify as performance-based compensation); *see also* I.R.C. § 421(a)(1) (2000); *id.* § 162(m).

38. Walker, *supra* note 23, at 568–69; *see id.* at 570 ("Congress and the Financial Accounting Standards Board (FASB) severely penalized the grant of in-the-money options, and few public companies have granted such options.").

39. *See id.* at 570. However, some scholars have argued that while many company option plans require that the option's exercise price equal the stock's fair market value on the grant date, they do not technically require the grant date be the same date the decision to issue the option was made. *See* Lie, *supra* note 13, at 807; Shipman, *supra* note 30, at 1217. This claim ignores the fact that companies appeared to be prohibiting grants of in-the-money options.

40. *See Backdating Hearing*, *supra* note 35 (asserting that misrepresenting the option grant date disguises in-the-money options, giving the recipient a chance to realize larger gains, while the company avoids reporting compensation expense); Maremont, *supra* note 33 (explaining that backdating results in misleading disclosures because companies issue proxy statements claiming the strike price equals the stock's market value on the grant date but then use an earlier date, where the price was lower).

earlier date.[41] Studies show the chosen backdate was often one where the company's stock was at its lowest selling price of the month, quarter, or even the year.[42] Concealing the date on which the option was actually granted resulted in improper accounting and tax treatment, which led to misstated earnings.[43] It also misled shareholders about the amount of compensation employees and executives received.[44] Backdating allowed option holders to purchase stock at a greater discount than they would have received if the options had been priced at fair market value on the date of issuance, thereby lowering the amount the company was paid when the options were exercised.[45] In some cases backdating also amounted to a violation of the shareholder-approved compensation plan.[46]

In 2005, federal regulators began investigating whether companies were engaging in the practice of backdating stock options.[47] Recent academic research had revealed a pattern of options being granted when stock prices had reached low points, only to rise again after the grants.[48] Some suggested this indicated that executives waited to see how the market evolved before deciding which date would be the most beneficial for issuing stock options.[49] SEC investigators initially opined that companies were timing option grants to coincide with positive corporate news, which would have the effect of

41. For example, executives at Brocade and Comverse Technologies, Inc. were accused of falsifying documents to hide backdating. *See* Judith Burns, *Ex-Counsel at Comverse Settles Lawsuit*, WALL ST. J., Jan. 11, 2007, at A11; Steve Stecklow & Peter Waldman, *Brocade Ex-CEO Found Guilty in Backdating Case: Criminal Trial Victory for U.S. Likely to Serve as Model for Prosecutors*, WALL ST. J., Aug. 8, 2007, at A3.

42. Walker, *supra* note 23, at 574.

43. *See Executive Compensation: Backdating to the Future, Oversight of Current Issues Regarding Executive Compensation Including Backdating of Stock Options; Tax Treatment of Executive Compensation, Retirement and Benefits: Hearing Before the S. Comm. on Finance*, 109th Cong. (2006) [hereinafter *Executive Compensation Hearing*], *available at* http://finance.senate.gov/hearings/testimony/2005test/090606testpm.pdf (statement of Paul J. McNulty, U.S. Deputy Att'y Gen.).

44. *Id.*; Walker, *supra* note 23, at 589–91 (stating that because the backdated options were recorded at values much lower than they were actually worth, the amount of compensation reported was significantly understated).

45. *See* Derivative Action Complaint at 9, 13, Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) (No. 2213) (seeking recovery for the company of the difference between the exercise price and the stock's fair market value on the actual date of the grant). Some also argue that allowing option holders to purchase stock discounted below fair market value on the date of the grant dilutes share value. *See Executive Compensation Hearing*, *supra* note 43.

46. *See* Walker, *supra* note 23, at 570.

47. Maremont, *supra* note 33.

48. *Id.*; Lie, *supra* note 13.

49. Maremont, *supra* note 33 (referencing Erik Lie explaining that his study showed "executives may have backdated options, already knowing how the market moved").

increasing the stock price.[50] However, as more information was gathered, the evidence suggesting the options were backdated became stronger.[51] The data indicated that the practice was utilized in numerous companies.[52]

The SEC's early investigation into backdating targeted fewer than twenty companies.[53] As time passed, the number of companies suspected of backdating greatly increased. The SEC has now investigated over 140 companies for backdating.[54] Over eighty companies have restated their financials.[55] More than 160 shareholder derivative suits have been filed against corporate directors for engaging in backdating schemes.[56]

II. DERIVATIVE SUITS

Shareholders are suing corporate directors for backdating stock options.[57] Many have chosen to bring derivative suits because a direct suit against the board of directors is more difficult to sustain.[58] In a derivative suit, the cause of action sought to be enforced belongs to the corporation.[59] The shareholder alleges damage to the corporation, resulting in indirect harm to himself.[60] In a backdating scenario, the plaintiff-shareholder asserts that by backdating the stock options the defendant-directors breached their fiduciary duties to the company.

Since a derivative suit is brought on behalf of the corporation itself, any recovery goes to the corporation.[61] Any damages the defendants owe will be awarded to the company, but often the directors who are sued have indemnification clauses in their employment agreements.[62] This means the

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50. *Id.*

51. *See* Forelle & Bandler, *supra* note 13.

52. *See* Dash, *supra* note 13; Stephanie Saul, *Study Finds Backdating of Options Widespread*, N.Y. TIMES, July 17, 2006, at C1; *see also* Lie, supra note 13; *Lucky CEOs*, *supra* note 13; *Lucky Directors*, *supra* note 13; Yermack, *supra* note 13.

53. Forelle & Bandler, *supra* note 13.

54. Eric Dash & Matt Richtel, *Backdating Conviction, a Big First*, N.Y. TIMES, Aug. 8, 2007, at C2.

55. Jones, *supra* note 21.

56. *Id.*

57. *See id.*

58. *See supra* notes 17–22 and accompanying text.

59. Mary Elizabeth Matthews, *The Shareholder Derivative Suit in Arkansas*, 52 ARK. L. REV. 353, 353 (1999).

60. *Id.*

61. Kraakman et al., *supra* note 19, at 1734.

62. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1083 (2006) ("Almost all public companies have indemnification agreements with outside directors . . . providing that the corporation shall advance legal expenses and indemnify legal fees, damages, and amounts paid in settlement to the fullest extent permitted by law."); Nishchay H. Maskay, Comment, *The Constitutionality of Federal Restrictions on the Indemnification of Attorneys'*

corporation has agreed to cover the directors' liability, leading to the circular result where the damages paid to the company come from the company's funds or its own insurance.[63] However, indemnification is typically not allowed if the directors are found liable for intentional misconduct.[64] Furthermore, even if the monetary recovery in a derivative suit is low, such suits often bring about changes in corporate governance.[65] They also serve as a deterrent for directors, helping to prevent them from ignoring their fiduciary duties in the future.

There are several procedural requirements for a shareholder to bring a derivative action.[66] The shareholder must first demand that the board of directors handle the action on behalf of the corporation.[67] Directors have the authority to manage the corporation, which includes the power to decide whether the corporation should bring a lawsuit.[68] Thus, the shareholder is expected to bring an issue to the board before taking other action so that the directors have an opportunity to decide how to pursue the matter, if at all.[69] The ideal situation is that once a shareholder makes a meritorious demand, the board recognizes the harm to the company and acts to address it. However, the typical board response to a shareholder's demand is a decision not to take action.[70] If the board rejects the shareholder's demand, the shareholder is free to file a complaint on behalf of the corporation.[71]

The defendants, typically the company's directors, will invariably file a motion to dismiss asserting that their decision to reject the demand is protected by the business judgment rule.[72] This rule protects reasonable decisions made

Fees, 156 U. PA. L. REV. 491, 497 (2007) ("Indemnification has become common in American companies.").

63. *See* Kraakman et al., *supra* note 19, at 1736, 1745–47.

64. Sandra K. Miller, *The Duty of Care in the LLC: Maintaining Accountability While Minimizing Judicial Interference*, 87 NEB. L. REV. 125, 149 & n.102 (2008) (explaining that under Delaware law an indemnification agreement may not limit a director's liability for intentional misconduct or other acts not in good faith).

65. *See* Stephen P. Ferris et al., *Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings*, 42 J. FIN. & QUANTITATIVE ANALYSIS 143, 163 (2007) (concluding that shareholder derivative suits "ultimately lead to beneficial adjustments in corporate governance").

66. *See* Thomas P. Kinney, Comment, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 173 (1994).

67. *Id.*; *see also* FED. R. CIV. P. 23.1.

68. *See* Tamar Frankel & Wayne M. Barsky, *The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suits*, 12 HOFSTRA L. REV. 39, 48–49 (1983); Kinney, *supra* note 66, at 173, 176.

69. Kinney, *supra* note 66, at 175–76.

70. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 408 (2005); Kinney, *supra* note 66, at 176.

71. Kinney, *supra* note 66, at 172, 176.

72. *Id.* at 176.

by informed, independent, disinterested directors from judicial scrutiny.[73] "[I]t creates 'a presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company.'"[74] Essentially, the rule assumes that directors act in accordance with their fiduciary duties. The shareholder must then show that the directors' decision to reject demand is not protected by this rule, either because the directors are not disinterested,[75] they failed to fully inform themselves before making the decision,[76] or the decision had no rational business purpose and could not have been in the corporation's best interest.[77] This is a high standard for shareholders to overcome, and courts will often defer to the board's decision, resulting in the case being dismissed.[78]

Shareholders do have the option of not making a demand on the board.[79] The directors would then bring a motion to dismiss for failure to make a demand, and the shareholder would allege that demand is futile and therefore excused.[80] The shareholder must show that the board could not have made an "unbiased business judgment" in considering the demand if it had been made.[81] This will require alleging that a majority of the directors on the board were interested in the underlying transaction, or not independent of those who were,

73. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988).

74. Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (second alteration in original) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

75. Craig W. Palm & Mark A. Kearney, *A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game (Part 1)*, 40 VILL. L. REV. 1297, 1309–12 (1995) (noting that a director has a disqualifying self-interest violating the duty of loyalty if the interest "is material or substantial enough" to cause the director to decide differently than he would otherwise or if the director is not independent of another director with such a self-interest).

76. *Id.* at 1307–08 (explaining that uninformed or misinformed decisions would violate the directors' duty of care).

77. *See id.* at 1313–15.

78. Fairfax, *supra* note 70, at 408; *see* Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) ("[B]ecause . . . derivative suits challenge the propriety of decisions made by directors pursuant to their managerial authority, . . . plaintiffs must overcome the powerful presumptions of the business judgment rule . . . ."); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (declaring that boards of directors are "better-suited than courts to make business decisions"). Courts want boards of directors to be free to make managerial decisions without fearing litigation over the decision anytime a shareholder disagrees. *See* S. Samuel Arsht, *The Business Judgment Rule Revisted*, 8 HOFSTRA L. REV. 93, 95 (1979); Douglas M. Branson, *The Rule that Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 637 (2002) ("[The] business judgment rule is necessary to encourage . . . directors to engage in the type of informed risk taking that is essential to business success.").

79. Kinney, *supra* note 66, at 177.

80. *See id.*

81. Palm & Kearney, *supra* note 75, at 1337–38.

or that the transaction was not the result of valid business judgment.[82] To determine whether the board is capable of impartially reviewing a demand, the court has to consider the board's decision regarding the actual transaction challenged by the shareholder's claim, while in cases where demand was made and rejected the court initially looks only at the board's decision to reject the demand and not at the underlying transaction.[83] If the business judgment rule does not protect the challenged transaction, the board cannot be deemed impartial in considering demand and requiring it would be futile.[84] To convince the court that demand is excused, the shareholder must "plead with particularity facts sufficient to rebut the presumptions of the business judgment rule."[85]

Even if a shareholder can overcome the business judgment rule in arguing that demand was excused or that the board's rejection of a demand was wrongful, he is not free from the business judgment rule.[86] The directors may assert the business judgment rule in a motion to dismiss for failure to state a claim or as a defense on the merits.[87] If the shareholder successfully rebuts the business judgment rule at trial, the directors must then satisfy the high burden of proving the action at issue was entirely fair to the corporation and its shareholders.[88] If the directors cannot meet this burden, they are liable to the corporation for breaching their fiduciary duties. Below are discussions of two shareholder derivative suits brought against corporate directors for allegedly breaching their fiduciary duties by backdating corporate stock options.

82. *Id.* at 1338, 1341 (noting that a challenged transaction would not be an exercise of valid business judgment if the underlying decision involved a breach of the directors' duties of care or loyalty).

83. *See id.* at 1338–41.

84. *See id.* at 1337–38. To establish that the business judgment rule does not protect the underlying transaction, the shareholder must show that the directors were not disinterested in the transaction, the directors failed to fully inform themselves before making a decision regarding the transaction, or the decision had no rational business purpose and could not have been in the corporation's best interest. *See supra* notes 75–77 and accompanying text.

85. Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 371 (2004); *see also* FED. R. CIV. P. 23.1.

86. Palm & Kearney, *supra* note 75, at 1349 ("The shareholder must meet its burden of proof and rebut the business judgment rule at each stage of the case.").

87. *See id.*

88. *See id.*

III. CASES SETTING THE PRECEDENT FOR DELAWARE'S BACKDATING JURISPRUDENCE

A. Ryan v. Gifford

In 2006, Merrill Lynch published a report on semiconductor companies that appeared to have engaged in the practice of backdating stock options.[89] A majority of the options issued by the named companies were granted on days where the companies' stock prices were at their lowest points.[90] One company named in the report was Maxim Integrated Products, Inc., a designer and manufacturer of circuits used in microprocessor equipment located in California and incorporated in Delaware.[91] The Merrill Lynch report never actually accused Maxim of backdating, but it noted the significant improbability of a stock having a return ten times higher than the annual average during the twenty days following an option grant, as Maxim's stock did.[92] The report implied that backdating was the only logical explanation.[93]

After the report became public, Maxim shareholder Walter Ryan filed a derivative suit against the members of Maxim's board of directors.[94] Ryan cited nine specific option grants between 1998 and 2002 made to John Gifford, chairman of the board, chief executive officer, and company founder, which were too well-timed to correspond with stock price lows to be deemed coincidental.[95] The options, which could be exercised to purchase millions of shares of Maxim stock, were issued on dates with some of the lowest stock prices for each particular year.[96] Ryan argued that because the board of directors allowed grants of backdated options and misled shareholders in regards to the options, the directors violated their fiduciary duties of loyalty and due care to the company and the shareholders.[97]

Backdating stock options violated Maxim's shareholder-approved stock option plans.[98] A 1983 Stock Option Plan and a 1999 Stock Incentive Plan, both on file with the SEC, required that each option's exercise price be at or above the fair market value of the stock on the date of the grant.[99] This meant the shareholder-approved plans prohibited the company from issuing in-the-

89. Ryan v. Gifford, 918 A.2d 341, 346–47 (Del. Ch. 2007).
90. *Id.* at 346.
91. *See id.* at 345–46.
92. *Id.* at 347.
93. *See id.*
94. *Ryan*, 918 A.2d at 345–46.
95. *Id.* at 346.
96. *Id.*
97. *Id.* at 346, 348.
98. *See id.* at 354.
99. *Ryan*, 918 A.2d at 346–48, 354.

money options. Ryan claimed that Maxim directors backdated stock options to make them in-the-money, a violation of the approved option plans, and then attempted to conceal this from the shareholders.[100]

This intentional disregard of the stock option plan and ensuing dishonesty to the shareholders allegedly caused adverse tax and accounting problems for Maxim.[101] In-the-money options should have been treated as a compensation expense, which would have reduced reported earnings.[102] The fact that Maxim attempted to conceal the in-the-money options overstated the company's profits, and correcting the problem would require revising the financial statements and tax payments.[103] Also, when the options were exercised, Maxim would have received a lesser payment than if the options had not been backdated.[104]

Ryan sued in Delaware, and the director-defendants responded with a motion to dismiss the action.[105] They began by arguing Ryan failed to make a demand or to plead with particularity that demand was futile.[106] The test applied under Delaware law to determine if demand is excused as futile depends on whether the decision at issue was made by the board of directors in place when the suit was brought.[107] Since Maxim's shareholder-approved option plans allowed the board to delegate all decisions regarding the issuance of stock options to a compensation committee, the granting of the backdated options at issue was not considered a transaction entered into by decision of the board of directors, but rather by the compensation committee.[108]

In this situation, it initially appeared that the applicable test was the one laid out in *Rales v. Blasband*[109] for cases where the challenged decision was not made by the current board of directors.[110] Upon further consideration, however, the *Ryan* court determined that this was actually a situation where the challenged decision could be attributed to the board of directors in place when the suit was brought.[111] Although the compensation committee had been delegated the power to administer the challenged options, at all relevant times the committee consisted of the same three people, who were also members of

100. *Id.* at 348, 354–55.
101. *See id.* at 348.
102. *See id.*
103. *See id.*
104. *Ryan*, 918 A.2d at 348.
105. *Id.*
106. *Id.* at 351–52.
107. *Id.* at 352.
108. *See id.* at 353.
109. 634 A.2d 927, 933 (Del. 1993).
110. *Ryan*, 918 A.2d at 353.
111. *See id.*

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the board of directors at all relevant times.[112] Since the board consisted of only six members, half of the board approved the decision now at issue.[113] The court declared that a decision by half of the board could be "imputed to the entire board," making the challenged decision one by the board in place when the suit was brought.[114]

This meant the test laid out in *Aronson v. Lewis*[115] for demand futility applied, and the important inquiry was whether the directors were disinterested and independent or whether the decision was made in the exercise of valid business judgment.[116] If not, the directors could not be impartial, and demand would be excused as futile.[117] The shareholder bears the burden of alleging particularized facts showing a reason to doubt the business judgment rule applied.[118] The *Ryan* court acknowledged that creating enough doubt to overcome the business judgment rule and survive a motion to dismiss for failure to plead demand futility is a difficult feat.[119]

In applying the *Aronson* test to the facts of *Ryan*, the court went directly to the second prong: whether the decision to backdate was an exercise of valid business judgment.[120] Arguments could have been made in support of excusing demand based on the first prong of the test, but this was not a clear-cut case involving an obvious majority of interested directors.[121] The options at issue were all granted to Gifford,[122] making him clearly interested in the transaction because he had a direct financial benefit at stake. While three other directors were openly involved in the transaction because they comprised the compensation committee issuing the options, there was a question as to whether that made them interested.[123] The court passed over the matter in favor of the seemingly stronger arguments for excusing demand based on a lack of valid business judgment.[124]

112. *Id.*
113. *Id.*
114. *Id.*
115. 473 A.2d 805, 814 (Del. 1984).
116. *See Ryan*, 918 A.2d at 352–53.
117. *See id.* at 352.
118. *See Aronson*, 473 A.2d at 814.
119. *See Ryan*, 918 A.2d at 352 n.23.
120. *Id.* at 354.
121. For example, in *Aronson* the court referenced a case where demand was excused as futile when five of nine directors approved a stock plan likely to benefit them, making the board interested for demand purposes. *Aronson*, 473 A.2d at 805, 815 (citing Bergstein v. Texas Int'l Co., 453 A.2d 467, 471 (Del. Ch. 1982)).
122. *Ryan*, 918 A.2d at 348.
123. *Id.* at 353.
124. *See id.* at 354–55.

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Ryan argued that the board of directors could not undertake any action that would contravene the shareholder-approved option plans.[125] Intentionally altering the date of the option grant by changing it to an earlier date where the stock's fair market value was lower, thus making the strike price lower, would contravene the terms of the plans requiring that the exercise price be no less than the stock's fair market value on the date the option was granted.[126] Thus, Ryan claimed the directors' decision to backdate violated the shareholder-approved option plans and could not be considered a valid exercise of business judgment.[127]

In agreeing with Ryan's argument, the court compared the case with *Sanders v. Wang*,[128] where a board of directors allegedly granted shares of stock exceeding the number of shares authorized by the employee stock ownership plan.[129] The *Sanders* court held that allegations of a board acting in violation of an approved plan raised doubt as to whether the board's decision was a valid exercise of business judgment.[130] A knowing and intentional decision by the board to exceed the limited authority explicitly provided by the shareholders was enough to excuse demand as futile.[131]

In the *Ryan* case, the shareholder supported his claim that the directors had violated the option plans by alleging that nine instances of option grants over a long period came on the date with the lowest stock price of the month or year.[132] In addition to this suspicious timing, the Merrill Lynch report offered empirical evidence that the grant date was manipulated to fall on an already known low stock price date.[133] Noting that Maxim's options plans did not designate specific times at which options would be granted, the court deemed the actual dates chosen "too fortuitous to be mere coincidence."[134] The logical inference was that the options were backdated in contravention of the shareholder-approved option plan,[135] making it doubtful that the decision to backdate was an exercise of valid business judgment.[136] The court found that the shareholder's pleadings, pointing to specific option grants, plan terms, and

125. *Id.* at 354.
126. *Id.*
127. *Ryan*, 918 A.2d at 354.
128. No. 16640, 1999 WL 1044880 (Del. Ch. Nov. 8, 1999).
129. *Ryan*, 918 A.2d at 354.
130. *Sanders*, 1999 WL 1044880, at *5.
131. *Ryan*, 918 A.2d at 354.
132. *Id.*
133. *Id.*
134. *Id.* at 354–55.
135. *See id.* at 355 n.34 ("[T]he Court may reasonably infer [knowing manipulation of option grants], even when applying the heightened pleading standards.").
136. *See Ryan*, 918 A.2d at 355.

supportive empirical evidence, contained sufficient particularity to excuse demand as futile.[137]

After finding that demand was excused under the *Aronson* test, the *Ryan* court declared that even if the test in *Rales*, for situations where the contested decision was not made by the board of directors in place when the suit was filed, was to be applied, demand would still be excused.[138] The test inquires as to whether there is reasonable doubt that a majority of the board of directors would be disinterested and independent in considering the shareholder's demand.[139] Directors cannot be deemed interested merely because they are named in the suit,[140] but directors who are sued can be deemed interested if they face a substantial likelihood of liability.[141] The *Ryan* court said that the directors who approved the backdating of options faced "at the very *least* a substantial likelihood of liability."[142] The court could not accept that directors who lied to shareholders, especially about an activity that clearly violated a shareholder-approved plan, were fulfilling their fiduciary duty of loyalty.[143] Backdating was deemed one of the few instances where a transaction is "so egregious on its face" that the board's approval was not protected by the business judgment rule.[144] A director's approval of the transaction was enough to raise doubt as to his disinterestedness for purposes of considering demand because it created a high likelihood of liability not only for a breach of fiduciary duties, but also for other civil and criminal charges.[145] Here, the three directors comprising the compensation committee allegedly made the decision to approve backdated options, and a fourth director, Gifford, received the options, giving him a personal financial interest.[146] Ryan's pleading of particular facts alleging that a majority of the six directors were interested, either financially or in avoiding a situation of personal liability, raised enough doubt about the board's ability to impartially consider the demand to deem the demand requirement futile and thus excused.[147]

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137. *Id.*

138. *Id.* (citing Rales v. Blasband, 634 A.2d 927, 933–34 (Del. 1993)). The court was essentially saying that even if a decision made by half of the board of directors could not be imputed to the entire board (which the court found when it analyzed demand excusal under *Aronson*), demand would still be excused.

139. *Id.*

140. This would allow shareholders to avoid the demand requirement simply by suing a majority of the board of directors.

141. *Ryan*, 918 A.2d at 355.

142. *Id.*

143. *Id.*

144. *Id.* at 355–56.

145. *See id.* at 356 & n.38.

146. *Ryan*, 918 A.2d at 356.

147. *See id.*

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After rejecting the defendants' motion to dismiss for failure to make a demand, the court rejected the defendants' motion to dismiss for failure to state a claim upon which relief may be granted.[148] The defendants argued that the claim for breach of fiduciary duties failed to allege facts sufficient to rebut the business judgment rule's presumption that the directors acted in accordance with their duties, and thus dismissal was required.[149] The court noted that Ryan had already pled facts raising doubt as to the validity of the business judgment exercised in the decision at issue that were deemed sufficient under the demand excusal's higher pleading standard.[150] Furthermore, Ryan specifically alleged that the defendant-directors acted in bad faith, allowing his action to survive the motion to dismiss for failure to state a claim because actions in bad faith would breach a director's duty of loyalty.[151] The *Ryan* court stated that if directors intentionally defied the terms of a shareholder-approved stock option plan and then attempted to mislead the shareholders about the options granted by making false public disclosures concerning the grants, it would amount to conduct in bad faith.[152] Thus, the shareholder pled with particularity allegations of bad faith sufficient to rebut the business judgment rule's presumed protection of the directors' decision, allowing the claim to survive.[153]

The court did declare that at trial, after having time for discovery, the shareholder would need to provide evidence to actually prove the allegations and he could not merely rely on inferences drawn from empirical data to make his case.[154] If Ryan could prove the factual allegations he pled, the business judgment rule would not protect the underlying transaction.[155] The directors would still be free to argue the challenged decision was entirely fair to the company and shareholders, but that is a difficult standard to meet.[156]

Ryan's derivative action thus survived the defendants' motion to dismiss.[157] The case has since moved to the discovery stage preceding trial. However, its result, which seemed to signal that the court was willing to hold directors liable for participating in corporate backdating practices, appeared to be contradicted in *Desimone v. Barrows*.[158]

148. *See id.* at 358.
149. *See id.* at 356.
150. *Id.* at 357.
151. *See Ryan*, 918 A.2d at 357–58 (citing Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006)).
152. *See id.* at 358.
153. *Id.*
154. *Id.* at 358 n.49.
155. *Id.*
156. *Ryan*, 918 A.2d at 358 n.49.
157. *See id.* at 358.
158. 924 A.2d 908 (Del. Ch. 2007).

B. Desimone v. Barrows

The next shareholder derivative action stemming from a case of alleged stock option backdating heard by the Delaware Chancery Court did not fare as well for the shareholder-plaintiff. In 2006, Sycamore Networks, Inc. fell under the scope of an investigation conducted by the SEC and the U.S. Department of Justice for alleged backdating practices.[159] A Sycamore shareholder, John Desimone, brought a derivative action on behalf of the corporation against the board of directors and certain recipients of the allegedly backdated grants.[160] His claim relied largely on an anonymous internal memo that suggested that in 2000, option grants to six employees were backdated so the grant dates fell on the date where the company's stock was trading at the lowest price of the preceding quarter.[161] After this memo came to light, Sycamore's own audit committee conducted an internal investigation and concluded that certain stock option grants had been accounted for improperly.[162] The company restated its earnings for the years 2000–2003.[163]

Sycamore, a company involved in the creation and sale of optical networking products, had a six-member board of directors.[164] Two directors held positions within the company as chairman of the board and chief executive officer/president.[165] Neither owned Sycamore stock options.[166] The other four directors were outside directors, meaning they did not hold positions of employment within the company.[167] According to a shareholder-approved option plan, the outside directors received compensation in the form of stock options for their service on the board.[168] Two of the outside directors also served on the board's compensation committee at all relevant times.[169] Additionally, the company had a three-person audit committee, comprised of different outside directors at various times.[170]

The challenged option grants fell into three different types: grants to rank-and-file employees, grants to officers, and grants to outside directors.[171] Each of the four outside directors allegedly received backdated options.[172] Five

159. *Id.* at 912.
160. *Id.* at 912–13.
161. *Id.* at 913.
162. *Id.*
163. *Desimone*, 924 A.2d at 913.
164. *Id.* at 918.
165. *Id.*
166. *Id.* at 919.
167. *Id.*
168. *Desimone*, 924 A.2d at 919.
169. *Id.*
170. *Id.*
171. *Id.* at 913.
172. *Id.* at 917.

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executive officers each allegedly received at least one grant of backdated options.[173] These officers, along with the six members of the board of directors, were named as defendants in Desimone's lawsuit.[174]

The backdating scheme Desimone described revolved around one defendant, Sycamore's former chief financial officer (CFO).[175] She allegedly instructed a former director of human resources to carry out the backdating practice within the company.[176] This director was given orders to falsify personnel documents so they matched the altered option grant dates.[177] If a new hire received options, his start date on file would be changed to corroborate the chosen date for the backdated options.[178] After the director's dismissal, he presented the board with an anonymously written internal memo describing six option grants that had been backdated to a date when Sycamore's stock traded at $29.125.[179] Within twenty days, the stock price had increased to $51.38.[180] The options were, however, subject to a three-year vesting period.[181] The memo also included a discussion of ways to conceal each backdated option grant, such as creating new offer letters, and assessed the risk of audit discovery associated with each cover-up action.[182]

The challenged options were all issued under the authority of Sycamore's two shareholder-approved stock option plans.[183] The Non-Employee Director Stock Option Plan provided that the outside directors would receive compensation in the form of 30,000 options annually.[184] The plan directed that the options would be automatically granted every year on the date of the company's annual stockholder meeting.[185] Each option's strike price was required to be equal to the stock's fair market value on the grant date.[186] The options could be exercised immediately but were subject to a vesting period

173. *Desimone*, 924 A.2d at 919.

174. *Id.* at 913, 919.

175. *See id.* at 919.

176. *Id.* at 922.

177. *Id.*

178. *Desimone*, 924 A.2d at 922.

179. *Id.*

180. *Id.*

181. *Id.* Therefore, while the recipient had an instant profit on the options, it was not immediately realizable. Before the vesting period passed, the stock price actually dropped below $10 a share, erasing any profit. *Id.* at 922 n.28. While some may argue that this defeats any need for filing a derivative action, as the option holders ultimately took a loss, the actions that allegedly occurred within the company still brought about serious concerns relating to breaches of fiduciary duties that needed to be addressed.

182. *Id.* at 922–23.

183. *Desimone*, 924 A.2d at 919.

184. *Id.*

185. *Id.*

186. *Id.*

between one and three years, meaning that even if an option was exercised, the acquired stock could not be sold or borrowed against until the vesting period passed.[187]

The Stock Incentive Plan authorized the option grants to company officers and employees.[188] This plan was to be administered by a committee of two or more members of the board of directors.[189] The plan allowed the board to delegate all option-granting power to an executive officer or officers, so long as the board set the maximum number of shares subject to grant.[190] Unlike the Non-Employee Director Plan, the Stock Incentive Plan did not require that options be granted with an exercise price equal to the stock's fair market value, unless they were intended to qualify for the special tax treatment available only to certain at-the-money options.[191] While Desimone did not claim that the challenged options issued to the officers and employees were intended to qualify for this special treatment, he did allege that Sycamore accounted for the options as though they were priced at the fair market value of the stock on the date of issuance.[192] He further alleged that Sycamore led shareholders, the market, and regulatory authorities to believe that the more favorable tax and accounting treatment for at-the-money options applied to the options issued.[193] The compensation committee was to set the vesting schedule for these option grants, and Desimone stated that the employee grants at issue were subject to a three-year vesting period.[194]

In bringing his derivative action, Desimone did not make a demand upon Sycamore's board of directors to address the issue of backdated options.[195] The defendants responded to his suit with a motion to dismiss for failure to make a demand or to plead with particularity that demand is excused.[196] The parties agreed that the *Rales* test for demand excusal applied here because the challenged decision was not made by the current board of directors.[197] The

187. *Id.* at 919–20 ("[The] vesting schedule . . . prevented the recipients from realizing any immediate value from the options.").

188. *Desimone*, 924 A.2d at 920.

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.* at 921.

193. *Desimone*, 924 A.2d at 921.

194. *Id.*

195. *Id.* at 927.

196. *See id.* at 927–28.

197. The court does not go into detail about why the decision was not made by the board of directors, but since the option plans delegate authority over the grants to the compensation committee, it appears that the court is implying the committee made the challenged decisions. *See id.* at 928. Since the committee here is composed of two directors and there are six directors on the board, *id.* at 918–19, the committee's decision cannot be imputed to the entire board as it was in *Ryan* when half of the directors also served on the compensation committee.

court had to determine whether the current board could have considered a demand with independent and disinterested judgment.[198] To excuse demand, the court required particularized facts alleging either that a majority of board members were interested or not independent from those who were or that a majority of the board members faced a substantial threat of personal liability for the challenged transaction, compromising their ability to make an impartial decision about demand.[199]

The court first applied the test to the options granted to rank-and-file employees.[200] When Sycamore restated its financials in 2005, it admitted that a number of options issued to employees were actually granted in-the-money even though the company had concealed this and accounted for the options as though they were issued at fair market value.[201] However, there was no suggestion that any of the directors had a personal interest in those grants or were not independent of the recipients of the grants.[202]

Therefore, for Desimone to prove demand was excused under the *Rales* test, he had to allege with particularity that the directors faced a substantial threat of personal liability for the grants.[203] The shareholder-approved plan expressed that the board was free to delegate authority for granting options to non-directors.[204] While two directors made up the compensation committee, the court found the logical inference was that such small option grants to lower-level employees would have been overseen by corporate officers, especially since the directors on the committee were the outside directors who had no day-to-day employment within the company.[205] Desimone did not claim otherwise, making no allegation that the directors were responsible for issuing the grants or even directing the process by which the options were issued, which would include selecting the grant date.[206] Desimone himself referred to the former CFO, a non-director, as the "enforcer" of Sycamore's backdating practice.[207] The particular facts pled did not indicate that the directors shared her culpability.[208] Desimone admitted he could not show that the compensation committee was aware the employee options it approved were backdated, and there was no requirement in the plan that the options be issued

198. *Desimone*, 924 A.2d at 928.
199. *Id.*
200. *See id.* at 938.
201. *Id.*
202. *Id.*
203. *Desimone*, 924 A.2d at 938.
204. *Id.*
205. *Id.*
206. *See id.*
207. *Id.* at 919.
208. *Desimone*, 924 A.2d at 939.

at fair market value.[209] Thus, even though Sycamore admitted wrongdoing in relation to the grants, the complaint failed to plead with particularity facts sufficiently alleging that a majority of the directors faced a substantial likelihood of liability for their involvement in the backdating that occurred.[210]

Desimone further argued that the directors' ignorance of the fact that the options granted to the employees were being backdated amounted to a violation of the directors' duty to monitor corporate compliance with the law.[211] He alleged that the internal controls Sycamore had in place were flawed in that they had allowed the backdating practice to be carried out with little difficulty.[212] He claimed that the directors, especially the three on the audit committee, in fulfilling their duty to monitor, should have detected, prevented, or stopped the backdating and associated material misstatements in the financial records.[213] Desimone argued that this unsatisfactory monitoring amounted to a breach of the directors' fiduciary duties.[214]

For directors to be liable for failing to monitor corporate compliance they must have acted in bad faith, knowingly breaching their fiduciary duties.[215] The court said that for the shareholder to successfully argue that failure to monitor served as the basis for substantial likelihood of director liability, he would have to plead "facts suggesting that the board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed."[216] This heavy burden is why the court in *In re Caremark* labeled a failure to monitor claim one of the most difficult a plaintiff can hope to successfully establish.[217]

Desimone never alleged particular facts showing Sycamore's internal controls were inadequate.[218] He made no claim that the directors, the audit committee, or any auditors were aware of, or even suspected, any control weaknesses.[219] He also did not suggest that any of these people had indications that backdating was occurring within the company.[220] Desimone

209. *Id.* at 920, 939.

210. *See id.* at 938–39. Thus, while the options had been backdated, the pleadings did not establish that the directors were aware of it.

211. *Id.* at 939.

212. *Id.*

213. *Desimone*, 924 A.2d at 939.

214. *See id.* at 939–40.

215. *Id.* at 935, 940 (noting that this type of liability was a breach of the duty of loyalty and would require showing a "sustained or systematic failure of oversight" (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996))).

216. *Id.* at 940.

217. *Caremark*, 698 A.2d at 967.

218. *Desimone*, 924 A.2d at 940.

219. *Id.*

220. *Id.*

did argue that the internal memo implied company-wide awareness of control problems and the occurrence of backdating.[221] The court, however, refused to infer from the memo that the directors were actually aware of the backdating.[222] The memo itself only went to one employee, and it detailed the efforts undertaken to cover up the backdating and prevent it from being discovered in an audit.[223] This did not support the claim that awareness of the backdating was widespread within the company.[224] Desimone therefore did not plead with particularity a claim that would excuse demand on the basis that the directors were interested, and thus not impartial in considering the employee options.[225]

The *Desimone* court then applied the *Rales* test for demand excusal to the options granted to Sycamore officers.[226] Again there was no allegation that any member of the board of directors was personally interested in the grants or could not act independently of the recipients.[227] Desimone claimed that two sets of option grants were backdated.[228] Both grants came when market prices had dipped to low points, with increases following.[229] The first challenged grant involved the issuance of options to the former CFO and other officers, after which Sycamore's stock price increased by over 50% in the next twenty days.[230] The second challenged grant involved the issuance of more options to the ex-CFO and another defendant-officer.[231] These options increased only 10% over the following twenty days, but Sycamore essentially admitted that the grant date had been backdated when it disclosed that the defendant-officer's options had been repriced to reflect the stock's fair market value on the date believed to be the correct date of issuance.[232]

The court accepted that the compensation committee was less likely to delegate authority over these large option grants to officers, as it would be inappropriate for the officers to oversee grants to themselves.[233] However, Desimone did not allege that any directors were aware the option grants they approved were backdated.[234] None of the facts pled alleged that any director

221. *Id.*
222. *Id.*
223. *Desimone*, 924 A.2d at 940.
224. *Id.*
225. *Id.*
226. *See id.* at 941.
227. *Id.*
228. *Desimone*, 924 A.2d at 941.
229. *Id.*
230. *Id.*
231. *Id.*
232. *Id.*
233. *Desimone*, 924 A.2d at 941–42.
234. *Id.* at 942.

was actually involved in the process of carrying out the backdating, and the court refused to infer that the committee knew the options were backdated.[235] Since the pleadings failed to allege with sufficient particularity that the directors knowingly issued backdated options to the officers, it was not substantially likely that a majority of the board faced personal liability stemming from the transaction.[236] Furthermore, the court said that even if it could infer that the directors on the compensation committee knew the options had been backdated and thus were substantially likely to be personally liable, this would not excuse demand.[237] The committee consisted of only two out of six directors so less than half the board would be impartial in its ability to consider demand.[238] Thus, the demand requirement was not excused as futile.[239]

The court then analyzed the option grants to the outside directors under the *Rales* test.[240] These were grants of 30,000 options to the four outside directors, which the Non-Employee Director Plan automatically scheduled on the date of the company's annual meeting.[241] Desimone argued that because the grants were issued on dates where the market price was so favorable, backdating must have occurred.[242] Four out of the six directors on the board were outside directors and therefore received the options at issue.[243] Thus, a majority of the board had a personal financial interest in the transaction.[244] Furthermore, the two other directors on the board could not be considered independent because they relied on board approval to maintain their positions within the company.[245] Thus, under the *Rales* test, demand was excused as futile because the board could not impartially consider the challenged transaction.[246]

After the court determined that demand was excused, it considered the defendants' argument that the complaint should be dismissed for failing to state a claim.[247] The court noted Desimone never alleged that the director grants at issue were not made on the date of Sycamore's annual meeting, as the shareholder-approved plan required.[248] Nor was there an allegation that the

235. *Id.*
236. *Id.*
237. *Id.*
238. *See Desimone*, 924 A.2d at 942.
239. *See id.*
240. *See id.* at 946.
241. *Id.*
242. *See id.*
243. *Desimone*, 924 A.2d at 947.
244. *Id.*
245. *Id.*
246. *Id.*
247. *Id.* at 948.
248. *Desimone*, 924 A.2d at 948.

meeting dates were manipulated to fall on days where the stock price was at a low.[249] The grant was prescheduled and non-discretionary per the plan.[250] The court held that it could not logically infer that a claim for backdating, constituting a breach of fiduciary duties, had been made since the date of issuance was chosen in advance and the options were actually issued on the chosen date.[251]

Therefore, none of Desimone's claims survived the motion to dismiss, even though his case was decided after the shareholder in *Ryan v. Gifford* received a favorable ruling in a derivative action stemming from a corporate backdating situation. Following is a further analysis of shareholder derivative suits filed in response to backdating allegations, an examination of why the outcomes in these two cases were different, and a discussion of what shareholders can expect in the future.

IV. A PREFERENCE FOR SHAREHOLDER DERIVATIVE ACTIONS AND THEIR CHANCE FOR SUCCESS IN THE FUTURE

A. *A Derivative Suit Is More Attuned to the Company's Best Interests than a Direct Suit in a Backdating Situation*

While the law technically allows companies to backdate because it allows companies to grant in-the-money options, it requires that companies disclose the fact that options are granted in-the-money and properly account for the options by recording the associated compensation expense.[252] However, the actual practice of backdating appears to be a practice of avoiding disclosure.[253] The benefits of backdating would be eliminated if companies were required to disclose that it was occurring. Some scholars argue that the only problem with backdating is the lack of disclosure.[254] Yet by backdating, companies essentially lied to shareholders, regulators, and the market in general.[255] They

249. *Id.*

250. *Id.*

251. *See id.*

252. *See supra* notes 36–38 and accompanying text.

253. Companies hid the actual date of the grant (and thus the options' in-the-money status) and the fact that more compensation was being provided.

254. *See* Stephen Bainbridge, *The Most Efficient Policeman*, TCS DAILY, June 15, 2006, http://www.tcsdaily.com/article.aspx?id=061506D ("It's the lack of disclosure that's the real problem with backdated options."); Larry Ribstein, Bainbridge and Chandler on Backdating, on Ideoblog, http://busmovie.typepad.com/ideoblog/2007/02/bainbridge_and_.html (Feb. 8, 2007, 07:46 EST); Larry Ribstein, Criminalizing Backdating: Continued, on Ideoblog, http://busmovie.typepad.com/ideoblog/2006/08/criminalizing_b.html (Aug. 10, 2006, 16:55 EST).

255. *See* Posting of Matt Bodie to PrawfsBlawg, Backdating: Yes, Virginia, Execs Do Want Inflated Pay, http://prawfsblawg.blogs.com/prawfsblawg/2006/09/backdating_yes_.html (Sept. 1, 2006, 11:59 EST).

lied about the date the option was granted, whether it was priced at the stock's fair market value, the amount of compensation given, and whether tax and accounting consequences would apply.[256]

Furthermore, in many instances backdating violated shareholder-approved option compensation plans.[257] Not only is the true nature of the transaction not disclosed to the shareholders, but the action also goes beyond the scope of authority expressly granted to the directors by the shareholders. Therefore, many shareholders feel that directors who engage in backdating company stock options breach their fiduciary duties.

The same circumstances that would make backdating a breach of fiduciary duties would qualify it as a violation of Rule 10b-5. A plaintiff bringing a 10b-5 claim must prove the defendant made a manipulative or deceitful material misstatement or nondisclosure regarding the sale or purchase of securities.[258] The defendant's conduct must be intentional, and the plaintiff must establish causation between the conduct and the harm suffered.[259] The plaintiff is required to demonstrate the amount of loss incurred, which would equal the decline in the stock's value attributable to the misstatement or nondisclosure.[260] With backdating, often no significant loss is apparent because stock prices did not noticeably decrease when backdating schemes were revealed.[261] This, along with the fact that the statute of limitations for a 10b-5 claim had often run by the time the backdating was discovered, encouraged shareholders to turn to the derivative suit.[262]

A derivative suit better serves the interests of the company than a shareholder's direct claim. If a shareholder brings a Rule 10b-5 action, the company is forced to pay out damages. As already discussed, the majority of shareholders did not suffer significant monetary damages in the form of lower stock prices, so it would be better for the company, and indirectly the shareholders, to avoid paying out any more and instead have the recovery come back to the company. Companies within which backdating occurred face the risk of paying penalties to the SEC and having to restate their financials. They may incur tax liabilities. Plus, they receive lower payments when the

256. *See supra* notes 40–44 and accompanying text.

257. *See supra* notes 36–39 and accompanying text.

258. 17 C.F.R. § 240.10b-5(b) (2008); Goldman, *supra* note 20, at 263.

259. Goldman, *supra* note 20, at 263–64.

260. *Id.* at 264–65.

261. Some argue this means backdating caused no harm. *See, e.g.*, Posting of Larry Ribstein to Harvard Law School Corporate Governance Forum, Lucky CEOs and Directors: How Serious is the Problem?, http://blogs.law.harvard.edu/corpgov/2006/12/22 (Dec. 22, 2006, 11:08 EST). However, this ignores the misconduct within the company, including grants of stealth compensation, lying to shareholders about grant dates, violations of tax and accounting rules, and contravening shareholder-approved option plans.

262. *See* Jones, *supra* note 21.

options were exercised than they would have if backdating had not occurred. A shareholder derivative suit helps the company recover some of its loss. Backdated options could be rescinded or repriced. Option recipients could be required to disgorge profits gained from backdating. Those responsible for backdating could even be forced to reimburse the company for any penalties it had to pay. Changes in corporate governance should help prevent future problems.

B. The Future of the Derivative Suit as a Successful Method for Addressing Backdating

1. Distinguishing *Ryan* and *Desimone*

After the Delaware Chancery Court's decision in *Ryan*, it appeared that Chancellor Chandler was paving the way for shareholder-plaintiffs to bring derivative suits against companies based on the backdating of stock options.[263] Chancellor Chandler excused demand as futile, found the business judgment rule would not protect the directors' decision if the allegations were true, and allowed the case to go forward.[264] Many potential shareholder-plaintiffs likely viewed this as a victory. Ryan's complaint against the Maxim directors was largely based on circumstantial evidence, including statistical analysis, from which the court was willing to infer that the directors were involved in the backdating practice.[265] The standard for demand excusal in a backdating case did not seem out of reach, and the court said that empirical evidence would be considered.[266] Thus, it seemed that shareholders would not have too difficult of a time reaching the discovery stage, where they hoped to find firmer evidence of the directors' involvement in the backdating practice.

A few months later, Vice Chancellor Strine changed directions in *Desimone*.[267] His opinion suggested it was not going to be easy for shareholders to meet the pleading standard for demand excusal in a derivative

263. *See Delaware Ruling Lights Way for Stock-Option Backdating Suits*, Andrews Del. Corp. Litig. Rep., Feb. 26, 2007, at 4.

264. Ryan v. Gifford, 918 A.2d 341, 355–58, 361 (Del. Ch. 2007).

265. *See id.* at 354–55; Posting of J. Robert Brown to The Race to the Bottom, Backdating: *Ryan v. Gifford* (Continued), http://www.theracetothebottom.org/preemption-of-delaware-law/backdating-ryan-v-gifford-continued.html (July 10, 2007, 06:15 EST) (noting that the statistical evidence was compelling enough to advance the case to discovery).

266. *See Ryan*, 918 A.2d at 354–55 ("In other words, it did not take much to get past a motion to dismiss. It was enough that options were issued, that evidence of backdating existed (even if only statistical), that the board (or relevant committee) approved the options (with a mere assertion enough), and that there had been false disclosure.").

267. Posting of Vaughn Marshall to The Race to the Bottom, Delaware Courts and Backdating: A Summary, http://www.theracetothebottom.org/preemption-of-delaware-law/delaware-courts-and-backdating-a-summary.html (July 24, 2007, 06:15 EST).

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action based on allegations of backdating.[268] He rejected the complaint for failing to plead with particularity facts establishing that the board of directors knowingly issued or approved backdated stock options.[269] Since the facts did not specifically allege that the board knew of the backdating, the shareholder's claim was denied the chance to move on to the discovery stage.

On first glance, the results in *Ryan* and *Desimone* seem conflicting. The claims were very similar, yet one survived a motion to dismiss and one did not. Both alleged that the boards of directors were engaged in a practice of backdating stock options. Both relied mostly on circumstantial and empirical evidence to support their allegations. In fact, *Desimone* seemed to have more evidence that backdating occurred as the company had already restated earnings and repriced certain options after conducting an internal investigation into the backdating practice by the time the shareholder sued.[270] The *Desimone* case also relied partly on an internal memo describing certain backdating practices within the corporation.[271] Yet, the *Desimone* case was dismissed and the *Ryan* case moved forward.

There were certain key differences between the backdating claims alleged in *Ryan* and *Desimone* that may have contributed to the different outcomes. In *Desimone*, Vice Chancellor Strine refused to infer that because the grants were made on dates with some of the lowest stock prices the directors must have knowingly backdated the options in breach of their fiduciary duties.[272] This does not mean that backdating did not occur, but that there were not particular factual allegations from which Vice Chancellor Strine was willing to infer that the board was aware of the practice. Such a conclusion was bolstered by the fact that the shareholder-approved option plans allowed oversight of option granting to be delegated to company officers.[273] This made it harder to infer that the board had knowledge of the backdating. It was plausible that an officer had been authorized to administer the option grants, and the board was unaware of any impropriety.[274] Vice Chancellor Strine required that the shareholder allege with particularity that the directors knowingly backdated,

268. Posting of Vaughn Marshall to The Race to the Bottom, *Desimone v. Barrows*: Backdating, Spring Loading and the Imposition of a Scienter Standard, http://www.theracetothebottom.org/preemption-of-delaware-law/2007/7/13/desimone-v-barrows-backdating-spring-loading-and-the-imposit.html (July 16, 2007, 06:15 EST) (noting that plaintiffs will be held to rigorous pleading standards).

269. *See* Desimone v. Barrows, 924 A.2d 908, 914–17, 941–43 (Del. Ch. 2007).

270. *Id.* at 912–13.

271. *Id.* at 913.

272. *Id.* at 938, 941–42, 948.

273. *Id.* at 938.

274. *Desimone*, 924 A.2d at 938.

and since Desimone could not sufficiently allege "how, when, or by whom" the grants were issued, he did not meet this standard.[275]

In *Ryan*, the shareholder-approved plans did not explicitly state that authority over option issuances could be delegated to non-directors. The compensation committee, comprised of half the board of directors, oversaw option grants.[276] Chancellor Chandler said the committee could be reasonably expected to know the actual date of the grant as well as the date listed as the issue date.[277] This made it easier for Chancellor Chandler to infer that if the allegations of backdating were true, the directors were at least aware of the practice, if not actually engaging in it. As he said, an allegation that directors backdated options would simultaneously allege that they acted knowingly in doing so.[278]

While refusing to impute knowledge to the directors in regards to the backdating of the employee option grants might be justified because administration of the options was delegated to company officers, the rationale does not apply as easily to *Desimone*'s officer grants. Vice Chancellor Strine admits that administration of the large option grants to company officers would not likely have been delegated to the officers, as it was highly improbable that they would oversee grants to themselves.[279] After admitting that the compensation committee likely retained authority over the grants, he refused to infer that those on the committee would have been aware that the options were backdated.[280] If neither the officers nor the compensation committee administered the option grants, who did? Vice Chancellor Strine went on to say that even if it could be inferred that the two directors on the compensation committee had been aware that the options were backdated, which according to *Ryan* would be sufficient to find lack of valid business judgment and personal interest due to substantial likelihood of liability, it would make no difference because a majority of the directors would still be impartial.[281] However, in Vice Chancellor Strine's later analysis of the outside director grants, where he found demand excused, he suggested that the two inside directors were not independent of the outside directors because they relied on the outside directors to keep them in their executive positions within the company.[282] He failed to make any mention of this lack of independence when he declared that

275. *Id.* at 942.
276. Ryan v. Gifford, 918 A.2d 341, 353 (Del. Ch. 2007).
277. *Id.* at 355 n.35.
278. *Id.*
279. *Desimone*, 924 A.2d at 941–42.
280. *Id.* at 942.
281. *See id.*
282. *Id.* at 947.

even if the compensation committee were deemed interested, the majority of the board remained impartial.

Another distinguishing factor between *Desimone* and *Ryan* stressed by Vice Chancellor Strine was the fact that the Stock Incentive Plan in *Desimone*, authorizing option grants to officers and employees, did not require that the options be issued with an exercise price equal to the stock's fair market value on the date of issuance.[283] This meant that the company could backdate and issue in-the-money options without contravening a shareholder-approved plan. It may be that the lack of such a requirement in the shareholder-approved option plan is why Vice Chancellor Strine would not infer that the compensation committee knowingly approved backdated options. Since it was not a violation of the plan to issue options below fair market value, there was a possibility that the board was innocently approving backdated grants. In *Ryan*, however, the shareholder-approved plan clearly required that all options be granted at the stock's fair market value.[284] Chancellor Chandler emphasized the fact that by backdating the directors acted in violation of their shareholder-granted power.[285] In finding that demand was excused because the board's decision was not an exercise of valid business judgment, it was key that the board had decided to disregard the shareholder-approved option plan.

Without a clause in a shareholder-approved plan requiring options be issued at fair market value, a decision by the board to engage in backdating cannot likely be deemed so egregious on its face that it could not be the exercise of valid business judgment. When there is no explicit limitation on directors to prevent them from granting in-the-money options, the decision to backdate is not as clearly suspect. However, even if directors are not violating a shareholder-approved plan when they backdate, they still lie to the shareholders, authorities, and market when they conceal it. Directors failing to properly disclose and account for options, and instead trying to pass them off as at-the-money options by issuing fraudulent paperwork to that effect, still commit a falsehood that should amount to a breach of the duty of loyalty. In *Ryan*, Chancellor Chandler even acknowledged that it was hard to imagine a scenario where a director could lie to his shareholders and still fulfill the duty of loyalty.[286]

A final distinguishing feature between *Desimone* and *Ryan* was that the *Desimone* grants to the outside directors were set to occur automatically on a predetermined date. In *Ryan* all of the challenged grants were discretionary, and evidence showed that over a period of years the grants consistently fell on

283. *Id.* at 920.
284. Ryan v. Gifford, 918 A.2d 341, 354 (Del. Ch. 2007).
285. *See id.* at 355.
286. *Id.*

dates where the stock price was unusually low.[287] In *Desimone*, the challenged grants to the outside directors came on the date of the annual stockholder meeting, chosen in advance.[288] There was no allegation that the meeting date was manipulated.[289] Only grants from two years over a multi-year period were challenged, suggesting that in the other years the grants had not come on dates quite as beneficial for the recipient-directors.[290] This is consistent with the purpose of a nondiscretionary, prescheduled option issuance plan. There will be good dates and bad dates, and the recipient shares in the gains and the losses.

2. Where the Delaware Courts Are Headed

Although Vice Chancellor Strine's change of course in *Desimone* leaned toward dismissing shareholder derivative suits based on allegations of backdating by requiring somewhat rigorous pleading standards,[291] the Delaware Chancery Court's future approach might not be quite as anti-shareholder as that case hinted.[292] In *Conrad v. Blank*, decided post-*Desimone*, Vice Chancellor Lamb employed a more *Ryan*-like approach in accepting the shareholder's circumstantial evidence, including statistical analysis, alleging that the directors affirmatively backdated options or wrongly approved their

287. *Id.* at 354.

288. *Desimone*, 924 A.2d at 948.

289. *Id.*

290. *Id.* at 917.

291. Some scholars have even claimed that Vice-Chancellor Strine's opinion did everything possible to validate backdating as merely another form of compensation. Posting of J. Robert Brown to The Race to the Bottom, Backdating, the Delaware Courts, and a Guest Appearance of Common Sense: *Conrad v. Blank*, http://www.theracetothebottom.org/preemption-of-delaware-law/backdating-the-delaware-courts-and-a-guest-appearance-of-com.html (Oct. 29, 2007, 06:46 EST).

292. In a backdating case following *Desimone*, Vice-Chancellor Lamb declared that he was declining to follow certain cases decided in California federal courts applying Delaware law in that they imposed a "harsher standard than is applied in *Ryan*." Conrad v. Blank, 940 A.2d 28, 38 n.22 (Del. Ch. 2007). While the California federal district courts have continued acting somewhat unfavorably to shareholders bringing derivative claims based on allegations of backdating, *see, e.g.*, *In re* CNET Networks, Inc. S'holder Derivative Litig., No. C 06-03817 WHA, 2008 WL 2445200 (N.D. Cal. June 16, 2008) (dismissing the derivative complaint for failure to allege demand futility with sufficient particularity), the Delaware Chancery Court has recently indicated a willingness to open the door for the shareholders' backdating derivative suits by declaring that evidence of stock option backdating amounts to a "credible basis" from which possible corporate misconduct can be inferred, justifying a grant of access to corporate books and records under a Section 220 action to assist the shareholders in drafting derivative pleadings, *see* La. Mun. Police Employees' Ret. Sys. v. Countrywide Fin. Corp., No. Civ.A. 2608-VCN, 2007 WL 2896540, at *15 (Del. Ch. Oct. 2, 2007); Melzer v. CNET Networks, Inc., 934 A.2d 912, 920 (Del. Ch. 2007) (granting the CNET shareholder access to corporate books and records in the derivative action that was later dismissed by the California federal district court).

issuance.[293] Although the directors argued the complaint failed to plead with particularity that the directors knowingly backdated, the court relied on *Ryan* to find it could be reasonably inferred that directors on the compensation committee acted knowingly in granting backdated options because they would be expected to know the date listed on the option as well as the date they approved the grant.[294] The court excused demand as futile, allowing the case to proceed to discovery.[295]

The cases show there are certain factors that, if present, will make the chances of success on a shareholder derivative action based on allegations of backdating much stronger. Being able to allege the directors acted in violation of a shareholder-approved option plan will vastly strengthen a claim that demand is excused as futile because the directors either did not exercise valid business judgment when they disregarded the plan or put themselves in positions of substantial personal liability by violating the plan. Showing a pattern of grants falling on dates where the stock is at a very low point, as opposed to only a few isolated instances, is beneficial. The courts have been quite receptive to statistical evidence in support of backdating claims. Any restatement of earnings or other disclosure by the company that the options were improperly accounted for would be favorable.

Other factors are less favorable. A clause in the option plan allowing the directors to delegate authority over option granting to someone else within the corporation will be problematic. Also, if the option grants were prescheduled, the chances that the court will find misconduct occurred are greatly reduced. A shareholder should closely consider the individual circumstances of a case before deciding whether it is worth pursuing. Courts will not be sympathetic to claims rushed forward at the first mention that backdating may have

293. *Conrad*, 940 A.2d at 35. This was a shareholder derivative action against Staples, Inc. *See id.* at 34. The shareholder alleged that the directors knowingly backdated at least twelve specific option grants over a ten-year period in violation of a shareholder-approved option plan requiring the grants to be priced at the stock's fair market value. *Id.* at 31, 33. In support of this, the shareholder relied on the fact that most grants came on dates where the stock price was at the low for the quarter or month, as well as statistical data showing the high return on the options compared to the average annual rate. *Id.* at 34–35. The company had also issued a report that certain options were accounted for with incorrect measurement dates, although it denied intentional wrongdoing. *Id.* at 33–34. The court applied the *Rales* test for demand excusal because the parties agreed that the compensation committee, comprised of three of the company's ten directors, issued the options, not the board itself. *Id.* at 36–37. Two other directors were recipients of the challenged options. *Id.* at 38. Thus, the court concluded that half of the board was interested in the transaction, either financially or by facing a substantial risk of personal liability, and therefore could not impartially consider demand. *Id.* at 40.

294. *Id.* at 40.

295. *Id.*

occurred, with the shareholder failing to make pre-suit demand or to present through the pleadings allegations showing that demand is excused.[296]

If demand is excused, the shareholder will have to gather more concrete evidence that the directors knowingly backdated company stock options to survive the case on the merits. Statistical analysis and financial restatements will likely not be enough.[297] Surviving the motion to dismiss gets the shareholder to the discovery stage, where he may be able to uncover the necessary evidence. At this stage, the defendants may be more willing to settle rather than go through the long and expensive discovery and trial process. In settlement discussions, or even after a successful trial on the merits, the shareholder is in a good position to repair some of the harm that backdating may have caused to the company.

In cases where the directors' awareness of the backdating can be shown, the derivative suit proves to be an advantageous forum for addressing the matter. It provides a means of punishing misconduct and regulating the relationship between the company and its agents, the directors. Since the major problems with backdating are the lack of disclosure and lying to the shareholders, the preferred means of addressing the problems should involve the parties within the company. There needs to be some check on those with the power to act for the company, and the derivative suit gives shareholders a way to address improper conduct by those in charge. The derivative suit allows the company to recover some of the loss it may have incurred by directors' misconduct. It also provides an important way to achieve changes in the company's practices.[298] While new accounting rules may have significantly decreased the likelihood of backdating in the future, the fact that it occurred shows there were people within the company who believed it was acceptable, and there were insufficient controls to stop it.[299] The changes in corporate governance and deterrence of future misconduct that the derivative

296. *See, e.g.*, Desimone v. Barrows, 924 A.2d 908, 951 (2007) (deriding the shareholder for filing suit without seeking access to corporate books or records and before the directors' investigation was complete).

297. At trial, after having the benefit of discovery, the plaintiff has the burden to prove by a preponderance of the evidence that the business judgment rule does not protect the transaction because the defendants breached their fiduciary duties by backdating. *See* Ryan v. Gifford, 918 A.2d 341, 358 n.49 (Del. Ch. 2007). However, in the most egregious cases, where there is little doubt that the directors were involved in backdating, this evidence may be sufficient. *Id.* at 358.

298. *See supra* notes 61–65 and accompanying text.

299. *See* The Sarbanes-Oxley Act of 2002 § 403, 15 U.S.C. § 78p(a)(2)(C) (2006) (requiring option grants be reported to the SEC within two business days after issuance); SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123R (Fin. Accounting Standards Bd. 2004), *available at* http://www.fasb.org/pdf/aop_FAS123R.pdf (requiring that companies record a compensation expense for both in-the-money and at-the-money options).

suit provides make it a preferable choice over other means of regulatory enforcement.[300]

Companies should prefer a derivative suit over the alternative forums for addressing the problem. The final results in a derivative suit are more satisfactory than paying large civil fines or damages to shareholders in direct suits. Many have also suggested that there has been an over-criminalization of corporate law and that backdating should not amount to a criminal violation.[301] The shareholder derivative action provides a means for punishing the misconduct without criminalizing it. The problem is that the SEC and Justice Department are not asking which forum the company would prefer, so if there were instances of backdating, chances are the company could have to address them in all forums. If, however, companies were allowed to choose a forum for regulating the problems of backdating, the shareholder derivative suit should be at the top of the list. It is the one option that focuses only on restoring some of the company's loss or correcting its problems, instead of increasing its loss.[302]

CONCLUSION

As the cases here demonstrate, each backdating scenario is unique. Not all backdating cases can be linked together, and not all of them should have the same result. Each instance of backdating will not necessarily translate into a successful shareholder derivative suit because if the directors were unaware of the backdating, then it is doubtful that shareholders could succeed on a claim for breach of fiduciary duties. As Vice Chancellor Strine explained, "a cautious, non-generic approach to addressing the various options practices now under challenge in many lawsuits" is necessary.[303] However, as this analysis suggests, when certain key factors are present and the shareholder is able to

300. While there may be little need for deterring backdating in the future, the derivative suit can still help deter directors from failing to make disclosures, or essentially lying, to shareholders about corporate practices in the future.

301. *See* Dick Thornburgh, Keynote Luncheon Address at the Georgetown University Law Center Conference on Corporate Criminality: Legal, Ethical, and Managerial Implications: The Dangers of Over-Criminalization and the Need for Real Reform: The Dilemma of Artificial Entities and Artificial Crimes (March 15, 2007), *in* 44 AM. CRIM. L. REV. 1279 (2007) (criticizing Congress for abusing "its power in creating more criminal statutes involving non-traditional criminal conduct"); Larry E. Ribstein, Criminalizing Backdating, on Ideoblog, http://busmovie.typepad.com/ideoblog/2006/07/criminalizing_b.html (Jul. 21, 2006, 07:30 EST) ("[C]riminalizing this business practice [of backdating] is not the answer.").

302. SEC charges and Rule 10b-5 actions will likely result in the corporation paying penalties or damages. Criminal charges against individuals may decrease a company's ability to attract qualified management and do nothing to address the internal management problems the company experienced.

303. Desimone v. Barrows, 924 A.2d 908, 931 (2007).

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show the directors were involved in backdating, addressing the matter through a shareholder derivative suit is the preferable option.

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