
United States Commercial Law Seminar

Masaryk University

April 11-21, 2011

Lecture Three:

***Duties and liability of officers and
directors; shareholder derivative actions***

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Readings

1. *Ryan v. Gifford*, 918 A.2d 341 (2007)
2. *In re Caremark Int'l Inc. Deriv. Litig.*,
698 A.2d 959, 967 (Del. Ch. 1996)
3. Shareholder Derivative Complaint,
White v. Jung (Avon Products)

“The Perfect Payday”

The Perfect Payday

Some CEOs reap millions by landing stock options when they are most valuable. Luck -- or something else?

By CHARLES FORELLE and JAMES BANDLER
March 18, 2006; Page A1

On a summer day in 2002, shares of Affiliated Computer Services Inc. sank to their lowest level in a year. Oddly, that was good news for Chief Executive Jeffrey Rich.

His annual grant of stock options was dated that day, entitling him to buy stock at that price for years. Had they been dated a week later, when the stock was 27% higher, they'd have been far less rewarding. It was the same through much of Mr. Rich's tenure: In a striking pattern, all six of his stock-option grants from 1995 to 2002 were dated just before a rise in the stock price, often at the bottom of a steep drop.



What is a STOCK OPTION?

A stock option gives an employee the right to buy shares in the future at the market price on the date a grant is approved. If the stock rises, exercise, sell and make a profit.

Grant date – June 30 >> \$10.00/share market price

1,000 options granted, vesting over 4 years

All exercised at the end of Year 4 >> employee pays \$10,000.

Sold on the same day, \$25.00/share >> employee receives \$25,000

Gain >> \$15,000

Who was doing it?

140 Companies under Federal investigation; 70 executives lost jobs and 10 face federal or state criminal charges.

Numerous SEC investigations.

- ❑ **KLA-Tencor** – Settled with 3 city/state pension plans for \$65 million
- ❑ **Brocade** – Settled with the SEC for \$7M and CEO Greg Reyes convicted and sentenced to 21 months in prison
- ❑ **Monster Worldwide** – Deferred prosecution for terminally ill former CEO

Backdating of Executive Stock Options (ESO) Grants

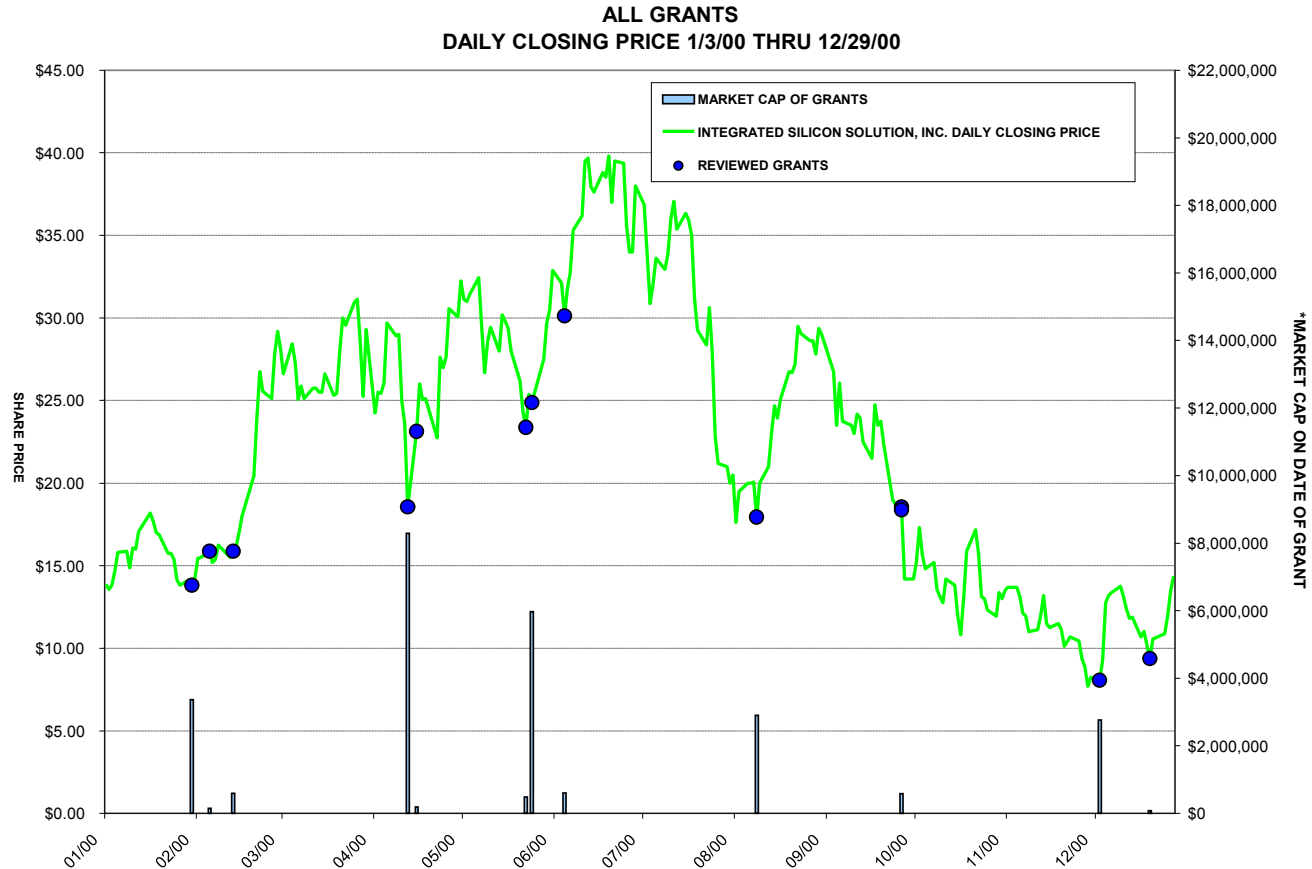


Stock Option Backdating: Ethical and Accounting Challenges

Rick Fezell, Ernst & Young
Kirk Hanson, Markkula Center for
Applied Ethics, SCU

V-Charts – “The pictures were telling us a story” - WSJ

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* MARKET CAPITALIZATION OF GRANTS WAS CALCULATED BY MULTIPLYING THE CLOSING MARKET PRICE ON THE RESPECTIVE GRANT DATE BY THE NUMBER OF SHARES ISSUED.

What is BACKDATING?

Backdating is selecting a date prior to the actual grant when the stock price was lower, thus increasing the award's value.

Grant date – June 30 >> \$10.00/share market price

“Backdated” grant date – May 19 >> \$6.00/share

1,000 options granted, vesting over 4 years

All exercised at the end of Year 4 >> employee pays \$6,000.

Sold on the same day, \$25.00/share >> employee receives \$25,000

Gain >> \$19,000

How Was Backdating Detected?

- ❑ Academics, analysts and news organizations. The WSJ won a Pulitzer Prize for its investigative reporting, which began in March 2006 – *The Perfect Payday*
- ❑ *Affiliated Computer Services CEO - all six of his stock-option grants from 1995 to 2002 were dated just before a rise in the stock price, often at the bottom of a steep drop. Just lucky? A Wall Street Journal analysis suggested the odds of this happening by chance are extraordinarily remote -- around one in 300 billion.* The odds of winning the multistate Powerball lottery with a \$1 ticket are one in 146 million.
- ❑ Maybe insider trading? No, the SEC eventually came to "an increasing realization that the companies were in fact lying about the timing of the grants."

Why Was it Done?

- Intense competition for employee talent
- Non-cash – nobody cares and nobody gets hurt
- Everyone else does it

Duty of Care (Lack of Oversight)

- ❑ Leading case: *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).
- ❑ “Possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”
- ❑ “Absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company’s behalf.” *Id.* at 969.
- ❑ “Only a sustained or systematic failure of the board to exercise oversight – such as an *utter failure* to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability.”

Shareholder Derivative Suits

- ❑ Brought by shareholder of a corporation on its behalf
- ❑ Typically brought against company's most senior officers and directors
- ❑ Suits are authorized by state statutes
- ❑ “Demand futility” hurdle

Duty of Loyalty

- ❑ “Acts taken in bad faith breach the duty of loyalty.” *Ryan v. Gifford*, 918 A.2d at 357.
- ❑ Bad faith may be shown where
 - “the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation”
 - “where the fiduciary acts with the intent to violate applicable positive law,” or
 - “where the fiduciary intentionally fails to act in the face of known duty to act, demonstrating a conscious disregard for his duties.”
- ❑ *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006)
- ❑ Under many state statutes, directors are immunized from liability for a breach of the duty of loyalty, so long as it does not involve:
 - intentional misconduct
 - knowing violation of the law, or
- ❑ a transaction from which they would receive undue personal benefit.

Business Judgment Rule

- *Ryan v. Gifford*:
 - “The business affairs of a corporation are to be managed by or under the direction of its board of directors.”
 - “In an effort to encourage the full exercise of managerial powers, Delaware law protects the managers of a corporation through the business judgment rule.”
 - “This rule ‘is 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 interest of the company.’”
- Presumption can be rebutted by evidence of:
 - Bad faith
 - Intentional wrongdoing
- Action for personal gain