Ending Executive Manipulations of Incentive Compensation+

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

 The authors wish to thank Alina Charniauskaya, J.D. 2015, University of Michigan Law School and Julia Xin, J.D. Candidate, University of Michigan Law School, for valuable research assistance. Avci gratefully acknowledges a research grant from TUBITAK.

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I. INTRODUCTION

It has been nearly ten years since the scandals broke regarding the backdating of executive stock option grants in 2006.[1] Stock option packages in executive compensation, once heralded as a simple device to solve the agency problem inherent in the separation of ownership and control to align the interests of management with those of the shareholders,[2] were found to be too tempting to leave to chance. Executives found ways to manipulate the size of their compensation by fraudulently changing the date of a grant, i.e., backdating or forward-dating, so that options that were meant to be granted "at-the-money" as of the grant date were "in-the-money" instead. This provided top executives and directors with an immediate unearned bonus.[3] Researchers have documented that the backdating of options granted between 2000 and 2004 resulted in an average loss of about 7% to shareholders, or about $400 million per firm.[4] This meant that, on average, executives gained over $500,000 per firm each year.[5]

The Sarbanes–Oxley Act of 2002 (SOX),[6] which was meant to bring transparency and honesty to financial statements,[7] was passed in reaction to massive corporate frauds

1. *See* Linda Chatman Thomsen, Director, Div. of Enf't, Speech by SEC Staff: Options Backdating: The Enforcement Perspective (Oct. 30, 2006), https://www.sec.gov/news/speech/2006/spch103006lct.htm (discussing the SEC's ongoing investigation into 100 potential abuses of stock options and enforcement plans).

2. *See* Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 211, 233–34 (George Constantinides et al. eds., 2013) (stating that research on CEO incentives is primarily based on the agency theory); Jay M. Zitter, Annotation, *Liability for Backdating of Stock Options Under Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b), and 17 C.F.R. § 240.10b-5*, 32 A.L.R. Fed. 2d 85, Art I, § 2 (2008) (stating that stock options help to align the incentives of officers with shareholders).

3. Murphy, *supra* note 2, at 290.

4. M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1638 (2007).

5. *Id.*

6. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 28, and 29 U.S.C.).

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

such as Worldcom,[8] Tyco,[9] and Enron.[10] Regarding stopping options backdating however, we find that the practice continues. Executives have simply ignored SOX's two-day reporting requirements and fraudulently manipulated their compensation.[11] In addition, SOX has failed to prevent other forms of stock option value manipulation, i.e., spring-loading and bullet-dodging.

In this study, we show that, despite the effect of SOX and all the reforms in response to the backdating scandal of 2006,[12] manipulation of options is still too tempting and

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1, 5 (Summer 2006), https://www.andrewskurth.com/media/pressroom/820_Doc_ID_3555_41720071129256.pdf (describing the financial statement certification requirements of SOX).

8. *See generally* DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. (2003) https://www.sec.gov/Archives/edgar/data/723527/000093176303001862/dex991.htm#ex991902 (finding that a few senior executives of Worldcom committed accounting fraud); Bob Lyke & Mark Jickling, *WorldCom: The Accounting Scandal*, CONG. RES. SERV. (2002), http://www.law.umaryland.edu/marshall/crsreports/crsdocuments/RS21253_08292002.pdf (discussing the circumstances of the Worldcom accounting fraud scandal and how corporate management has strong incentives to engage in secretive accounting practices).

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

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

11. Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 802–11 (2005); M.P. Narayanan & H. Nejat Seyhun, *Do Managers Influence Their Pay? Evidence from Stock Price Reversals Around Executive Option Grants* 24 (Ross Sch. of Bus., Working Paper No. 927, Jan. 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649804 (finding that executive options are backdated); M.P. Narayanan & H. Nejat Seyhun, *Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation* 18 (Nov. 2005), http://ssrn.com/abstract=852964 (again finding that options are backdated and that SOX mandatory grant date reporting decreases, but does not eliminate opportunism); Randall A. Heron & Erik Lie, *Does backdating explain the stock price pattern around executive stock option grants?*, 83 J. FIN. ECON. 271, 271 (2007) [hereinafter Heron & Lie, *Does Backdating Explain*] (finding significantly less abnormal stock returns after the passing of the SOX, and that "in those cases in which grants are reported within one day of the grant date, the pattern has completely vanished, but it continues to exist for grants reported with longer lags, and its magnitude tends to increase with the reporting delay"); M.P. Narayanan & H. Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?*, 21 REV. FIN. STUD. 1907, 1907–45 (2008). *See also* Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 856–57 (2008) (stating that "thousands of firms continued to secretly backdate options by weeks or months after SOX, even though it entailed—in addition to other legal violations—a blatant disregard of the Act's two-day reporting requirement"); Stephen M. Bainbridge, Book Review, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1642 (2005) (citing 15 U.S.C. § 7243, 15 U.S.C. § 78m(k) and 15 U.S.C. § 7244) (arguing that executive compensation is indirectly regulated by SOX; specifically, it forces the CEO and CFO to return "any bonus, incentive, or equity-based compensation" in the previous year if the company has to restate its financial statements due to misconduct; it precludes corporations from giving loans to executives and directors; and outlaws executive trading during "blackout periods"); John Despriet, *Options Backdating: Scrutinizing Options-Based Compensation Practices*, 18 TR. LEADERS 4, 4 (Spring 2007), http://www.sgrlaw.com/resources/trust_the_leaders/leaders_issues/ttl18/817 (stating that it is widely believed that SOX "short-circuited" options backdating).

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

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

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

II. STOCK OPTIONS: POTENTIAL FOR ABUSE

Including stock options as part of the executive compensation package can have important advantages. For instance, it can lead to an alignment of interests between managers and shareholders.[15] It may also allow firms to conserve resources and yet remain attractive to the best talent.[16] Startups in particular find stock options useful because they often have growth potential but shallow pockets initially.[17] Yet, in executive compensation plans, stock options can be, and have often been, abused.

Professor David Yermack first found irregularities in stock price returns around executive stock option grants in 1997.[18] He argued that the executives accelerated the date of the grants when the corporation was getting ready to release good news.[19] In the early 2000s, researchers provided evidence that managers have manipulated the release of information around option grant dates to maximize the value of those grants.[20]

13. 15 U.S.C. § 78j (2016).

14. 17 C.F.R. § 240.10b-5 (2016).

15. Zitter, *supra* note 2, at § 2; *see generally* Randall S. Kroszner et al., *Economic Organization and Competition Policy*, 19 YALE J. REG. 541 (2002) (discussing the relationship between business organization and competition policy).

16. *See generally* Kroszner et al., *supra* note 15 (discussing the relationship between business organization and competition policy); *see also* Zitter, *supra* note 2, at § 2 (noting that stock options are a cost-effective form of compensation for cash-strapped start-ups).

17. Zitter, *supra* note 2, at § 2*; see generally* Kroszner et al., *supra* note 15 (discussing the relationship between business organization and competition policy); *see also* David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 567 (2007) (discussing the effects of backdating on actual and reported stock values).

18. David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcement*, 52 J. FIN. 449, 450 (1997).

19. *Id.*

20. David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 74–76 (2000); Keith W. Chauvin & Catherine Shenoy, *Stock price decreases prior to executive stock option grants*, 7 J. CORP. FIN. 53, 65–75 (2001).

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

Backdating was discovered simultaneously by Professors Lie, Heron, Narayanan, and Seyhun and reported in the financial press as early as February 2005.[24] Researchers showed that managers falsified grant dates to receive options with lower strike prices.[25] The stock price of the company would decline right before the exercise of the grant and

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21. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 28, and 29 U.S.C.).

22. Barasch & Washburn, *supra* note 7, at 5; *see* Sarbanes–Oxley Act of 2002, § 302. (describing the requirement of corporate financial reports); 15 U.S.C. § 7241(a) (2016) (delineating the requirements of corporate financial reports).

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

24. *See generally* Lie, *supra* note 11 (discussing the timing of stock options); *see also* Narayanan & Seyhun, *Do Managers Influence Their Pay?*, *supra* note 11, at 24 (finding that executive options are backdated); Narayanan & Seyhun, *Effect of Sarbanes–Oxley Act*, *supra* note 11, at 18 (finding options are backdated); Heron & Lie, *Does Backdating Explain*, *supra* note 11, at 280–94 (finding less abnormal stock returns after SOX); Jay R. Ritter, *Forensic Finance*, 22 J. ECON. PERSP. 127, 133 (2008), http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.22.3.127 (mentioning such works); Mark Hulbert, *Test of good corporate citizenship*, MARKETWATCH (Feb. 18, 2005), http://www.marketwatch.com/story/timing-of-managers-option-grants-a-good-litmus-test (discussing the ramifications of executive behavior) ; *see generally* Narayanan & Seyhun, *The Dating Game*, *supra* note 11 (finding evidence of backdating).

25. Ritter writes: "On January 19, 2000, when computer manufacturer Apple's stock closed at $106.56 per share, Apple announced that one week previously it had granted options to buy 10 million shares to CEO Steve Jobs with an exercise price of the January 12 closing market price of $87.19. The January 12th close was the lowest closing price of the two months prior to January 19. Seven years later, Apple admitted that the dates of many options grants had been chosen retroactively, and that documents purporting to show that the board of directors had approved the grants on the dates chosen had in some cases been fabricated. Wealth transfers from option backdating can be large. For the January 2000 grant alone, if there was a 70 percent chance that the options would eventually be exercised, the difference between the January 12th and 19th dates for the exercise price was worth almost $140 million to Jobs due to the difference between the $87.19 and $106.56 exercise prices." Ritter, *supra* note 24, at 131–32; *see* Robert M. Daines et al., *Right on schedule: CEO option grants and opportunism* 2 (Stan. U & BYU, Working Paper, No. 3314, 2015), http://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/DainesR-2013FallBS.pdf (mentioning prior data on backdating); *see generally* Lie, *supra* note 11; Heron & Lie, *Does Backdating Explain*, *supra* note 11, at 294; Randall Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, 55 MGMT. SCI. 513, 513–20, 523–25 (2009) [hereinafter Heron & Lie, *What Fraction*]; Narayanan & Seyhun, *Do Managers Influence Their Pay?*, *supra* note 11, at 1; Narayanan & Seyhun, *Effect of Sarbanes–Oxley Act, supra* note 11, at 2; Narayanan & Seyhun, *The Dating Game*, *supra* note 11, at 1943.

increase thereafter.[26] In 2008 and 2009, research further suggested that managers are likely to make accounting changes beneficial to the CEO prior to option grant dates.[27]

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

A. Options Backdating

Options backdating is a practice whereby the date of the option grant is changed to a date prior to when the option was in fact granted. This practice was possible and easy when the SEC rules did not require reporting of the issuance of stock options until months after the grant date.[32] This reporting delay allowed companies to wait until the company's stock price rebounded from a drop before submitting their disclosure forms.[33] The option would then be backdated at its lowest point or near that point so that this lower exercise price could be reported to the SEC.[34] Backdating of stock options thus allows the individual to benefit from larger gains.[35]

Shortly after SOX was signed into law, the SEC changed its disclosure rules to also require disclosure of option grants within two days of the grant,[36] thereby effectively closing the loophole giving rise to backdating. This information must be disclosed

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

27. Daines et al., *supra* note 25, at 2 (citing Mary L. McAnally et al., *Executive Stock Options, Missed Earnings Targets, and Earnings Management*, 83 ACCT. REV. 185, 186–90 (2008)); Terry A. Baker et al., *Incentives and Opportunities to Manage Earnings around Option Grants*, 26 CONTEMP. ACCT. RES. 649, 650–56 (2009).

28. *See generally* Heron & Lie, *Does Backdating Explain*, *supra* note 11, at 294; Heron & Lie*, What Fraction*, *supra* note 25, at 513; Lie, *supra* note 11 (concluding that the patterns of stock returns around stock option grant dates support findings of backdating).

29. *See* Mark Maremont & Charles Forelle, *How Backdating Helped Executives Cut Their Taxes*, WALL ST. J. (Dec. 12, 2006), http://www.wsj.com/articles/SB116589240479347248 (stating "there is strong statistical evidence that executives manipulated the exercise dates of their options").

30. *See generally* Aboody & Kasznik, *supra* note 20 (discussing varying timing of information release and its consequences); Chauvin & Shenoy, *supra* note 20.

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

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

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

34. *Id.*

35. *Id.*

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

electronically, allowing shareholders access to the information almost instantly.[37] Furthermore, the SEC approved changes to the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations system (NASDAQ) Stock Market listing standards, which mandate that nearly all equity compensation plans be presented to shareholders for a vote.[38] The terms of the plan must be disclosed, as well as whether the plan allows for the exercise price to be less than the fair market value at the time of the grant.[39] Nevertheless, based on the discoveries of the backdating studies, it appears that executives have simply ignored these requirements and continued backdating.[40]

In December 2004, the Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standards (FAS) 123R, which essentially eradicated the accounting benefit of stock options issued at-the-money.[41] The Standards state that all stock options granted to any employee must be documented as an expense on the financial statements regardless of whether the exercise price is at fair market value.[42] In 2006, the SEC began to require all public companies to also report information including: "the grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer); [t]he FAS 123 grant date; [t]he closing market price on the grant date if it is greater than the exercise price of the option; and [t]he date of the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date."[43] Companies are also required to explain the goals and policies behind the executive compensation plans.[44] Reports to investors must discuss whether the company has backdated executive stock options (or utilized "any of the many variations on that theme concerning the timing and pricing of options") or might do so in the future and, if so, how.[45] Once again, these changes have been ineffective in stopping executive malfeasance with respect to option grants.

In addition, in 2007, the SEC enacted rules requiring full disclosure of all aspects of executive and director pay and benefits, including stock options. These rules require the company to disclose the full amount of an executive's compensation in a single number and whether a stock option was backdated.[46] If the stock option was backdated, the corporation must provide the reason why. The goal of the rule is to make executive compensation more transparent to the shareholders.

In the wake of the 2006 backdating scandal, many corporations began to award their

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37. Cox, *supra* note 33.

38. *Id.*

39. *Id.*

40. *See supra* note 11 and accompanying text (listing such studies and their findings).

41. *Statement of Financial Accounting Standards No. 123*, FIN. ACCT. STANDARDS BD. (2004), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124271&acceptedDisclaimer=true.

42. *Id.* at 1.

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

44. *See* 17 C.F.R. §§ 229.402(b), 229.402(s) (2015) (requiring a "Compensation Discussion and Analysis" section, consisting of "material information that is necessary to an understanding of the [company']s compensation policies and decisions regarding [the executive officers falling within the scope of the rule]").

45. Cox, *supra* note 33.

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

employee option grants at scheduled times each year.[47] This practice has given rise to other forms of options manipulation as described below. Whether these reforms have finally stopped the practice of backdating and other timing games is the subject of our current study.

B. Manipulation of Exercise Date

There is evidence that some executives have changed the exercise date of their options without disclosure, thereby decreasing their tax liability.[48] By backdating the exercise date to a date with a lower stock price, executives reduce their taxable income.[49]

C. Spring-Loading and Bullet-Dodging

The most frequently discussed form of option timing manipulation, other than backdating, is "spring-loading:" timing stock option awards to occur just before a positive public announcement by the company.[50] The positive announcement increases the value of the stock, resulting in a "windfall" gain for the recipients of the stock options.[51] This theory was first put forward by Professor David Yermack who examined a sample of 620 stock option awards to CEOs of Fortune 500 companies between 1992 and 1994.[52] He found that the average abnormal increase in option award value after 20 trading days was $30,000 and $48,900 after 50 trading days.[53]

In contrast, executives who engage in bullet-dodging are awarded stock options following a negative public announcement. The negative information may cause a temporary reduction in the market value of the stock, resulting in stock option grants at a low price.[54] If the stock subsequently restores to its pre-announcement value, recipients of these stock options would have benefited from a favorable exercise price.[55]

Spring-loading and bullet-dodging have been empirically observed in the timing of option repricing.[56] A statistical analysis of 236 option re-pricings for 166 companies between 1992 and 1997 suggested that executives who expected positive earnings reports repriced their option before the announcement and, alternatively, managers who expected negative earnings reports repriced their options after the announcement of the report.[57]

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47. Daines et al., *supra* note 25, at 3.

48. Maremont & Forelle, *supra* note 29; *see* S. Burcu Avci et al., *Timing of Gifts of Common Stock by Corporate Executives*, 18 PA. J. BUS. L. 1131 (2016) (analyzing timing games of gifts of common stock by executives to increase their tax deductions).

49. JAMES M. BICKLEY & GARY SHORTER, CONG. RES. SERV., STOCK OPTIONS: THE BACKDATING ISSUE 28 (2008). If executives hold their stock for at least one year, the appreciation in the stock's value at disposition will be taxed at the lower long-term capital gains rate, rather than the ordinary income rate. Fried, *supra* note 11, at 877; *see also id*.

50. *Id.*

51. *Id.*

52. Yermack, *supra* note 18, at 449.

53. *Id.* at 458.

54. BICKLEY & SHORTER, *supra* note 49, at 28.

55. *Id.*

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

57. *Id.* (discussing the findings in Sandra Renfro Callaghan et al., *The Timing of Option Repricing*, 59 J. FIN. 1651, 1651–76 (2004)).

D. Manipulation of Information Release

SOX, SEC regulations, and increasing public scrutiny curbed the practice of options backdating to a large extent. But the problem has not been completely resolved. As noted above, many firms began to award options on a specific schedule every year to avoid allegations of illegal options backdating. In 2003, it was found that about 60% of all CEO option grants were scheduled.[58] Although this reduced the instances of backdating, it has resulted in other agency problems. Executives who know about the upcoming option grants have "an incentive to temporarily depress stock prices before the grant date to receive options with lower exercise prices."[59] CEOs may use various mechanisms to distort the strike price, such as changing the substance or the timing of the company's disclosures.[60]

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

When the dates for stock option grants are fixed, the timing of corporate announcements can be manipulated in relation to known dates for the granting of options. An executive may induce or accelerate the release of bad news before an option grant date in order to set a lower strike price for the option—analogous to bullet-dodging.[61] The executive could also delay the release of good news until after the grant is made—analogous to spring-loading.[62] Thus, for purposes of our study, we include manipulation of information flow as an aspect of spring-loading and bullet-dodging. Additionally, the executive could delay projects until after an options grant or otherwise manipulate the timing of the corporation's investments.[63] An executive may also change the firm's profit trajectory or accounting options to move earnings from before the grant to after.[64] All these actions may impact the corporation's value by influencing investment choices.[65]

Empirical evidence suggests that, to manage investors' expectations around fixed dates of scheduled awards for their stock options, management may delay good news and accelerate the release of bad news.[66] The bad news may be disclosed in a public

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

59. *Id.* at 39.

60. *Id.* at 1.

61. Chauvin & Shenoy, *supra* note 20, at 54–55. The authors statistically analyzed a sample of 783 stock option grants from May 1991 to February 1994 issued to 209 CEOs and found "a significant stock price decrease prior to executive stock option grants." *Id.* at 74; *see* Aboody & Kasznik, *supra* note 20, at 73 ("CEOs make opportunistic voluntary disclosure decisions that maximize their stock option compensation."). The authors investigated the hypothesis "that CEOs manage investors' expectations around award dates by delaying good news and rushing forward bad news." *Id.* at 98. They analyzed 2,039 stock option grants between 1992 and 1996 to the CEOs of over 500 firms and concluded "that CEOs of firms with scheduled awards make opportunistic voluntary disclosures that maximize their stock option compensation." *Id.*

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

63. *Id.*

64. *Id.*

65. *Id.* at 5.

66. Chauvin & Shenoy, *supra* note 20, at 59*; see* Aboody & Kasznik, *supra* note 20, at 74 (hypothesizing "that CEOs opportunistically manage the timing of their information disclosures to increase the value of their awards").

announcement, or managers may "put a more negative 'spin' on information than otherwise, speak 'off the record' to analysts, or strategically use rumor and innuendo to 'leak' information."[67]

Evidencing this behavior, the data shows "abnormal stock returns surrounding SEC Form 8-K filings (which report material corporate events) tend to be negative in the months immediately before a scheduled CEO option grant and then positive in the months after the grant."[68] Executives also tend to move earnings to after the grant period. Scholars have found that scheduled options may result in executives making disclosure, accounting, and investment decisions based on their own self-interest rather than increasing shareholder value.[69] These actions may be even worse than backdating because they distort stock prices and may decrease firm value if significant projects are postponed as a result.[70] This practice is an ongoing concern.

Empirical research has also demonstrated that corporations with scheduled options tend to show the same pattern associated with backdating.[71] This pattern was not found in grants made prior to the SEC's 2002 regulations.[72] CEOs with significant compensation in scheduled options have more incentive to disrupt the company's stock price, and research shows they have earned an average 3% abnormal return on the option.[73] This trend is more striking the more options the CEO holds and the more difficult the corporation is to value.[74]

Our empirical study, described in Part III below, provides further evidence of this practice, analyzing current data. Most studies on the topic of stock option grant manipulation in executive compensation have focused primarily on pre-2006 backdating of stock options. Once the excitement of the backdating scandal simmered and the regulatory changes of the early 2000s were implemented, research turned to the other forms of manipulation (i.e., spring-loading and bullet-dodging). Even now, however, there is very limited research on these topics analyzing information in the last decade after these important regulatory changes took effect. Our research adds to the empirical studies on the issues of stock option grant manipulation with a more comprehensive dataset than those of previous studies. Importantly, as we look at the period between 2008 and 2014, our information encompasses the effects of the regulatory changes of the mid and late-2000s, concluding that these changes have not prevented the unfair manipulation of stock option grants. Notably, as our earliest data is from 2008, our evidence is not explained entirely by backdating of options. Finally, our study takes prior studies further by considering manipulation of data flow around scheduled grants as well as manipulation of grant dates.[75]

Spring-loading and bullet-dodging in the context of executive stock options are difficult to address because the tactics employed may differ year to year. Executives

67. BICKLEY & SHORTER, *supra* note 549, at 37 (citing Chauvin & Shenoy, *supra* note 20, at 59).
68. Daines et al., *supra* note 25, at 7.
69. *Id.* at 7–8.
70. *Id.* at 8.
71. *Id.*
72. *Id.* at 3; Heron & Lie, *What Fraction*, *supra* note 25, at 514.
73. Daines et al., *supra* note 25, at 7.
74. *Id.*
75. *See infra* Part III (discussing the empirical evidence supporting the current state of options manipulation).

could make strategic disclosures, use accruals, or act in a number of different ways to impact stock price.[76] It is also easy to rationalize and justify the timing of disclosures because executives are given discretion about these decisions.[77]

To reduce the risk of this type of distortion, scholars have suggested that boards and analysts stay aware of the incentives established by scheduled options and closely monitor disclosures.[78] Furthermore, it has been suggested that boards decouple stock and exercise prices, as well as spread out at-the-money option grants over months to dilute the size of the grant per period.[79] In addition, the directors could set the strike price at an average of stock prices over a period, restrict the period of time in which executives can sell stock to the month the options are granted, or give officers and directors options at separate times from the CEO.[80] We further suggest regulatory changes to close the opportunities giving rise to these manipulative behaviors by requiring options awards to be awarded on a pro-rata daily basis, as discussed in Part VI below.

III. CURRENT STATE OF OPTIONS MANIPULATION: THE EMPIRICAL EVIDENCE

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

Following the work of Professors Narayanan and Seyhun,[81] we investigate two hypotheses involving dating and timing games. Our first hypothesis, the backdating hypothesis, is that executives are continuing to backdate option grant dates. Our second hypothesis, which encompasses a number of timing hypotheses, is linked to spring-loading and bullet-dodging activities. We anticipate that executives continue to manipulate the dating of their options, the flow of information, or both, to increase their compensation.

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

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

76. Daines et al., *supra* note 25, at 30–31.

77. *Id.* at 31.

78. *Id.* at 27.

79. *Id.* at 39 (citing Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-term Performance*, 158 U. PENN. L. REV. 1915 (2010)).

80. *Id.* at 42.

81. Narayanan & Seyhun, *The Dating Game*, *supra* note 11.

award on Form 4 to the SEC without any further delays. At this point, anyone examining Form 4 who is unaware of the fraud committed by the executive will deduce the following: 1) executives received an option award on January 2 when the stock price was $25; and 2) executives reported this award on March 2 with a two-month delay.

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

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

To test these hypotheses, we obtain option grant data. Our data comes from the Thomson Reuters database and contains all option grants to executives in all publicly listed firms in the United States. The database includes the date of the grant, reporting date, number of shares granted, and underlying security on which options are granted, in addition to firm name, firm identification information, and the executive's name and title. Although the database starts in 1986, we limit our attention to the January 1, 2008 to December 31, 2014 period to contrast from previously documented evidence of abuse. Our main objective is to understand whether executives continue to abuse their privilege and manipulate their option grants to unfairly increase their compensation.

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

Table 1

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

Firm Size	Small-Cap Firms	Mid-Cap Firms	Large-Cap Firms	All firms
Firm Definition	Market Capitalization is less than $1 Billion	Market Capitalization is between $1 Billion and $5 Billion	Market Capitalization is more than $5 Billion	
	Executive Option Awards			
Number of Firms	3,574	926	375	4,875
Number of Option Awards	964,175	251,404	143,176	1,358,755
Average Award Size (Number of shares)	11,907.90	18,272.30	25,389.10	14,506.00
Total Awards to Officers (million shares)	3,976.34	2,581.24	1,313.73	7,871.31
Total Awards to Directors (million shares)	2,550.87	927.64	1,101.62	4,580.13
Total Awards to Top Executives (million shares)	4,954.09	1,084.86	1,219.77	7,258.71
Average number shares awarded per firm (in millions)	3.21	4.96	9.69	4.04
Total Shares Awarded (in millions)	11,481.30	4,593.74	3,635.12	19,710.15

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

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

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

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

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

$$AR_{it} = (R_{it} - R_{mt})$$

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

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

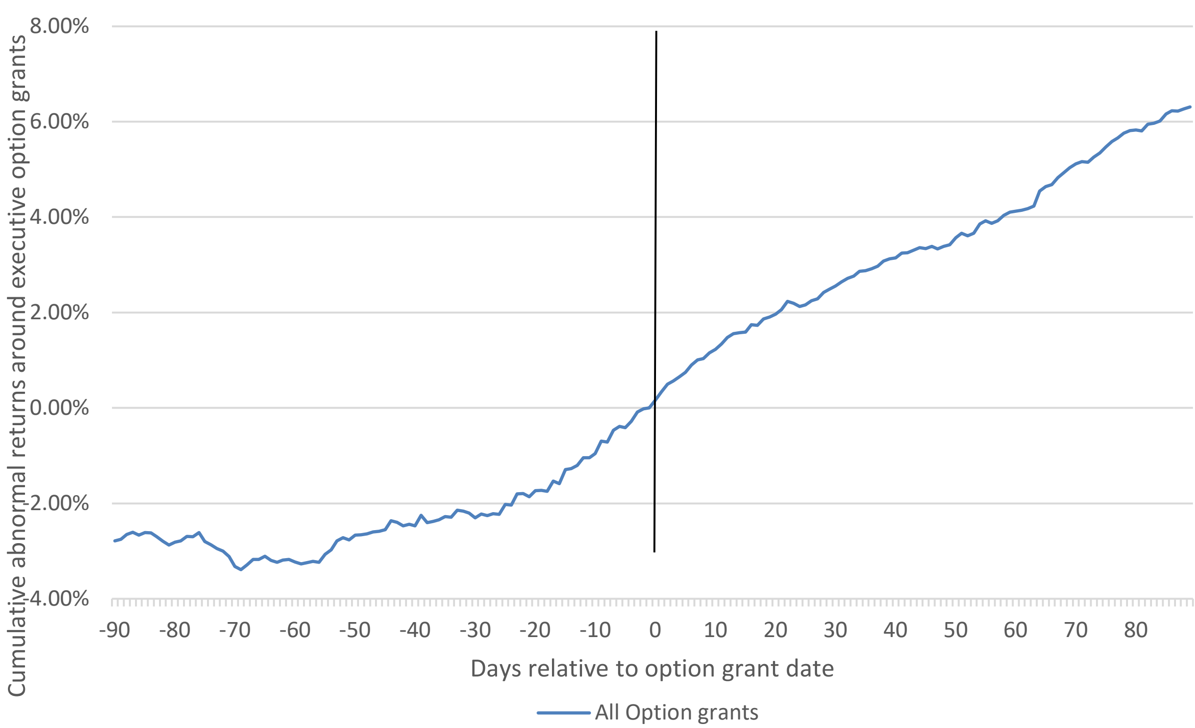
The average abnormal returns are then cumulated across the event dates as follows:

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

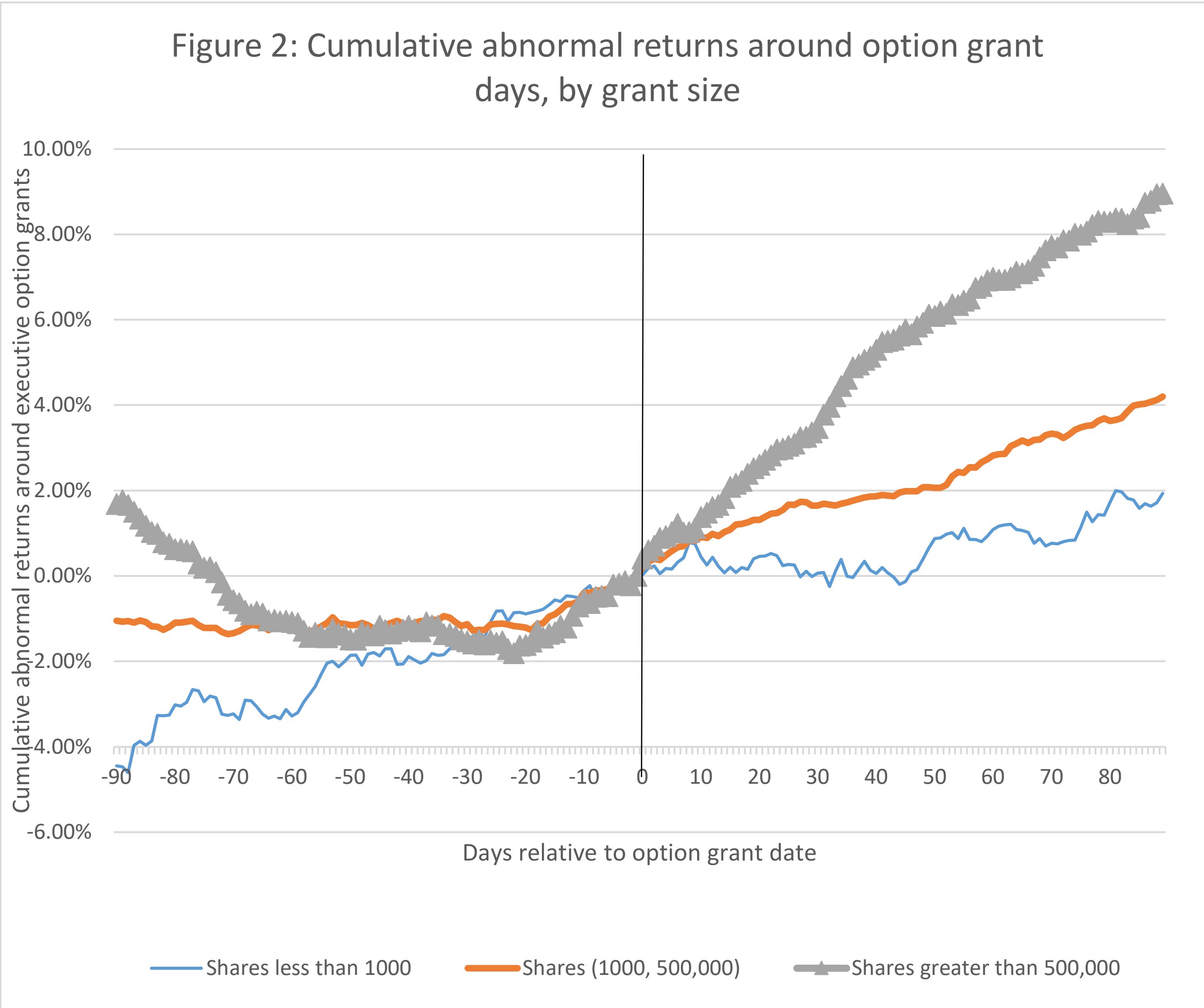
These cumulative abnormal returns are then graphed to examine the behavior of abnormal returns around option granting dates.In Figures 1 through 6, abnormal returns are computed using market adjusted model. Day 0 refers to the grant day. Day 10 refers to the tenth trading day after the grant date, while Day -10 refers to the tenth trading day before the grant date. Executives have the titles of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair, and members of the various board committees.

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

Figure 1: Cumulative abnormal returns around option grant days



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

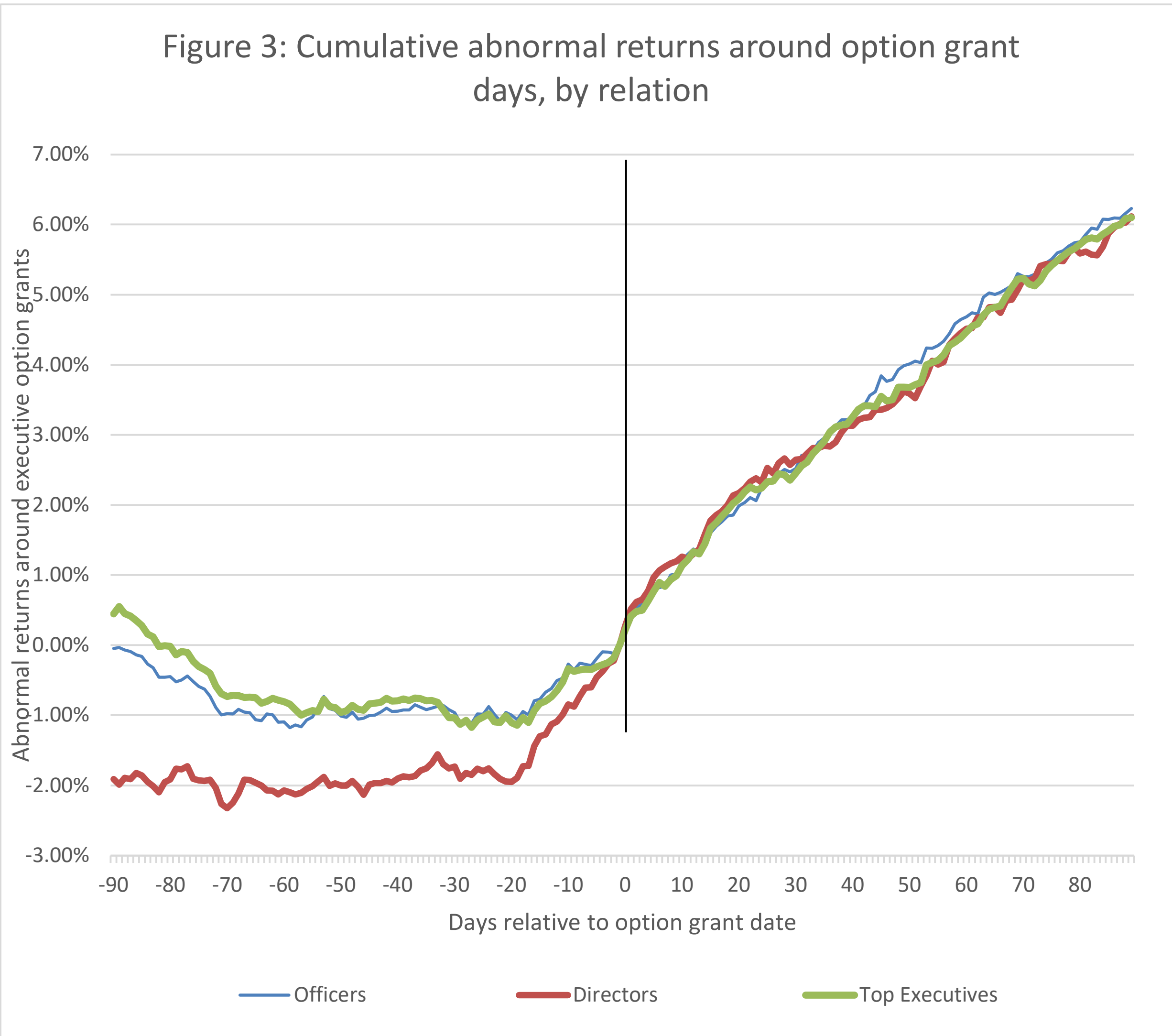


In Figure 2, abnormal returns are computed using a market adjusted model. Day 0 refers to the grant day. Day 10 refers to the tenth trading day after the grant date, while Day -10 refers to the tenth trading day before the grant date. Executives have the titles of CEO, CFO, CI, CO, CT, President, Chairman of the Board, Director, Officer, Vice President, Vice Chair, and members of the various board committees.

We also examine the abnormal stock return patterns grouped by the relation of the executives. Figure 3 displays 180 days of abnormal returns around grant date for officers, directors, and top executives.[82] One hypothesis is that, because top executives have

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

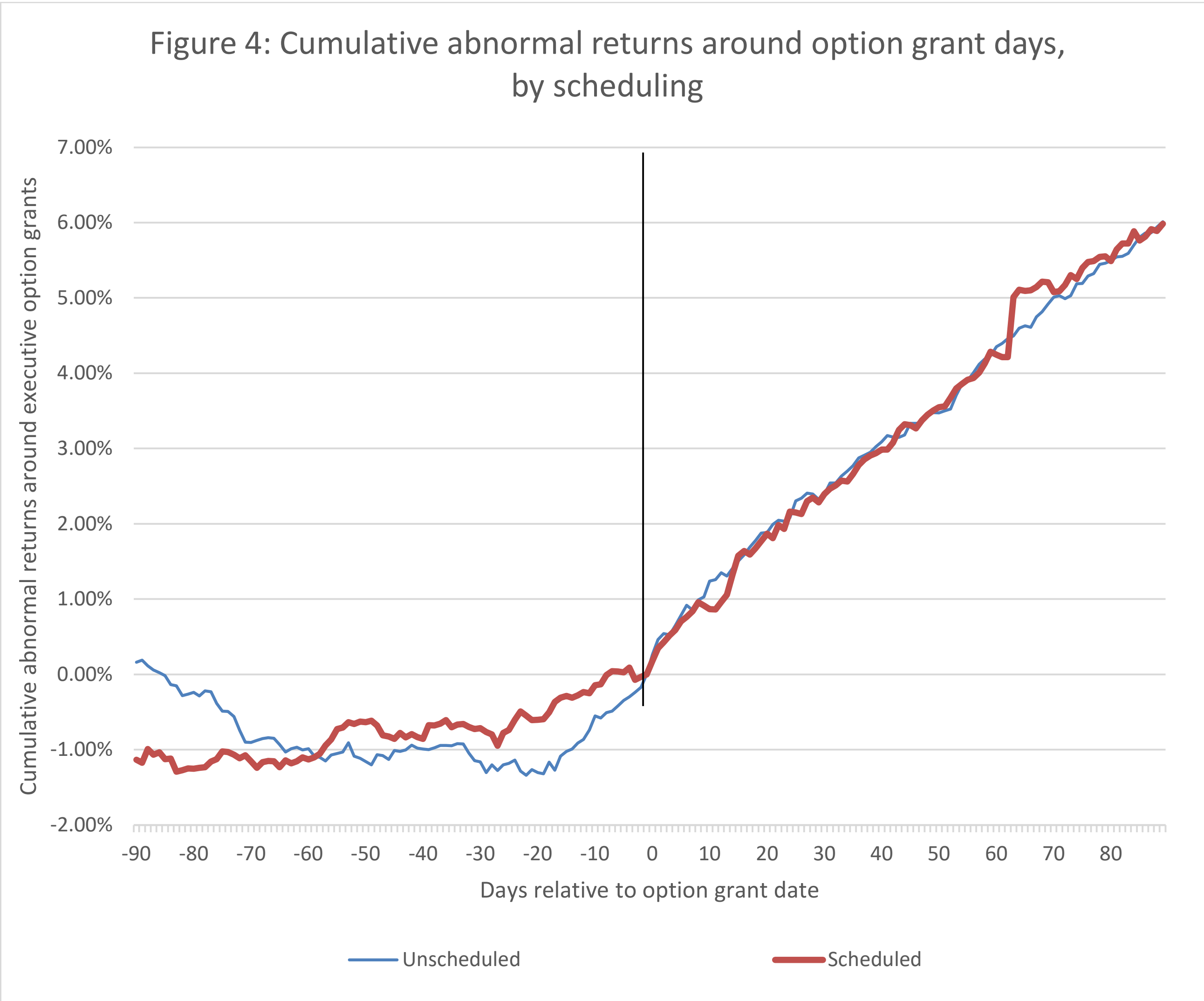
access to all private information about the company, they should have the most ability to influence stock prices. Another hypothesis is that manipulations originate from the board of directors. Using this logic, directors' options should show the largest evidence of manipulations. The evidence shown in Figure 3, however, indicates the stock price patterns are the same for all three groups. This finding indicates that options are typically granted on the same day to all executives and directors, and thus, it is not possible to distinguish between subgroups of insiders.



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

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

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



Scheduled awards are preceded by another option award 365 days before, plus or minus two days. An empirical implication of the backdating hypothesis is that options with greater reporting delays should show greater evidence of manipulation. To examine this issue, we group option grants by reporting delays in Figure 5. About 1.2 million option grants are reported within the two business days as required by SOX. In contrast, 77,173 are reported between three and ten days later; 38,505 are reported between 10 and 60 days later; and finally, 23,290 option grants are reported more than 60 days later. The approximately 140,000 options (about 10% of the total) that are reported late are in direct violation of the reporting requirements of SOX. Figure 5 also shows that stock returns rise about 6% following timely reported option grants. The corresponding abnormal return is a little smaller for options with delays up to 60 days, as they average between 4% and 5%. However, for options reported with more than a 60-day delay, the abnormal returns rise to about 8%. This evidence is consistent with the conclusion that at least some of the options could still be backdated.

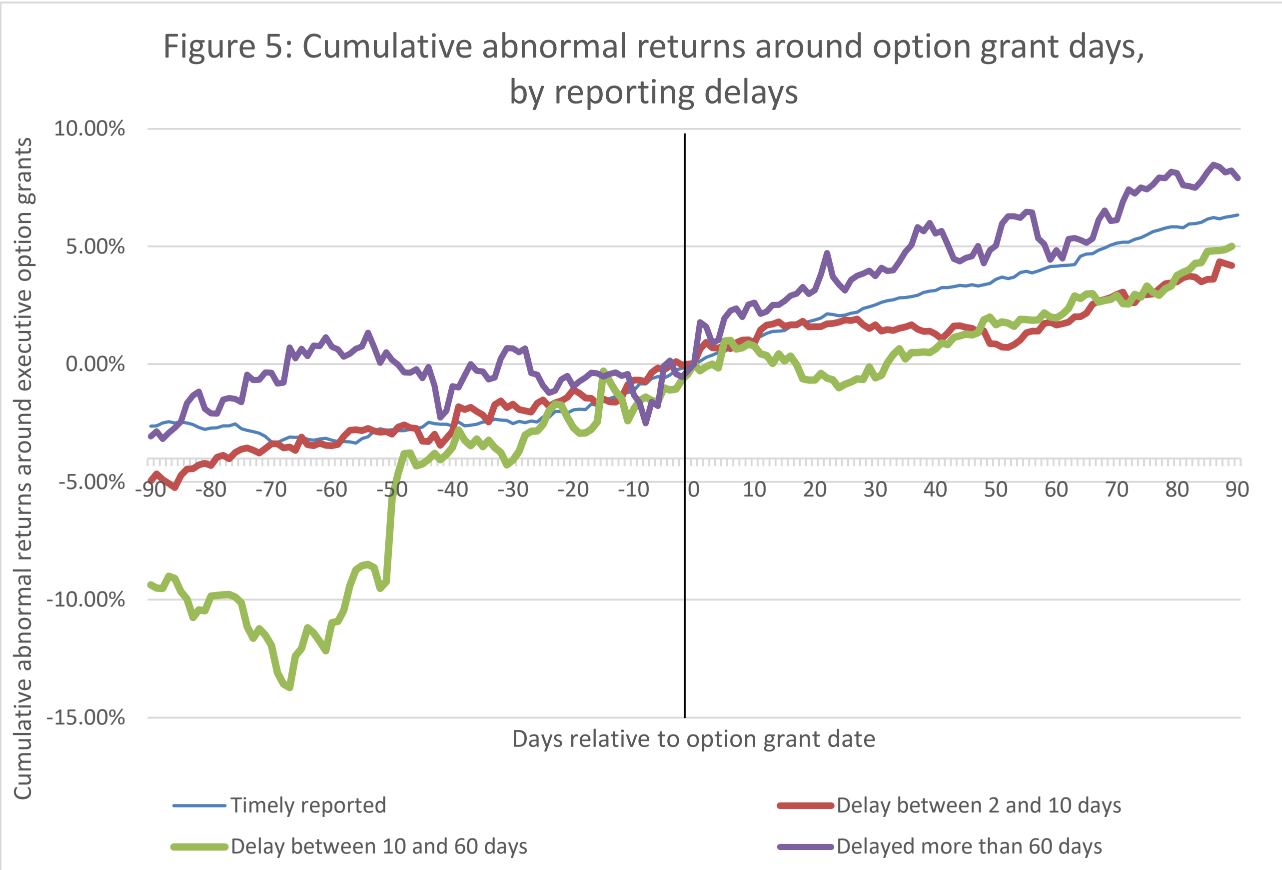
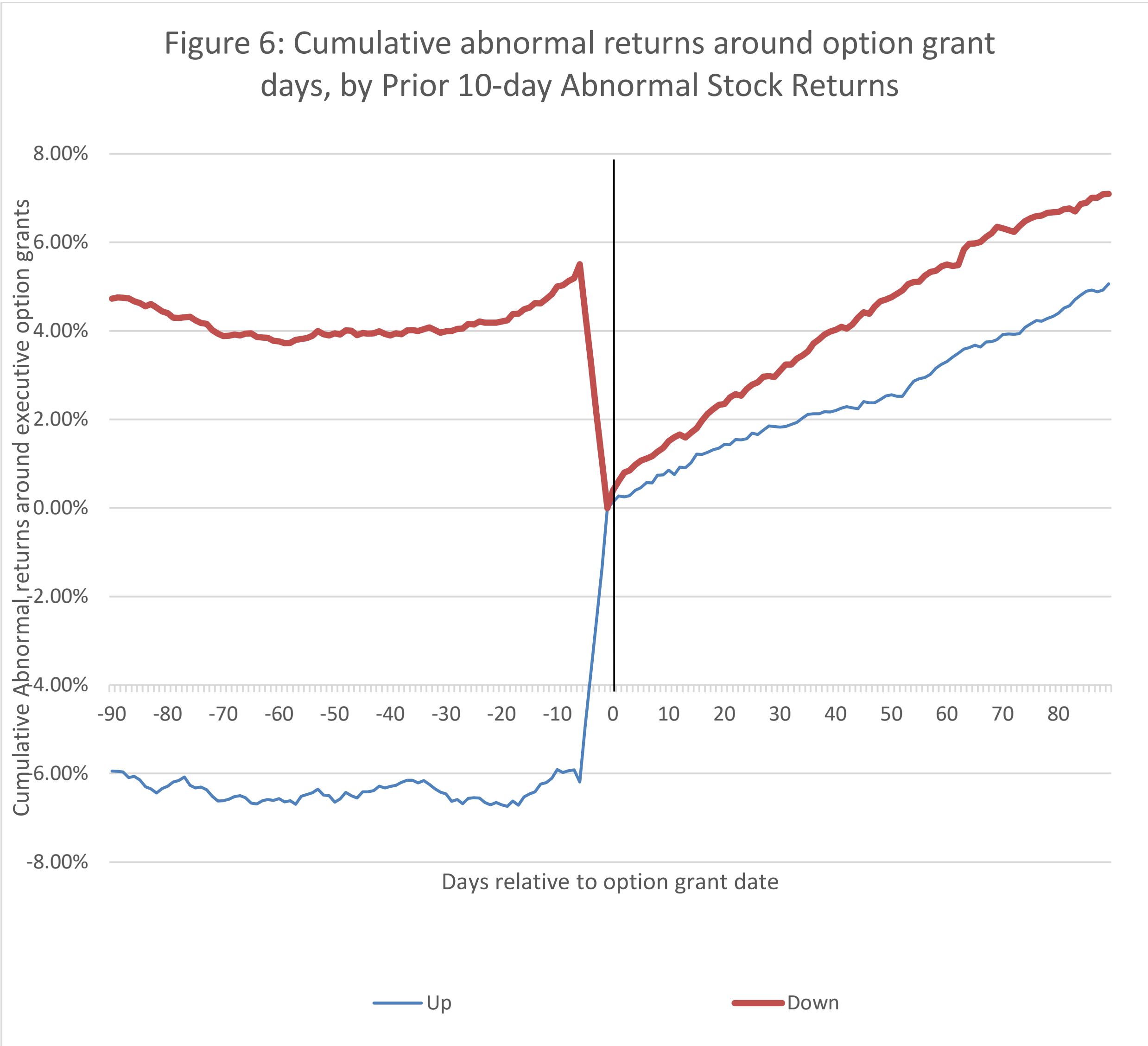


Figure 5 addresses reporting delays. Reporting delays are measured from the grant date to the SEC receipt date.

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

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



If the ten-day cumulative abnormal return from Day -10 to Day -1 is positive, then the prior return is classified as "Up." If the ten-day cumulative abnormal return from Day -10 to Day -1 is negative, then the prior return is classified as "Down."

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

IV. Federal Securities Laws Implicated in Stock Option Manipulations

Section 10(b) of the Securities Act of 1934 makes it illegal for anyone to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[83] Under SEC Rule 10b-5, it is unlawful for anyone "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," in connection with a purchase or sale of securities.[84]

To establish a violation of these federal securities laws, the SEC must show that there was "(1) a material misrepresentation, (2) in connection with the purchase or sale of a security, (3) scienter, and (4) use of the jurisdictional means."[85] Material misrepresentation exists where there is "a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[86] The determination of materiality depends on both questions of law and fact.[87] Courts entertain factors such as whether the disclosure in question impacted stock price[88] as well as the degree to which the earnings or losses were misstated.[89] The SEC has resisted establishing a quantitative standard for determining materiality[90] and emphasizes qualitative factors, such as the intent of the misstatement or omission, in the analysis.[91]

A. Options Backdating and Forward-Dating

Between 2003 and 2010, the SEC brought charges against 32 companies and/or their executives for options backdating.[92] Upon discovery of options backdating, corporations

83. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2015).

84. 17 C.F.R. § 240.10b-5 (2016).

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

86. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus., Inc. v. Northway Inc., 426 U.S. 438, 448–49 (1976)).

87. SEC v. Todd, No. 03CV2230, 2006 U.S. Dist. LEXIS 41182, at *13 (S.D. Cal. May 23, 2006) ("Whether an omitted fact is material is generally considered a mixed question of law and fact, and therefore uniquely within the province of the factfinder.").

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

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

90. The Second Circuit adopted the SEC's 1999 Staff Accounting Bulletin in dismissing quantitative benchmarks as well-reasoned and consistent with law in *Ganino v. Citizens Utilities Co*., 228 F.3d 154, 163–64 (2d Cir. 2000) (citing Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944)) (stating SEC staff accounting bulletins are "a body of experience and informed judgment").

91. *See* Narayanan et al., *supra* note 4, at 1608–09 (referencing SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45, 150 (1999)).

92. The SEC charged the following companies and/or their officers/directors in the following chronological order: Peregrine Systems, Inc. (June 30, 2003); Symbol Technologies, Inc. (June 3, 2004) (resulting in a $37 million fine for the company); Brocade (July 20, 2006) (resulting in a $7 million penalty); Comverse Technology, Inc. (Aug. 9, 2006); Engineered Support Systems, Inc. (Feb. 6, 2007) (resulting in a $886,557 payment for the former controller of the company); Take-Two Interactive Software, Inc. (Feb. 14, 2007) (resulting in the company settling for $3 million in civil penalties and the former CEO/Chairman settling

may be required to restate financial statements and could face significant penalties. The board of directors may also be implicated in this wrongdoing, particularly if they knew or should have known about the practice.[93] The former CFO and member of the board of Brocade Communication Systems, Inc. (Brocade), for example, was implicated under allegations that he had knowledge of the practice and did not address it.[94]

Undisclosed options backdating and forward-dating violate Section 10(b) of the Securities Exchange Act of 1934[95] and SEC Rule 10b-5.[96] First, undisclosed backdating and forward-dating satisfy the material misrepresentation requirement. It is likely that a reasonable investor would find this information to be significant in making investment decisions, especially because executive compensation is a major focus for shareholders.[97] When backdating and forward-dating ensues, corporate financial statements are inaccurate, and tax laws are violated.[98]

In its first action in 2003, for example, the SEC alleged that Peregrine Systems, Inc. understated its expenses by about $90 million when it "fail[ed] to record any expense for compensation when it issued incentive stock options."[99] Next, the SEC charged Symbol Technologies, Inc. for manipulating exercise dates of stock options at the cost of $229 million.[100] In one prominent case, the SEC required Brocade to restate six years of financial statements.[101] The civil fraud action filed by the SEC against three former executives of Brocade alleged that backdating of stock options caused the inflation of the

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

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

94. Complaint at 2, SEC v. Reyes, 491 F. Supp. 2d 906 (N.D. Cal. July 20, 2006) (No. 06-4435), 2006 U.S. Dist. Ct. Pleadings LEXIS 2134.

95. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2015).

96. 17 C.F.R. § 240.10b-5. For a full and comprehensive analysis of the illegality of options backdating and forward-dating, as well as the economic impact of the practices, see Narayanan et al., *supra* note 4.

97. Narayanan et al., *supra* note 4, at 1608; *see infra* Section IV.B.2 (discussing how shareholders want clearer and more comprehensive disclosures on executive compensation).

98. Narayanan et al., *supra* note 4, at 1610.

99. Cox, *supra* note 33; *see generally* Peregrine Sys., Inc., Accounting & Auditing Enforcement Act No. 1808, 2003 WL 21496556 (June 30, 2003) (discussing what the SEC sued Peregrine for and on what specific counts).

100. Cox, *supra* note 33; *see generally* Symbol Techs., Inc., Accounting & Auditing Enforcement Act No. 2029, 2004 WL 1217620 (June 3, 2004) (explaining Symbol Technologies fraud scheme).

101. Cox, *supra* note 33; *see generally* Alexander, Accounting & Auditing Enforcement Act No. 2472, 2006 WL 2285561 (Aug. 9, 2006) (explaining similarly filed action against Comverse Technology executives).

company's net income by approximately $1 billion in just 2000.[102] Even when the amount has a minor effect on financial statements, research shows that it has a significant impact on shareholder earnings.[103]

Second, the fraud must have occurred in connection with the purchase or sale of securities. This requirement is met when the "scheme to defraud and the sale of securities coincide."[104] That is, "[t]he misrepresentation need not be made with respect to a particular sales transaction;" courts consider misrepresentations in press releases, quarterly reports, or any documents that investors may rely on as satisfying the "in connection with" requirement.[105] Because backdating of stock options almost always results in misrepresentations in financial statements, which investors rely on when purchasing and selling securities, the element can generally be satisfied.[106]

In its recent charges for option backdating, the SEC charged Trident Microsystems and the company's former CEO and CAO with stock option backdating in 2010.[107] The SEC alleged that executives in the corporation backdated stock options from at least 1993 to May 2006, thereby concealing millions of dollars in expenses from its shareholders.[108] The company filed a restatement in 2007 showing about $37 million in compensation expenses that were not accurately recorded with the SEC over a 13 year period.[109] By not accounting for these grants, Trident overstated its pre-tax income by as much as 113% in each fiscal year during the period.[110]

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

The last element mandates that the fraud is conducted "by the use of any means or instrumentality of interstate commerce, or of the mails."[115] This element is also easily

102. Cox, *supra* note 33.

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

104. *Id.* at 1612 (quoting SEC v. Zandford, 535 U.S. 813, 822 (2002)).

105. SEC v. C. Jones & Co., 312 F. Supp. 2d 1375, 1380 (D. Colo. 2004) (citing SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993).

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

107. Trident Microsystems, Inc. et al., Accounting & Auditing Enforcement Act No. 3154, 2010 WL 2799416 at *1 (July 16, 2010).

108. *Id.*

109. *Id.*

110. *Id.* at *2. Trident and the two executives settled the matter without admitting or denying the SEC's allegations. *Id.*

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

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

113. *Id.*

114. *Id.*

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

satisfied, as it requires a link to either mail or interstate commerce, which the courts have historically interpreted very broadly.[116] Importantly, the SEC filing required of executive compensation plans "satisfies the jurisdictional means requirement."[117]

B. Spring-Loading

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

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116. *See, e.g.*, United States v. Kunzman, 54 F.3d 1522, 1526 (10th Cir. 1995) (stating that use of mails was sufficient to establish a link to interstate commerce); Dupuy v. Dupuy, 511 F.2d 641, 643–44 (5th Cir. 1975) ("[W]e align ourselves with the great majority of courts which have considered this issue, and hold that intrastate use of the telephone may confer federal jurisdiction over a private action alleging violation of [Section] 10 of the Securities Exchange Act of 1934 and SEC Rule 10b-5.").

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

118. *See, e.g.*, Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031, 1041 n.32 (2007) (discussing the variety of ways backdated options may be in violation of the law); Stephen Bainbridge, *Spring-Loaded Options and Insider Trading*, PROFESSORBAINBRIDGE.COM (July 10, 2006), http://www.professorbainbridge.com/professorbainbridgecom/2006/07/springloaded-options-and-insider-trading.html (describing Professor Iman Anabtawi's argument that spring-loaded options constitute a form of insider trading or breach of fiduciary duty).

119. For a discussion about the differing views of SEC Commissioners on the legality of spring-loading, see William Hughes, *Stock Option "Springloading": An Examination of Loaded Justifications and New SEC Disclosure Rules*, 33 J. CORP. L. 777, 788–89 (2008); Matthew E. Orso, *"Spring-Loading" Executive Stock Options: An Abuse in Need of a Federal Remedy*, 53 ST. LOUIS U. L.J. 629, 637–38 (2009) (discussing the mixed signals sent by the SEC regarding spring-loading).

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

121. *Id.* at 788–89 (citing Former SEC Chief Accountant Lynn Turner's remarks *in* Hearing on Stock Options Backdating Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 2–4 (2002)).

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

123. *Id.* at 638 (citing Kara Scannell et al., *Can Companies Issue Options, Then Good News?,* WALL ST. J., July 8, 2006, at A1).

124. Kara Scannell & John Hechinger, *SEC, Analog Settle Case-'Spring-Loading' Options Complaint Isn't*

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

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

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

Although the SEC has not taken a clear stand on the issue, the legality or illegality of spring-loading, specifically relating to insider trading rules, has been debated by scholars. Professor Iman Anabtawi, for example, argues that spring-loaded options can be considered as discounted options.[127] She states:

> [G]ranting a stock option with an exercise price that does not reflect favorable inside information is substantively equivalent to granting a discount option; that is, an option with an exercise price below the market price on the date of the grant. The upward price adjustment that results from the release of the inside information is the size of the discount.[128]

Therefore, spring-loading and backdating may be different in form, but are largely the same in substance.[129] Anabtawi further argues that, "[w]hile it is true that using discount

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Included, WALL ST. J. (May 31, 2008), http://www.wsj.com/articles/SB121217424643533359.

125. 71 Fed. Reg. 53158–01, 53163 (Sept. 8, 2006) (codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, and 274).

126. *See* 17 C.F.R. § 229.402(b)(2)(iv) (2015) (stating that such information includes "[h]ow the determination is made as to when awards are granted, including awards of equity-based compensation such as options").

127. *See* Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835, 843–44 (2004) (discussing the timing of options).

128. Bainbridge, *supra* note 118 (describing Anabtawi, *supra* note 127, at 855–57).

129. *Id.*

options may be efficient compensation policy, doing so without adequate disclosure to shareholders involves making materially misleading statements in connection with a securities transaction—in other words, insider trading."[130] The purpose and policy considerations of Section 10(b), which will be discussed in greater detail below, strongly weigh in favor of making the grant of spring-loaded options a disclosure-inducing event.

1. Disclosure requirements

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

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

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

131. Orso, *supra* note 119, at 638 (quoting 17 C.F.R. § 229.402(b)(1)).

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

133. 71 Fed. Reg. 53158–01, 53163 (Sept. 8, 2006) (codified at 17 CFR pts. 228, 229, 232, 239, 240, 245, 249, and 274).

134. Orso, *supra* note 119, at 639 (quoting Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33-8732A, 71 Fed. Reg. 53,158, 53,163 (Sept. 8, 2006)).

135. *Id.*

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

137. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

138. *Id.* at 843–44.

139. Orso, *supra* note 119, at 639–40 (citing *Texas Gulf*, 401 F.2d at 844).

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

options.[141] The executives failed to make the required disclosure and the court rescinded the option grants.[142]

Texas Gulf Sulphur provides an early articulation of the "disclose or abstain rule," which forms the basis of classical insider trading theory[143] and requires that "an insider possessing material inside information must either disclose such information before trading or abstain from trading until the information has been disclosed."[144] This rule was initially based on the ground that all members of the open market were "entitled to equal access to material information."[145] The Supreme Court, however, later limited the scope of the rule. In *Chiarella v. United States*, the Court adopted the SEC's argument from *In re Cady, Roberts & Co*. and held that the defendant must have an established duty arising from a "fiduciary or other similar relation of trust and confidence" before the "disclose or abstain" rule applies.[146] The Court further confirmed this requirement in *Dirks v. SEC*.[147]

The question then arises as to whether, by spring-loading and manipulating the timing of information flow, executives and directors might be in breach of a pre-existing duty. Under *Dirks*, not every breach of fiduciary duty in relation to a securities transaction is a violation of Rule 10b-5;[148] the breach must come from some "manipulation or deception."[149] *Dirks* followed *Santa Fe Industries v. Green*,[150] which held that only conduct that "can be fairly viewed as 'manipulative or deceptive' within the meaning of [Section 10(b)]" could be the source of liability.[151]

The Supreme Court has not clarified the source of the fiduciary duty within the context of federal securities law.[152] In fact, the Court explicitly argued against a federal common law fiduciary duty in *Santa Fe*, as it would "bring within [Rule 10b-5] a wide

141. *Texas Gulf*, 401 F.2d at 855–57.

142. *Id.* at 857.

143. Anabtawi, *supra* note 127, at 876 (discussing the inadequacy of extending misappropriation theory to classical insider trading cases). An alternative theory of liability for insider trading is the misappropriation theory, which imposes liability under Rule 10b-5 when an individual "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." United States v. O'Hagan, 521 U.S. 642, 652 (1997). The misappropriation theory is not applicable to the manipulation of stock option grants or information flow because misappropriation theory imposes liability on corporate outsiders, and the parties involved in the contexts discussed here are corporate insiders. *Id.* at 652–53. On average, insiders are able to trade profitably using their information acquired from the firm, though not all insider trading is illegal. For abnormal profitability of insider trading in general, see H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 210 (1986); H. Nejat Seyhun, *The Information Content of Aggregate Insider Trading*, 61 J. BUS. 1, 22 (1988); H. Nejat Seyhun, *Why Does Aggregate Insider Trading Predict Future Stock Returns?*, 107 Q. J. ECON. 1302, 1329 (1992); Bin Ke et al., *What Insiders Know About Future Earnings and How They Use It: Evidence from Insider Trades*, 35 J. ACCT. & ECON. 315, 315 (2003); H. Nejat Seyhun & Michael Bradley, *Corporate Bankruptcy and Insider Trading*, 70 J. BUS. 189, 203, 214 (1997).

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

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

146. Chiarella v. United States, 445 U.S. 222, 228 (1980) (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961)).

147. Dirks v. SEC, 463 U.S. 646 (1983).

148. Anabtawi, *supra* note 127, at 861 (citing Dirks v. SEC, 463 U.S. at 654).

149. *Dirks*, 463 U.S. at 654 (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).

150. 430 U.S. 462 (1977).

151. *Dirks*, 463 U.S. at 654 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473–74 (1977)).

152. Anabtawi, *supra* note 127, at 864.

variety of corporate conduct traditionally left to state regulation."[153] Despite this reluctance, however, the Court has implied a federal source of the fiduciary obligation in key cases following *Santa Fe*.[154]

Professor Anabtawi argues that the difficulty is in determining whether spring-loading satisfies the "fraud or deception" element as the source of the fiduciary duty is uncertain.[155] The courts have held that the "fraud or deceit" element is satisfied by evidence of material misrepresentation on the part of the defendants.[156] The information that is being traded on in the context of spring-loading is likely to be material to the extent that the public information released after option grant significantly affects the price of the company's stock[157] and to the extent that investors would find the information important in making their investment decisions.

Some commentators disagree with Professor Anabtawi, finding that there is both a federal and state common law source of the fiduciary duty. Matthew Orso argues that, under the true interpretation of the "disclose or abstain" rule, the disclosure of material insider information must be provided to the shareholders prior to the granting of the stock option.[158] Without such disclosure, there is a violation of Rule 10b-5. He finds that the Delaware Chancery has established that spring-loading is a breach of a fiduciary duty in *Tyson I* and *Tyson II*, further discussed in Part V below. Orso concludes that, "if the federal securities laws are 'designed to protect shareholders from trading on incomplete or inaccurate information,' then the SEC is failing this goal in regard to spring-loading."[159]

Assuming that a federal common law fiduciary duty exists, *Dirks* and *Chiarella* imply that a fiduciary relationship between corporate insiders and shareholders gives rise to a duty imposed on insiders to either abstain from trading or disclose to shareholders "material nonpublic information," that is, "information intended to be available only for a corporate purpose and not for the personal benefit of anyone."[160] The difficulty in applying the "disclose or abstain" rule to stock option grants is that most other cases to which the rule applied involves open market transactions.[161] Option grants, in contrast, are "intra-corporate transactions" which do not involve a direct trade with a shareholder.[162] The holding in *Texas Gulf Sulphur* would indicate that, in the context of insider trading on option grants, disclosing the inside information to the compensation committee would absolve insider-executives of liability.[163]

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

154. *Id.* at 863–64 (discussing the implications of Chiarella v. United States, 445 U.S. 222 (1980), Dirks v. SEC, 463 U.S. 646 (1983), and U.S. v. O'Hagan, 521 U.S. 642 (1997) on the possible existence of a federal common law fiduciary duty).

155. *Id.* at 860 n.115.

156. *Id.*

157. *See In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1424–25 (3d Cir. 1997) (discussing executive stock options granting and its materiality on the stock price of the corporation).

158. Orso, *supra* note 119, at 643.

159. *Id.* at 661 n.264 (citing Yablon & Hill, *supra* note 159, at 92 n.36 ("There is much language in the debates prior to passage of those statutes and in later case law to the effect that the federal securities laws were designed to prevent the kinds of abuses of naïve investors that took place during that period.")).

160. *Id.* at 648 (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).

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

162. Anabtawi, *supra* note 127, at 888.

163. *Id.*

2. Insufficiency of Disclosure

Although there are no federal cases addressing the disclosure requirements for spring-loading or manipulation of the timing of information release, two principles can be extracted from the cases applying the "disclose or abstain" rule. First, insider trading is a breach of the fiduciary duties owed to shareholders[164] and second, using material nonpublic information that is intended for business purposes for the insider's own self-interest is intrinsically unfair.[165] According to *Dirks*, the duty of corporate insiders to disclose to shareholders is not a general duty but one arising from a fiduciary relationship.[166] Although the Court has suggested that adequate disclosure requires a broader, more public release of information in some circumstances,[167] it is shareholders who are owed the duty of disclosure.[168]

We contend that allowing spring-loading for the sole purpose of increasing the value of executive options, even if the practice is disclosed, is inconsistent with the purposes of Section 10(b) of promoting investor confidence and protecting investors. First, a company "in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them."[169] This reasoning implies that a company cannot trade its own stock through the use of material nonpublic information.[170] Professor Anabtawi argues that "[a]llowing a company to time option grants around inside information can be analogized to allowing a company to engage in insider trading in the open market and then use the profits to pay its executives."[171] Furthermore, disclosure to the board only may not be enough to satisfy the duty of disclosure under Section 10(b) because standard disclosure relating to executive compensation is usually considerably delayed.[172]

Furthermore, although disclosure is the preferred method of the SEC and Congress in curbing potential abuses of executive compensation, there is little evidence to suggest that greater disclosure results in fewer abuses. Many shareholders simply do not read every disclosure, and those who do often cannot digest effectively what these disclosures state. According to a recent study, almost half of institutional investors think that disclosures about executive compensation need to be clearer and more comprehensive.[173] As the Director of Governance Research at Equilar simply states, "it

164. Orso, *supra* note 119, at 647 (citing Theresa A. Gabaldon, *State Answers to Federal Questions: The Common Law of Federal Securities Regulation*, 20 J. CORP. L. 155, 198 (1995)). There exists a "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." Chiarella v. United States, 445 U.S. 222, 228 (1980).

165. Orso, *supra* note 119, at 647–48 (citing Gabaldon, *supra* note 164, at 198–99). "This relationship [of trust and confidence] gives rise to a duty to disclose because of the 'necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders.'" *Chiarella*, 445 U.S. at 228–29 (alteration in original) (quoting Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951)).

166. Dirks v. SEC, 463 U.S. 646, 654 (1983).

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

168. *Id.* at 653 n.10.

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

170. Anabtawi, *supra* note 127, at 874 (citing WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING, 297–98 (1996)).

171. *Id.*

172. *Id.*

173. DAVID F. LARCKER ET AL., 2015 INVESTOR SURVEY: DECONSTRUCTING PROXY STATEMENTS-WHAT MATTERS TO INVESTORS 1 (2015), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-

is more important than ever that companies explain to their shareholder base why the compensation packages they offer are appropriate in size and structure."[174] The study found that investors are highly dissatisfied with the compensation disclosure and that the proxies are unmanageably long and difficult, forcing them to rely on a small percentage of the information when making decisions. In addition, investors are dissatisfied with the structure and amount of pay of the executives, and only 21% think that CEO pay is linked to performance.[175] Therefore, it is unreasonable to expect SEC disclosure rules as they stand today to result in shareholders clearly understanding the details of the executive compensation plan they are approving. There is a real need to further regulate these disclosures to ensure that the information is comprehensible to the average shareholder and that the executive compensation adequately correlates to performance. Mere disclosure of a practice of spring-loading does neither.

3. Legislative Intent

The legislative policy considerations behind the Securities Acts imply that disclosure should be extensive. The 1933 Act was intended to "substitute . . . a philosophy of full disclosure for the philosophy of *caveat emptor*."[176] Moreover, Congress passed the 1934 Act in hopes that it would "[renew] investors' confidence" through "a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations."[177] The 1934 Act was the answer to the public concern of the "unscrupulous insider . . . [using] inside information for his own advantage."[178] The legislative history, which takes account of the concerns giving rise to the need for and the popularity behind the Acts, suggests that "an executive must disclose material nonpublic information in some manner prior to an option grant in order to discharge a federal fiduciary duty to disclose or abstain."[179]

Professor Anabtawi argues that the 1934 Act promotes full disclosure and requires the board of directors to "avoid making materially misleading statements in connection with a securities transaction."[180] The legislative intent behind the Acts also supports the argument that the "disclose or abstain" rule ought to also bar materially misleading omissions.[181] As shareholders often base their investment decisions on corporate communications, it is imperative that these board disclosures are both honest and full.[182] Moreover, there is an expectation that stock option grants are part of the executive compensation plan to incentivize officers to make decisions that raise the company's stock price. When stock options are spring-loaded and this fact is omitted from corporate

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2015-deconstructing-proxy-statements_0.pdf. For a summary of key points of the study, see *Even the Experts are Dissatisfied with CEO Pay Disclosure*, STAN. GRADUATE SCH. BUS. NEWSROOM (Feb. 17, 2015), http://www.gsb.stanford.edu/insights/even-experts-are-dissatisfied-ceo-pay-disclosure.

174. LARCKER ET AL., *supra* note 173, at 1.

175. *Id.* at 2.

176. Orso, *supra* note 119, at 648 (quoting SEC v. Cap. Gains Res. Bureau, 375 U.S. 180, 186 (1963)).

177. *Id.* (quoting H.R. REP. NO. 73-1383, at 13 (1934)).

178. *Id.* at 649.

179. *Id.*

180. *Id.* (quoting Anabtawi, *supra* note 127, at 880 (citing Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 415 (1990))).

181. Orso, *supra* note 119, at 649.

182. *Id.*

disclosures to shareholders, the shareholders are misguided about the extent of the incentive device.[183]

In *In re Cady, Roberts & Co*.,[184] the SEC considered factors that are just as powerful in arguing against insider trading as they would be in relation to spring-loading.[185] The court focused on two factors in analyzing whether there is an affirmative duty to disclose material information. First, the SEC looked for a relationship that provides access to information that is "intended to be available only for a corporate purpose and not for the personal benefit of anyone."[186] Second, the SEC analyzed whether allowing one party to take advantage of that information is unfair.[187] This interpretation was used in *Texas Gulf Sulphur*, where the court found that "the purpose of the Securities Exchange Act was to prevent unfairness and inequities in securities transactions."[188] The court also noted in a footnote that the Act was envisioned to "eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office."[189] The themes of unfairness and inequality are focal points in analyzing whether spring-loading and the manipulation of the timing of information flow should be considered illegal.

Furthermore, gaming release of information contradicts the economic purpose of insider trading prohibitions. In *Texas Gulf Sulphur*, the court found that Rule 10b-5 was Congress' attempt to level the risks in the financial market among insiders and outsiders so that all have equal access to potential profits.[190] Mandatory disclosure and insider trading prohibitions affect the way that investors act. Investors are usually risk-averse, and disclosure of information gives them a higher level of trust and confidence in the market. This reduction in risk means lower cost of capital for the firm because investors agree to a lower rate of return during time of public disclosures.[191] The goal of leveling the risks in financial markets, though, is undermined by the use of spring-loaded stock option grants.

4. Nature of the Harm

Some scholars disagree with Commissioner Paul Atkins's arguments alleging the legality of spring-loading. These scholars find both that a party is harmed by the practice and that the decision to award loaded options does not fall within the discretion of the corporate board of directors under the business judgment rule.[192] Professor Hughes argues that there is a counterparty that is harmed by spring-loading, specifically as (1) spring-loaded options represent a cost to the corporation and its shareholders,[193] and (2)

183. *Id.* (citing Lucian A. Bebchuk et al, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 820 (2002)).

184. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

185. Hughes, *supra* note 119, at 793.

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

187. *Id*.

188. *Id.* at 787 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851–52 (2d Cir. 1968)).

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

190. Hughes, *supra* note 119, at 787 (citing *Texas Gulf*, 401 F.2d at 851–52).

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

192. *Id.* at 789.

193. *Id.* at 789–91.

the benefits that may be intended for shareholders cannot compensate for the costs of the practice.[194] Therefore, spring-loading is not victimless.

First, options represent real value and cost to the corporation as they dilute the value of current stock. The practice also "conceals from investors the full scope of the costs attributed to management compensation."[195] Before 2005, the options awarded to employees were included as compensation expenses only if the exercise price on the date of the award was less than the market price.[196] Therefore, spring-loading "conceal[ed] from investors the full scope of the costs attributed to management compensation."[197] Spring-loading prior to 2005 was in fact "artificially inflat[ing] corporate profits."[198] Furthermore, even though all employee stock option awards create diluted costs for shareholders, spring-loaded options aggravate the problem. Further, the practice increases the chance that a manager would exercise the option because timing the option award with the release of good news places the option at a more favorable position than the market price.[199]

5. Role of Incentives

It has also been argued that spring-loading does not result in compensation incentives that align officer incentives with the incentives of the shareholders.[200] After all, the higher the increase of the stock price vis-à-vis the option's exercise price, the greater the compensation for the officer. Hence, spring-loading "destroys the performance benefit that stock options are intended to provide shareholders,"[201] because "[f]rom the outset of the grant, a spring-loaded option immediately provides the officer with an unrealized profit."[202] Moreover, the possibility of spring-loading would presumably lead investors to question the effectiveness of the option grants in promoting long-term company performance because spring-loading allows corporate officers to unfairly profit without the intended incentive to act to maximize shareholder value. It would be virtually impossible under these circumstances to predict the incentive effects of the adoption of an option plan or of individual grants. Although the practice does not completely eliminate the incentive to perform (the higher the eventual stock price, the more wealth to the officer), the practice decreases the performance incentive that stock options were intended to provide in exchange for compensation.[203] Thus, it may be appropriate to require disclosure by executives who are granted options while in possession of inside information similar to that required of insiders in their open market dealings; that is, substantive disclosure of the inside information to shareholders before the grant is made or abstention from accepting the grant.

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194. *Id.*
195. Hughes, *supra* note 119, at 790 (citing Anabtawi, *supra* note 127, at 852).
196. *Id.* at 789–90.
197. *Id.* at 790.
198. *Id.*
199. *Id.*
200. Hughes, *supra* note 119, at 791.
201. *Id.*
202. *Id.*
203. *Id.*

C. Bullet-Dodging

Although spring-loading and bullet-dodging achieve the same result—the grant of stock options at a price lower than what they would have been otherwise—and are essentially mirror images of each other, courts differ on whether bullet-dodging raises the same legal issues as spring-loading. In *Desimone v. Barrows*,[204] the court distinguished spring-loading (which it likened to an in-the-money option grant) from bullet-dodging, noting that in the latter case the market has already absorbed the negative information, and thus, bullet-dodging involves a strike price at the stock's actual market price.[205] That is, bullet-dodging does not involve trading on nonpublic material information because the relevant information will already have been released by the time of grant.

Moreover, *Dirks* states that "an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes 'secret profits.'"[206] Because the relevant nonpublic information that the insider-executive has about the company is already public by the time the grant is made, liability must be established by some other means. Yet, the practice of bullet-dodging itself, if not disclosed, would seem to constitute material, nonpublic information. To the extent that bullet-dodging influences executive compensation, bullet-dodging practices are likely to be considered material.

V. CORPORATE GOVERNANCE IMPLICATIONS: FIDUCIARY DUTIES

In addition to potentially violating federal securities laws, manipulation of stock options more clearly violate the fiduciary duties of the executives and directors. Corporate officers and directors owe the corporation and its shareholders the fiduciary duties of care and loyalty, and imbedded in these duties is the obligation to act in good faith.[207] In addition, these individuals may also be violating their duties of disclosure when participating in the manipulation of stock options.

A. Overview of Fiduciary Duties

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

1. Duty of Care

The duty of care imposes a "reasonable person" standard on officers and directors, requiring that they inform themselves "prior to making a business decision, of all material information reasonably available to them,"[208] and to play an active role in protecting the interests of the corporation and its stockholders.[209] Whether a fiduciary was informed of

204. Desimone v. Barrows, 924 A.2d 908, 944 (Del. Ch. 2007).

205. *Id.* at 944–45.

206. Dirks v. SEC, 463 U.S. 646, 654 (1983) (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907, at 916 n.31 (1961)).

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

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

209. *See id.* (citing how the duty of care applies to the board of directors to protect the interests of

"all material information" is a fact-specific question as to the quality of the information, the advice considered, and whether the fiduciary had "sufficient opportunity to acquire knowledge concerning the problem before acting."[210]

Delaware courts consider a variety of factors related to the fiduciary's actions and knowledge in determining the fiduciary's compliance with the duty of care.[211] The standard with respect to the duty of care is gross negligence, which in this context has been judicially defined as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason."[212] Delaware statutory law, however, permits corporations to include in their articles of incorporation a provision exculpating directors from monetary liability to the corporation and shareholders for breach of the duty of care.[213] Most Delaware corporations have adopted a provision exculpating their fiduciaries to the extent possible under Section 102(b)(7). Notably, this exculpation provision does not apply to violations of the duty of loyalty or the obligation of good faith.[214]

The duty of care also implies a duty to monitor the behavior of management. In *In re Caremark International, Inc. Derivative Litigation* (*Caremark*), the Delaware Court of Chancery indicated (in dicta) that directorial liability may attach for failure to implement adequate reporting systems.[215] The court stated that, because "relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role . . . a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[216] The court further defined a multi-factor test to determine when directors breached their duty of care. To establish a violation of the duty of care, plaintiffs would need to show that

> (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of [by the plaintiffs.][217]

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shareholders).

210. *Id.* (quoting Moran v. Household Int'l, Inc., 490 A.2d 1059, 1075 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985)).

211. For a list detailing some of these factors, see *id.* at 842–43, and see generally Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989).

212. Lafferty et al., *supra* note 208, at 843 (quoting Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 192 (Del. Ch. 2005) (quoting Tomczak v. Morton Thiokol, Inc., No. 7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990)).

213. *Id.* at 844 (citing DEL. CODE ANN. tit. 8, § 102(b)(7) (2011)). "The Delaware legislature amended § 102 of the General Corporation Law in 1986, in part, to address the concerns of directors following decisions of the Delaware Supreme Court in the mid-1980s holding directors liable for breaches of the duty of care (such as *Van Gorkom*) and the concomitant rise in the cost of directors' and officers' insurance." *Id.* at 844 n.29. *See* Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) (describing this amendment).

214. Lafferty et al., *supra* note 208, at 844.

215. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969–70 (Del. Ch. 1996).

216. *Id.*

217. *Id.* at 971.

2. Duty of Loyalty

The duty of loyalty requires that corporate officers and directors act in the best interest of the corporation and prioritize the interests of the corporation over their own self-interests.[218] Corporate fiduciaries must "affirmatively[] protect the interests of the corporation," in addition to "refrain[ing] from doing anything that would work injury to the corporation" or depriving it of profit or advantage that the fiduciary might otherwise lawfully have brought to it.[219] Therefore, a fiduciary "must not have disabling conflicts of interest."[220] If there is such a conflict, the board must take affirmative steps to ensure the decision-making process is not tainted by the conflict.[221]

The Delaware courts will find corporate officers or directors to be in breach of the duty of loyalty if they: "(i) cause the corporation to engage in an interested transaction which is not entirely fair to the corporation;"[222] "(ii) profit from the use of confidential corporate information;"[223] "(iii) take any action solely or primarily to entrench themselves in office;"[224] or "(iv) otherwise place benefits to themselves or to affiliated entities ahead of benefits of the corporation."[225] The Delaware courts have generally considered a director fully independent only when his or her decision is solely based on the business merits of the transaction.[226] The traditional example of a breach of the duty of loyalty is when a fiduciary either appears on both sides of the transaction or collects a personal benefit that the corporation does not.[227]

3. Acting in Good Faith

There has been much debate about whether there is a separate duty of good faith.[228] Regardless, the duty of care and loyalty imbed the fiduciary duty of good faith.[229] It also

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218. Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 472 n.72 (2009) (citing *In re* Walt Disney S'holder Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) ("To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation."). Recent research finds that insiders stretch the legal boundaries while exploiting their private information, see Taylan Mavruk & H. Nejat Seyhun, *Do SEC's 10b5-1 Safe Harbor Rules Need to be Rewritten?*, 2016 COLUM. BUS. L. REV. 133, 179 (2016) (finding evidence that insiders exploit SEC trading plans to conduct informed trading undetected); S. Burcu Avci et al., *Manipulative Games of Gifts by Corporate Executives,* 18 PA. J. BUS. L. 1131 (2016).

219. Lafferty et al., *supra* note 208, at 844 (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).

220. *Id.* at 845

221. *Id.*

222. *Id.* (citing Cinemara, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167–68 (Del. 1995) and Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362–63 (Del. 1993)).

223. Lafferty et al., *supra* note 208, at 845, n.34 (citing Brophy v. Cities Serv. Co., 70 A.2d 5, 7–8 (Del. Ch. 1949) ("A fiduciary is subject to a duty to the beneficiary not to use on his own account information confidentially given him by the beneficiary or acquired by him during the course of or on account of the fiduciary relation or in violation of his duties as fiduciary, in competition with or to the injury of the beneficiary . . . unless the information is a matter of general knowledge.")).

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

225. *Id*. (citing Gantler v. Stephens, 965 A.2d 695, 706–08 (Del. 2009) and Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

226. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 751 (Del. Ch. 2005).

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

228. *See In re* Walt Disney, 907 A.2d at 745 (discussing the issue of good faith as separate of the duty of

goes beyond those duties, as it requires the fiduciary to take "all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."[230] The good faith requirement generally requires an "honesty of purpose" and genuine respect and care for the interests of the fiduciary's constituents.[231] The Delaware courts, however, presume that directors are acting in good faith;[232] thus, the corporate law jurisprudence tends to focus on the components of a claim of bad faith.[233]

The Supreme Court of Delaware has held that bad faith may be shown where the fiduciary 1) intentionally acts with a purpose other than that of advancing the best interests of a corporation, 2) acts with the intent to violate applicable positive law,[234] or 3) intentionally fails to act in the face of known duty to act, demonstrating a conscious disregard for his or her duties.[235] Other actions taken in bad faith "include any action that demonstrates a faithlessness or lack of true devotion to the interests of the corporation and its shareholders."[236] Furthermore, the reason for the failure to act in good faith does not matter.[237]

4. Duty of Disclosure

Although the Delaware courts have stated that there are no other fiduciary duties outside of the recognized duties of care, loyalty, and perhaps good faith, some

care and loyalty); *see also* Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("It does no service to our law's clarity to continue to separate the duty of loyalty from its own essence; nor does the recognition that good faith is essential to loyalty demean or subordinate that essential requirement. There might be situations when a director acts in subjective good faith and is yet not loyal (*e.g.*, if the director is interested in a transaction subject to the entire fairness standard and cannot prove financial fairness), but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally. . . . For example, one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 663 (Del. 1988) (finding that even if the directors acted in good faith, their actions "constituted an unintended violation of the duty of loyalty that the board owed to the shareholders" as it thwarted the franchise). *Cf.* Official Comm. Of Unsecured Creditors of Integrated Health Servs. V. Elkins, 2004 WL 1949290, at *9 (Del. Ch. Aug. 24, 2004) (discussing good faith arguments under both the duty of care and loyalty, and not as a separate duty).

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

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

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

232. *See* Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) (showing presumption of favor for directors in fixing terms and conditions of sale); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (stating there is a presumption of good faith for directors with no consideration of motive).

233. Delaware courts have been reluctant to include well-defined contractual standards of good faith and fair dealings into the corporate fiduciary duty context. *In re* Walt Disney, 907 A.2d at 753 n.449.

234. Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) (citing Miller v. AT&T, 507 F.2d 759 (3d Cir. 1974)); *see* Veasey, *supra* note 231, at 13 (stating that intentional violations of law implicate good faith).

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

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

237. *See* Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless."); *see also* Nagy v. Bistricer, 770 A.2d 43, 48 n.2 (Del. Ch. 2000) (stating that a director who disregards duty may suffer personal judgment for monetary damages for harm caused).

applications of these duties may include the duty of candor or disclosure.[238] Therefore, if there is a federal duty of disclosure, it must be understood in the context of the other fiduciary duties.[239] The duty of disclosure requires fiduciaries to disclose material information to shareholders.[240] This duty has been specifically articulated by the Delaware courts in cases where the board requests a shareholder vote on the matter at hand. For example, in *Turner v. Bernstein*, the court drew on a long list of cases and stated:

> The fiduciary duty of disclosure flows from the broader fiduciary duties of care and loyalty. That disclosure duty is triggered (*inter alia*) where directors . . . present to stockholders for their consideration a transaction that requires them to cast a vote and/or make an investment decision, such as whether or not to accept a merger or demand appraisal. Stockholders confronted with that choice are entitled to disclosure of the available material facts needed to make such an informed decision.[241]

This judgment and reasoning were recently affirmed by the Delaware Supreme Court in *Skeen v. Jo-Ann Stores, Inc.*,[242] where the court required that directors disclose all material facts within their control that a reasonable stockholder would consider important in deciding how to respond to the pending transaction.[243] Determining whether information is material is a fact-specific inquiry, wherein an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.[244]

Although the responsibility to disclose all material information is generally applied in the context of corporate mergers and acquisitions, it could have an impact on executive compensation grants insofar as they are approved by the shareholders. In this context, a director or officer may be in breach of the duty to disclose, as well as a duty of care, loyalty, or to act in good faith, when the shareholders vote on the compensation plan and

238. The duties may also include an analysis of the "Revlon" duties. *In re* Walt Disney, 907 A.2d at 745 n.400.

239. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995) ("A combination of the fiduciary duties of care and loyalty gives rise to the requirement that 'a director disclose to shareholders all material facts bearing upon a merger vote . . . .'" (quoting Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993))); *see also* Stroud v. Grace, 606 A.2d 75, 84–88 (Del. 1992) (noting that the duty of candor "represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action"). *Cf.* Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1287 (Del. 1994) ("[C]laims alleging disclosure violations that do not otherwise fall within any exception are protected by Section 102(b)(7) and any certificate of incorporation provision . . . adopted pursuant thereto.").

240. Lafferty et al., *supra* note 208, at 849.

241. Turner v. Bernstein, 776 A.2d 530, 542, (Del. Ch. 1999) (quoting Turner v. Bernstein I, No 16190, 1999 WL 66332, at *15–16 (citing, inter alia, Cinerama, Inc. v. Technicolor, 663 A.2d 1156, 1163 (Del. 1995)); *see* Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (stating that directors have a duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action).

242. Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1171 (Del. 2000).

243. Lafferty et al., *supra* note 208, at 848–49.

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

are not provided with all material information to make an informed decision. In either case, this duty to disclose sheds light on a general policy that shareholders should not be misguided about information that they must approve through a vote.

B. Standard of Review

Delaware courts apply two primary standards of review to cases involving fiduciary duties in corporate transactions: the business judgment rule and the entire fairness standard. The business judgment rule is a court-established default presumption that, "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[245] Therefore, the doctrine[246] protects the ability of corporate directors to make business decisions on behalf of the corporation without facing personal liability. The rule fights against the risk-averse nature of directors and pushes them to make difficult calls that they believe in good faith to be beneficial for the corporation and its shareholders, albeit potentially risky.

The rule is a deferential standard of review. The Delaware courts will generally refrain from imposing their judgment upon the business and affairs of a corporation when the board's decision can be attributed to a rational business purpose.[247] The rule establishes a presumption that the business decision made by the directors should not be substantively reviewed by the courts, so long as certain preconditions exist.[248] A plaintiff may overcome the business judgment rule by demonstrating that the directors breached their fiduciary duties of care or loyalty.[249] If the plaintiff is not able to do so, he or she is not entitled to any remedy unless the action is considered to be waste.[250]

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245. Ryan v. Gifford, 918 A.2d 341, 357 (Del. Ch. 2007) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)); *see* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (noting the lower court found the company acted in the best interest of stockholders); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1372–73 (Del. 1995) (outlining the business judgment doctrine); Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (defining "bad faith" as a transaction attempting something besides advancing corporate welfare); Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias,* 73 OR. L. REV. 587, 613–16 (1994) (discussing protection afforded to directors via the business judgment rule).

246. The doctrine has been defined as "the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors . . . . The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors." *Van Gorkom*, 488 A.2d at 872.

247. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005) (stating the understanding that "courts are ill equipped to engage in post hoc substantive review of business decisions").

248. The business judgment rule is a complicated doctrine and is often expressed in vague terms. The Delaware courts often explain the rule as "a *presumption* that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812 n.245) (emphasis added).

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

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

Traditionally, the rule applies to directors that are reasonably informed, disinterested and independent, as well as acting in good faith.[251] The presumption applies to cases where there is no evidence of "fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment" by the directors.[252] The rule does not apply, however, to directors who made an "uni[n]telligent and unadvised judgment."[253] Furthermore, directors who have not exercised business judgment due to inaction are also not protected by the rule.[254]

An issue regarding the business judgment rule also arises in cases where the independence of the board is questionable.[255] Specifically, a board's decision will not receive the benefit of deference under the business judgment rule where self-interested directors (1) constitute a majority of the board;[256] (2) control or dominate the board as a whole;[257] or (3) fail to disclose their interest in the transaction to the whole board, an interest which a reasonable board member would regard as having a significant effect on those directors' evaluation of the transaction.[258] Even under these circumstances, however, the business judgment rule is applied where procedural formalities and safeguards are utilized, such as special committees, stockholder approval, or even partial review of the action by a court.[259]

Compensation decisions are generally afforded the protection of the business judgment rule. Yet, in *Weiss v. Swanson*,[260] for example, the court acknowledged that the rule "applies to the directors' grant of options pursuant to a stockholder-approved plan only when the terms of the plan at issue are adhered to."[261] Therefore, when there is

251. *Van Gorkom*, 488 A.2d at 872.

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

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

254. Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) ("[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment.").

255. *Id.*

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

257. This is especially true in relation to takeovers, as the board members may be self-interested in maintaining their positions to the disadvantage of the shareholders' interests. *See* Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962) ("We must bear in mind the inherent da[n]ger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult."). For example, the Delaware Supreme Court held that the business judgement rule may be available in the context of hostile takeovers, but the burden of proof shifts to the defendants to show that the directors reasonably perceived the threat to the company and that the directors' responses were proportionate to that threat. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (discussing Cheff v. Mathes, 199 A.2d 548, 554–55 (Del. 1964)).

258. Lafferty et al., *supra* note 208, at 846.

259. *Id.* at 847.

260. Weiss v. Swanson, 948 A.2d 433 (Del. Ch. 2008).

261. *Id.* at 441.

evidence to support an "inference that the directors intended to violate the terms of stockholder-approved option plans," the business judgment rule is rebutted.[262]

There is another standard that may apply in certain instances. When executives or directors are engaged in related-party transactions—where, for example, a majority of the directors approving the transaction are interested parties— the transaction may be subject to the entire fairness standard of review.[263] In the absence of arm's-length bargaining, executives are obligated to disclose these transactions and seek approval by an independent committee of the board.[264] If the executive fails to obtain independent approval, the burden is to show that the transaction is entirely fair.[265] To satisfy this burden, the executive must demonstrate "to the court's satisfaction that the transaction was the product of both fair dealing [i.e., process] and fair price [i.e., substance]."[266] Notably, a major obstacle in all derivative actions is the "demand" requirement, under which a shareholder must first make demand on the corporation's board of directors before challenging a decision, giving it the opportunity to determine whether pursuing the action is in the best interest of the corporation.[267] In Delaware, a plaintiff may overcome a failure to make demand under Rule 23.1 by pleading with particularity why demand would be futile.[268] The courts apply two different tests depending on who made the decision being challenged. If the plaintiff's challenge is to a decision made by the board, the plaintiff must satisfy the *Aronson* test.[269] The plaintiff satisfies this test by alleging facts that raise a reasonable doubt that (1) a majority of the board is disinterested or independent, or (2) the challenged action was otherwise the product of the board's valid business judgment. When a plaintiff challenges a decision not made by the board of directors, however, a different test (known as the "*Rales* test") applies. In these circumstances, a plaintiff must "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." [270]

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262. *Id.*

263. Narayanan et al., *supra* note 4, at 1623.

264. *See, e.g.*, Stegemeier v. Magness, 728 A.2d 557, 562 (Del. 1999) (holding a transaction is not voidable when approved by committee of disinterested directors); Schock v. Nash, 732 A.2d 217, 225 n.21 (Del. 1999) (maintaining a safe harbor for directors from allegations of self-dealing); Oberly v. Kirby, 592 A.2d 445, 466–67 (Del. 1991) (noting approval by disinterested directors can bring decision within scope of business judgment).

265. *See, e.g.*, *Oberly*, 592 A.2d at 466–67 (stating if directors show entire fairness, decision is protected from challenge by stockholders); *Stegemeier*, 728 A.2d at 562 (noting directors must prove entire fairness if transaction is not approved by disinterested directors); President & Fellows of Harv. Coll. v. Glancy, 2003 Del. Ch. LEXIS 25, 69 (Del. Ch. Mar. 21, 2003) (stating that invoking fairness requires allegations of facts regarding the interests and lack of independence of board members).

266. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 2005) (emphasis omitted).

267. *See generally* Carole F. Wilder, *The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits*, 5 PACE L. REV. 633 (1985) (citing the demand rule as a longstanding procedural rules prior to a derivative action).

268. MARC J. LANE, REPRESENTING CORPORATE OFFICERS, DIRECTORS, MANAGERS, AND TRUSTEES § 3-118 (2d ed. 2013). A majority of states have this futility exception to the demand requirement, but a growing number of "universal demand" states have abolished this exception, e.g., ARIZ. REV. STAT. § 10-742 (1996); CONN. GEN. STAT. § 33-722 (2011).

269. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

270. The situation may arise in three ways: when a plaintiff challenges a decision made by directors who no longer sit on the board, where the decision at issue was made by a body or committee other than the board,

C. Fiduciary Duty Implications of Options Manipulation

1. Backdating

Options backdating does not comply with the abovementioned fiduciary duties due to the dishonest, manipulative, and self-serving nature of the act. Especially considering this practice is meant to enrich the executive at the expense of the company as a whole, and shareholders in particular, it stands in complete contrast to the ideal expressed through these fiduciary duties. It is not surprising that a number of scholars have suggested that options backdating is a result of weak corporate governance practices in corporations.[271]

The board of directors may be implicated in breaching fiduciary duties where backdating has occurred. Increasing or decreasing executive compensation, including through options backdating, is within the board's right so long as it is disclosed properly to the shareholders.[272] The board is protected by the business judgment rule which will shield these decisions against liability in most cases, unless it can be proven that the board acted in bad faith or there was a conflict of interest.[273] The business judgment rule does not apply, however, where the board violates its fiduciary duties through deception to the company and shareholders.[274] Additionally, board members may be implicated if they knew of or should have known that executives were changing the dates of the option grants without approval and took no action.[275]

In *Ryan v. Gifford*, the plaintiff contended that the board of directors of Maxim Integrated Products, Inc. (Maxim), a California computer chip manufacturer, actively approved Maxim's compensation committee's backdating of option grants issued to the former Chairman and CEO.[276] The complaint alleged that these approvals contravened the Maxim shareholder-approved stock option plan, which prohibited the granting of options at exercise prices below the closing price on the date of the grant, and that the directors made false representations regarding the option dates in public filings.[277] Notably, "the plaintiff had not alleged specific facts showing actual backdating by the committee," relying instead on a report by Merrill Lynch which stated "that each of the challenged grants was made on a date on which Maxim's stock traded at unusually low . . . trading days of the year in question, or on days immediately preceding sharp increases in the market price of the stock."[278]

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and where "the decision being challenged was made by the board of a different corporation." Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993). The *Rales* test may be satisfied when "the potential for liability is not a 'mere threat' but instead may rise to a 'substantial likelihood.'" *Id.* at 936.

271. *See, e.g.*, Daniel W. Collins et al., *Corporate Governance and Backdating of Executive Stock Options*, 26 CONTEMP. ACCT. RES. 403, 403 (2009); *see also* Narayanan et al., *supra* note 4, at 1639–40 (suggesting corporate governance reforms to curb dating games).

272. Narayanan et al., *supra* note 4, at 1618.

273. *Id.*

274. *Id.*

275. *Id.* (citing *In re* Caremark Int'l, 698 A.2d 959, 970–71 (Del. Ch. 1996)).

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

277. *Id.* at 342.

278. MILBANK CLIENT ALERT, *Delaware Chancery Court Takes On Stock Option "Backdating" and "Spring-Loading*,*"* (Millbank, Tweed, Hadley & McCloy, New York, N.Y.), Feb. 28, 2007, at 1 http://www.milbank.com/images/content/7/0/706/022807-DEChancery-Backdating-and-Springloading.pdf [*hereinafter* MILBANK].

In denying the defendants' motion to dismiss in *Ryan*, the court held that "the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith."[279] The court further held that allegations of intentionally misleading conduct were sufficient to rebut the business judgment rule.[280]

Importantly, *Ryan* indicates that evidence of options backdating would overcome the demand futility requirement. The court held that making demand would have been futile on directors who knowingly violated the company's stock option policy and then issued false disclosures to conceal the practices from shareholders and the SEC.[281] According to the court, "[b]ackdating options qualifies as one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"[282]

In *Desimone v. Barrows*, the Delaware Chancery Court dismissed backdating claims against the directors in a shareholder derivative suit for, among other reasons, failing to meet the "demand" requirement and, as to grants made to outside directors, for failure to state a claim.[283] The corporation, Sycamore Networks, Inc., had "essentially admitted" in public filings that options had been backdated, and "the options were represented to the public as having been issued at fair market value, when in fact they were issued at a price lower than the fair market value that prevailed as of the dates of the Grants."[284] Three categories of grants were made: grants to non-officer employees, grants to executive officers, and grants to outside directors.[285] With respect to non-officer employee option grants, the court found that the complaint failed to allege facts relating to "the key issues of who approved the Employee Grants and whether any of the directors knew that options were being backdated," and thus, there was insufficient basis to conclude that the Sycamore board "faces a substantial threat of liability" with respect to this category of demands, so the plaintiff's failure to make a demand was not excused.[286] Notably, the "stockholder-approved option plans contemplated delegation of the option-granting function to non-director executive officers," and most of the backdating was done by a single executive officer and actively hidden from the board and auditors.[287] Unlike the shareholders in *Ryan*, the plaintiff could not allege that any of the directors knowingly approved improperly-backdated options, and thus, demand was not excused.[288] Thus, in order for a backdating claim to succeed against directors, it is necessary for the plaintiffs to show that the board was either complicit in the behavior or should have known what was going on under a *Caremark* analysis.

279. *Ryan*, 918 A.2d at 358.
280. *Id.*
281. *Id.* at 355–56.
282. *Id.* at 355–56 (quoting Aronson v. Lewis, 473 A.805, 815 (Del. 1985)).
283. Desimone v. Barrows, 924 A.2d 908, 914 (Del. Ch. 2007).
284. *Id.*
285. *Id.* at 913.
286. *Id.* at 914.
287. *Id.*
288. The court stated that demand could be excused if the allegations created "a rational inference that the directors knowingly approved backdated grants of options, realizing that the corporation would deceptively account for them to investors and regulatory authorities as having been made at fair market value on the date of issuance, demand would be excused, consistent with the *Ryan* decision." *Desimone*, 924 A.2d at 915.

Scholars have suggested that boards implement controls to monitor stock option backdating and other manipulative practices of stock prices. Some ways to safeguard against these practices are to prohibit unanimous written consent for approval of option grants and single-person compensation committees.[289] In addition, conflicts of interest should be avoided.[290] We provide further proposals in Part VI below.

2. Spring-Loading and Bullet-Dodging

Some scholars have argued that the business judgment rule should not apply to spring-loading decisions because the high potential for abuse ought to warrant "a less deferential stance to protect shareholder interests."[291] The business judgment rule presumes that directors make informed decisions; however, officers are usually better informed about corporate performance. Hence, officers have a conflict of interest in disclosing certain information to the directors, including timing of stock option grants.[292] If plaintiffs show that the directors were not independent and well-informed when making these decisions, the rule does not prohibit judicial review.

In *Weiss v. Swanson*,[293] the plaintiff alleged that certain former and current directors of a company issued 22 spring-loaded and bullet-dodged option grants.[294] The options were granted in accordance with the stockholder-approved option plans, but the majority of the grants were "made in conjunction with quarterly earnings releases," and "the Director Defendants approved grants before positive releases and after negative releases."[295] Therefore, the court could infer that these particular directors granted spring-loaded and bullet-dodged options.[296] The court stated, "it is reasonable to infer that stockholders would consider the practice of timing options described in the complaint to be important in deciding whether to approve the option plans or to reelect board members."[297] Furthermore, because the defendants did not disclose the practice in the plans, subsequent proxy statements, or SEC filings, "the allegations . . . give rise to an inference that the Director Defendants, in violation of their fiduciary duties, intended to circumvent the restrictions found in the plans."[298] Hence, the court held the plaintiff succeeded in establishing reasonable doubt that the option grants were a product of a business judgment exercise.[299]

The *Hoover* court also noted that "[a] director does breach his duty of loyalty if he knows that the company has been defrauded and does not report what he knows to the board or to an appropriate committee of the board, at the very least when he is involved in the fraud and keeps silent in order to escape detection."[300] Thus, spring-loading, where

289. Narayanan et al., *supra* note 4, at 1619.
290. *Id.*
291. Hughes, *supra* note 119, at 792.
292. *Id.*
293. Weiss v. Swanson, 948 A.2d 433 (Del. Ch. 2008).
294. *Id.* at 441.
295. *Id.* at 443.
296. *Id.* at 442–44.
297. *Id.* at 443.
298. *Weiss*, 948 A.2d at 443.
299. *Id.* at 441–48.
300. Hoover Industries, Inc. v. Chase, 1988 WL 73758, at *2 (Del. Ch. 1988).

the director knows material nonpublic information, while keeping other board members in the dark, amounts to fraud and breach of duty of loyalty.[301]

In *In re Tyson Foods, Inc*. (*Tyson I)*, the Delaware Chancery Court held that spring-loading can give rise to a breach of fiduciary duty claim.[302] The *Tyson I* shareholders alleged that the directors approved the compensation committee's spring-loading of option grants in violation of the shareholder-approved stock option plan.[303] The complaint alleged that, on several occasions, the compensation committee had awarded options shortly before the corporation issued press releases containing favorable information, foreseeably leading to increases in the price of the company's stock.[304] The court first observed that "[w]hether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating;" whereas "all backdated options involve a fundamental, incontrovertible lie" in falsifying the date of option grant, "[a]llegations of springloading implicate a much more subtle deception" because the spring-loaded options are set at the market price on the date of the grant, which does not explicitly violate stock option plans.[305]

Nevertheless, the court concluded that "[g]ranting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception," and a board of directors breach their duty of loyalty when they distribute shares to managers "in such a way as to undermine the very objectives approved by shareholders" in a shareholder-approved option plan.[306] In effect, the court focused on the purpose of the shareholder-approved plan rather than the technical requirements. According to the court, even if a director authorized options with a market-value strike price in compliance with a shareholder-approved incentive option plan, the director may have acted in bad faith if at the time he or she knew that the shares were worth more than the exercise price.[307] Furthermore, if the directors at the time of the grants were aware of material nonpublic positive information, then they would have known that they were granting options with exercise prices that were less than the actual value of the underlying shares on the date of grant.[308] The court observed that, in spring-loading cases, the impropriety is not simply in granting an option that is, in practical effect, immediately in the money (an action that, in some circumstances, could be a legitimate exercise of business judgment) but, rather, in the accompanying deception of shareholders.[309]

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

302. *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 603 (Del. Ch. 2007).

303. *Id.* at 592.

304. *Id.* at 576.

305. *Id.* at 592.

306. *Id.*

307. *In re Tyson Foods*, 919 A.2d at 593.

308. Milbank, *supra* note 278.

309. *In re Tyson Foods*, 919 A.2d at 592 n.75 ("The touchstone of disloyalty or bad faith in a spring-loaded option remains deception, not simply the fact that they are (in every real sense) 'in the money' at the time of issue. A board of directors might, in an exercise of good faith business judgment, determine that in the money options are an appropriate form of executive compensation. Recipients of options are generally unable to benefit financially from them until a vesting period has elapsed, and thus an option's value to an executive or employee is of less immediate value than an equivalent grant of cash. A company with a volatile share price, or one that expects that its most explosive growth is behind it, might wish to issue options with an exercise price below the current market value in order to encourage a manager to work hard in the future while at the same time providing compensation with a greater present market value. One can imagine circumstances in which

The court concluded that the grant of spring-loaded options may, under certain limited circumstances, constitute a breach of fiduciary duty.[310] Such a grant is beyond the protection of the business judgment rule if the awards are made pursuant to a shareholder-approved plan and if the directors who approved the allegedly spring-loaded grants: (a) possessed material information soon to be released that would affect the company's share price; and (b) issued the options intending to circumvent shareholder-approved restrictions on their exercise price.[311]

The complaint in *Desimone v. Barrows*,[312] discussed above regarding the implications for backdating, also alleged claims against the board of directors of Sycamore for spring-loading and bullet-dodging by the executive officers.[313] Although the court noted the size of the grants and the identities of the recipients indicated that decisions about the officer grants were less likely to have been delegated to non-director executive officers, the allegations did not support an inference that "the board or even the Compensation Committee was likely to have driven details like the precise date of issuance of the Grants."[314] With respect to the spring-loading allegations, the court sought to distinguish *Tyson I* by focusing on the differences in the directors' knowledge of and involvement in the timing of the option grants in the two cases.[315] According to the court, although both *Tyson I* and *Desimone* involved officers receiving options just before a positive announcement, the plaintiff in *Desimone* did not "plead facts that suggest that members of the Sycamore board approved the . . . Officer Grants with knowledge of corporate information that, if made public on the date of the Grants, would have increased the fair market value of the corporation's stock."[316] In *Tyson I*, "the plaintiffs pled a multi-year pattern of large grants occurring at random times of year that preceded large, market-moving announcements," whereas the plaintiff in *Desimone* only pled that the corporation made officer grants two weeks before a far less impactful positive announcement.[317] Furthermore, the grants in *Desimone* "were subject to a three-year vesting schedule with sharp restrictions on pledging the options received."[318] Finally, two of the officers on Sycamore's board of directors owned a significant portion of the company, yet received none of the options in dispute, a fact that "powerfully undercut[s] any inference that the board itself had a motive to make its executive officers fat at the expense of the stockholders."[319]

The *Desimone* court also pointed out that, in contrast with the facts in *Ryan*, the stockholder-approved plan under which the officer and employee grants had been made explicitly permitted the issuance of in-the-money stock options.[320] As to bullet-dodging, the court opined that, insofar as bullet-dodging did not violate the terms of the

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

310. *Id.* at 593.
311. *Id.*
312. Desimone v. Barrows, 924 A.2d 908, 944 (Del. Ch. 2007).
313. *Id.*
314. *Id.* at 915.
315. *Id.* at 916.
316. *Id.* at 916.
317. *Desimone*, 924 A.2d at 916.
318. *Id.*
319. *Id.* at 917.
320. *Id.* at 930–31.

stockholder-approved agreement, such allegations are unlikely ever to support a claim for relief other than, in extreme circumstances, a claim for corporate waste (if approved by independent and disinterested directors) or self-dealing (if approved by interested or controlled directors).[321]

A third category of option grants was made to Sycamore's outside directors. As to the claims relating to grants to interested directors, the court noted that demand was excused and the pivotal issue was whether the complaint stated a claim upon which relief could be granted.[322] Those grants had been made under a shareholder-approved plan setting the amounts and dates of option grants to directors over a multiyear period.[323] Because the allegations of the complaint raised no inference of manipulation or impropriety, the court dismissed the claims relating to the outside director grants for failure to plead facts upon which relief could be granted.[324]

The *Desimone* court also addressed directors' oversight obligations under the *Caremark* standard. The court refined the requirement of cognitive culpability by saying that "directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care."[325] According to the court, *Caremark*:

> [P]lainly held that director liability for failure to monitor required a finding that the directors acted [in bad faith] . . . because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance.[326]

This is a very high burden of persuasion, and liability will not reach the director who simply fails to use due care in attending to her business and responsibilities.

In ruling on a subsequent motion in the *Tyson* litigation (*Tyson II*),[327] the court sharpened the distinction with *Desimone*. The *Tyson II* decision, issued August 15, 2007, denied the motion by outside director defendants for summary judgment.[328] The court examined its earlier refusal to dismiss the claim in *Tyson I*, and in light of the "more clearly delineated" allegations with respect to the current motion, altered the basis for allowing plaintiffs' claim to proceed.[329]

In their motion for judgment on the pleadings, defendants argued that the allegedly spring-loaded options were "nonqualified stock options," which *Tyson I*'s compensation committee could make exercisable at any price, as authorized under the company's

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

322. *Desimone*, 924 A.2d at 917.

323. *Id.*

324. *Id.* at 916–917.

325. *Id.* at 935.

326. *Id.*

327. *See In re* Tyson Foods, Inc. Consol. S'holder Litig., No. 1106-CC, 2007 Del. Ch. LEXIS 120 at *1 (Del. Ch. Aug. 15, 2007) (stating that this opinion is based on a subsequent motion in the *Tyson* litigation).

328. *Id.* at *19.

329. *Id.* at *3.

shareholder-approved stock option plan (in contrast to plaintiffs' previous claims).[330] The court accepted this assertion, finding it confirmed by a review of the stock option plan and *Tyson I*'s proxy statements.[331] The assertion appeared to invalidate the premise upon which the defendant's motion to dismiss had been denied: that the options "may have been issued 'with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options.'"[332] Rather than compel the granting of defendants' motion, however, the absence of such restrictions shifted the analysis to broader ground.

According to the court, the question addressed in *Tyson I* was the relatively narrow one of "whether a grant of spring-loaded options could be within the bounds of the Compensation Committee's business judgment in the face of a shareholder-approved agreement explicitly requiring a market value strike price."[333] But in light of the "more clearly delineated" allegations in *Tyson II*, the court indicated that the test stated in *Tyson I* for determining whether spring-loading is beyond the protection of the business judgment rule was possibly "couched in too limited a manner."[334] To overcome the business judgment rule, it may not be absolutely necessary to allege an implicit violation of a shareholder-approved stock incentive plan with respect to spring-loading; rather, a reasonable inference "that a board of directors later concealed the true nature of a grant of stock options" suffices to find a fiduciary breach of loyalty.[335] Thus, under *Tyson II*, the adequacy of company disclosures about the award of spring-loaded options is key in determining whether a fiduciary duty was breached. In the instant case, the court found the defendants' disclosures regarding the challenged options did:

> [N]othing to rebut the pleading stage inference that the defendants intended to conceal a pattern of unfairly stocking up insiders' larders with option grants shortly before the announcement of events likely to increase the Company's stock price.[336] In fact, the magnitude and timing of the grants, when accompanied with no disclosure of the reasons motivating the grants, is suggestive . . . of a purposeful subterfuge.[337]

The court also insisted that the *Tyson I* defendants' persistent failure to disclose the motivations for the stock option grants made the case distinguishable from *Desimone*.[338] The *Tyson II* court found that its conclusions were consistent with two hypothetical scenarios discussed by the *Desimone* court[339] because both hypotheticals "assume that the board of directors has revealed their strategy to shareholders in complete and utter

330. *Id.* at *2.
331. *Id.* at *6–7.
332. *Tyson Foods, Inc.*, 2007 Del. Ch. LEXIS 120, at *2.
333. *Id.* at *8.
334. *Id.* at *14.
335. *Id.* at *14–15.
336. *Id.* at *18.
337. *Tyson Foods, Inc.*, 2007 Del. Ch. LEXIS 120, at *18.
338. *Id.* at *15–17.
339. *Id.* at *16.

candor. In the absence of a shareholder-approved plan, the board clearly discloses in the merger proxy that these grants are rewards for exemplary service."[340]

VI. PROPOSAL FOR REFORM

Our evidence shows that executive option grants show distinct signs of manipulation during the 2008–2014 period. It has been nearly ten years since 2006 when the scandals broke regarding the backdating of executive stock option grants.[341] As discussed above, numerous firms have been sued in civil and criminal courts with settlements amounting to millions of dollars. In addition, the SEC has instituted new reporting requirements to prevent any future manipulations. Despite all this effort, corporate executives appear to be still benefiting from manipulating their option grants.

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

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

VII. CONCLUSION

In this study, we found that executives still continue to manipulate their option grants. We show that, despite all the reforms in response to the backdating scandal of 2006, manipulation of options is still too tempting and continues to this day.[342] Our evidence shows that executives employ a variety of manipulative devices to increase their compensation, including backdating, bullet-dodging, and spring-loading. Although each of these practices in isolation may have a small marginal impact on their compensation, together, these practices unfairly tilt the balance in executives' favor in a meaningful way. Overall, we find that as a result of these manipulative devices executives are able to increase their compensation by about 6% in the 2008–2014 period.

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

340. *Id.*

341. *See* Thomsen, *supra* note 1 (discussing the SEC's ongoing investigation into potential stock option and enforcement plan abuse).

342. *Id.*

Our recommendation calling for daily allocation of option grants is a simple regulatory reform that should put an end to executive option dating and timing games once and for all. As discussed above, option dating and timing games raise serious issues under federal securities laws and state fiduciary duties. Under our proposal, executives would no longer benefit from any of the dating and timing games documented in our study. Any backdating, spring-loading, bullet-dodging, or any other game that benefits one option will necessarily hurt the other options. This modest proposal, if implemented, should go a long way toward eradicating this illicit, self-serving behavior in accordance with the intent of federal securities laws and state fiduciary duty obligations.