

Legal Updates & News

Bulletins

Complaint Dismissed – Delaware Court Issues Significant Backdating Decision

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On June 7, Vice Chancellor Strine of the Delaware Chancery Court issued a significant 75-page decision in a stockholder's derivative action alleging stock option manipulation. See *Desimone v. Barrows*, C.A. No. 2210-VCS (Del. Ct. Ch. June 7, 2007) ("Sycamore Networks"). This decision is important for at least two key reasons: (1) it sets a high bar for plaintiffs to plead a derivative case; and (2) it casts serious doubt on two theories derivative plaintiffs have been asserting in stock option cases.

The Court, which dismissed plaintiff's complaint for failure to make a demand on the board and failure to state a cause of action, confirmed that under Delaware law, plaintiffs will be required to plead demand futility and stock option timing manipulation with a high degree of particularity. The Court also suggested that claims for breach of fiduciary duty based on "spring loading" (the practice of intentionally timing option grants to occur shortly before the release of good news to the market) and "bullet dodging" (the process of awarding grants shortly after the public disclosure of bad news) were unlikely to succeed absent unusual facts.

Demand Futility

To be allowed to bring a derivative case, a plaintiff must show either that he has first demanded that the board of directors initiate action, or alternatively show that demand was futile. Vice Chancellor Strine confirmed that plaintiffs must provide particulars when claiming that demand was futile – specifically, that a majority of the board received tainted options or "face[d] a substantial threat of personal liability" relating to improper option grants. In *Sycamore Networks*, the plaintiff could not make either showing.

The plaintiff attempted to show that a two-member compensation committee was, because of its role, likely to be involved in the options granting process. But the Court found that plaintiff's "vague and conclusory statement" that the stock option incentive plan was administered by the Compensation Committee "did not suggest in any way that the Compensation Committee was involved in or had knowledge of any backdating." Plaintiff failed to plead facts "about whether and to what extent any director was involved in the mechanics by which options were issued, or the dates on which administrative tasks were carried out."

The plaintiff also argued that compensation or audit committee members could be liable for simply failing to uncover backdating. The Court rejected this approach as well, holding that a plaintiff had to plead: (1) facts to show that directors consciously knew wrongdoing was occurring but chose to look the other way; or (2) facts "suggesting that the board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing . . ." According to the Court, plaintiff failed to meet these requirements.

Failure To State A Claim Against Directors or Officers

The Court noted that to survive a motion for failure to state a claim based on timing manipulations, "a complaint alleging breach of fiduciary duty must plead facts supporting an inference of a breach, not simply a conclusion to that effect." A plaintiff must also plead facts to suggest "a culpable state of mind" on the part of each individual director. Facts, not conclusory allegations, are required.

The Court found that plaintiff failed to plead any fact suggesting that any defendant (director or otherwise) “knowingly approved backdated options” or consciously abdicated his duty to monitor the management of the corporation. For example, the Court noted that “[p]laintiff admits that he ha[d] no idea how, when, or by whom the Officer Grants were issued.” Lacking such facts, plaintiff could not allege that any individual had breached any duty with respect to those grants.

The Court likewise expressed doubt that alleged “spring loading” and “bullet dodging” could violate a duty to the corporation where it was not clearly prohibited by the company’s stock option plan. The Court rejected plaintiffs’ spring loading claim, finding not only that plaintiff had failed to plead facts from which it could infer that any of the directors had positive inside information at the time the grants were made, but also questioning whether such spring loading, if true, could ever be material, noting that even if the announcement caused the stock price to spike, “the announcement would not have been likely to have had a substantial effect on the stock’s trading price months later when the first of the options vested . . .” — a point which could easily be extrapolated to backdating as well.

The Court also rejected plaintiff’s bullet dodging claim, holding that even if grants were intentionally awarded after the release of a negative quarterly earning report which caused the stock price to go down, such conduct did not violate Sycamore’s option plan which required only that grants be made on a fair-market-value basis. The Court noted that it may have reached a different result had the stock option plan required “non-discretionary, regularly-scheduled option grants.”

Standing

Plaintiff’s efforts to recover for stock option grants made before he owned stock in Sycamore Networks were also denied. Generally, for a plaintiff to have “standing” to bring a derivative action on behalf of the corporation, he must show that he owned stock in the corporation at the time of each alleged corporate wrong. Plaintiff’s theory that he had “standing to challenge all the grants because some of the later grants he challenge[d] follow a similar pattern of behavior as those that occurred before he owned the stock” was rejected. Holding that “the complaint actually challenges a number of discrete stock option transactions that were completed the moment the grants were issued,” the Court refused plaintiff’s invitation to convert the series of grants into a “continuing wrong” extending into the period in which he held the stock.

Vice Chancellor Strine’s self-described, “cautious, non-generic approach” to addressing the particularity required for plaintiffs to plead option timing manipulations, as well as his willingness to consider whether, and under what circumstances, spring loading and bullet dodging even constitute a breach of fiduciary duty, are likely to have a major impact on the thinking of courts throughout the country. This is particularly true with respect to courts outside of Delaware, which may have felt constrained by the more lenient pleading standards applied by earlier Delaware decisions.