Securities Litigation Alert

First Delaware Decisions on Option Grant Dating:
Ryan v. Gifford and *In re Tyson Foods, Inc. Consol. Shareholder Litig.*

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In two separate decisions issued on February 6, the Delaware Chancery Court weighed in for the first time on issues directly relating to the current wave of stock option matters. While the two decisions are highly fact-specific, both the tone and approach adopted in those cases suggest that shareholders are likely (at least in the short term) to pursue litigation more vigorously in Delaware than in alternative forums.

Among other things, the new cases reflect a reluctance (if not unwillingness) at the pleading stage to apply the business judgment rule to actions resulting in allegedly inaccurate dating of option grants, which makes it easier for shareholders to skirt the requirement of making pre-suit demand on the board of directors. In that respect, they stand in contrast to recent decisions in other courts – most notably, state and federal courts in California. The new Delaware cases also signal a more flexible approach to the statute of limitations.

In *Ryan v. Gifford*, No. 221-N (Del. Ch. Feb. 6, 2007), a derivative action purportedly brought on behalf of Maxim Integrated Products, Chancellor Chandler found that plaintiffs' claims were sufficient to survive the pleading stage notwithstanding defendants' arguments that: (1) pre-suit demand was not excused because a majority of Maxim's directors were disinterested and independent; (2) the allegations of backdating were not supported by particularized facts, and in any event the acts in question were within the scope of the business judgment rule; and (3) the claims were barred by the applicable statute of limitations, inasmuch as the purported backdating had occurred more than three years prior to commencement of litigation.

Based largely on the perceived statistical improbability that the grants were appropriately timed (*i.e.*, the grant prices were supposedly "too fortuitous to be mere coincidence"), the court concluded that plaintiffs had adequately alleged violation of an express provision of the option plans, and that – if ultimately proven – such conduct could not be viewed as a valid exercise of business judgment. The court opined that "backdating options" might qualify as an act "so egregious on its face that board approval cannot meet the test of business judgment…" Because a majority of the Maxim board either granted such options (while serving on the compensation committee) or received them, demand was excused. Moreover, the court found that the alleged violations of the option plan, and purportedly false disclosures regarding grant dates, were sufficient to state a claim for breach of the duty of loyalty. Defendants' argument that the claims were time-barred was rejected. Even though the alleged misconduct ended in 2002, the court reasoned that representations that the options were priced as of the date of grant could constitute fraudulent concealment. The court also refused to stay the litigation in favor of a duplicative (and previously filed) case pending in federal court in California, noting Delaware's strong interest in deciding important questions of its laws.

On the same day, Chancellor Chandler denied defendants' motion to dismiss in *In re Tyson Foods, Inc. Consol. Shareholder Litig.*, No. 1106-N (Del. Ch. Feb. 6, 2007). That case involved, inter alia, averments that Tyson's board breached its fiduciary duties by granting "spring-loaded" stock options to insiders (*i.e.*, granting options shortly before the announcement of positive news that increased the company's stock price). While conceding that granting spring-loaded options may be permissible where the decision is "made honestly and disclosed in good faith," the court held that "the facts alleged in [*Tyson*] are different." Based on its conclusion that plaintiffs had adequately alleged Tyson's directors approved grants while in possession of material non-public information and "with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options," the court found that such alleged conduct was not protected by the business judgment rule. As a result, demand was excused and a cognizable claim was stated. As in *Ryan*, the court also rejected defendants' statute of limitations arguments.

By contrast to the two Delaware decisions, a number of courts elsewhere have been unwilling to jettison the business judgment rule or traditional standards of demand futility in analyzing derivative lawsuits based on purportedly improper option grants. For example, in *In re Linear Technology Corp. Derivative Litig.*, C-06-3290-MMC (N.D. Cal. Dec. 7, 2006), Judge Chesney of the Northern District of California applied the same test ostensibly employed in *Ryan*, but noted (correctly) that under Delaware law plaintiffs bear the burden of pleading particularized facts creating a reasonable doubt that a majority of the directors are disinterested or independent. Despite plaintiffs' averments that seven grants were dated "just after a sharp drop" in Linear's stock price and "just before a substantial rise" – which plaintiffs characterized as a "striking pattern that could not have been the result of chance" – the court held that such allegations were insufficient to show that the directors faced a substantial likelihood of liability. Furthermore, the court rejected the argument that plaintiffs' allegations of backdating or inaccurate disclosures necessarily placed the directors' conduct beyond the scope of the business judgment rule; indeed, the court found that plaintiffs' allegations were inadequate to overcome the rule's presumption that the directors acted in good faith. The court accordingly found that plaintiffs failed to show that a majority of the board was interested or otherwise incapable of considering a pre-suit demand, and dismissed the complaint with leave to amend.

While plaintiffs' lawyers have chosen to litigate many options-related cases in courts outside Delaware, *Ryan* and *Tyson* may well prompt a new trend. Not only do the results of those cases suggest the possibility of a more (and perhaps unduly) forgiving attitude in applying the traditionally rigorous pleading standards for derivative lawsuits, but the opinions are indicative of a mindset that indiscriminately appends the same label to an entire array of widely divergent conduct. The term "backdating" has been applied to acts ranging from intentional misconduct to inadvertent errors by administrators to sloppy documentation. Yet *Tyson* opines that, "[a]t their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date on which the grant was actually made." Equally striking is *Tyson's* assertion that spring-loading "implicate[s] a much more subtle deception," when there is often little or no basis for concluding that the proximity of a grant and market-moving information involves any deception whatsoever. It may well be that, once the Chancery Court sees more of these cases and develops greater perspective, such sweeping pronouncements will end. But until that time, more and more corporations may find themselves litigating in Delaware – even if, as in *Ryan*, litigation has already been commenced elsewhere.

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