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Opportunity Knocks, but the SEC Answers: Examining the Manipulation of Stock Options Through the Spring-Loading of Grants and Rule 10b-5

Jonathan J. Tompkins*

INTRODUCTION

Gone are the days when lavish compensation and executive malfeasance surprised the average shareholder.¹ What typified the extravagant bonus payments made to officers and managers—namely corporate tobacco executives—starting in the 1930s intensified tremendously in the 1980s, in no small part due to the economic

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1. See MARK A. SARGENT & DENNIS R. HONABACH, PROXY RULES HDBK. § 4:1 (2006); see also Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 784–85 (2002) (questioning the actions of executives who use their power to influence compensation boards to grant them more favorable types of compensation). Coverage of the recent scandals, which intensified during the summer of 2006 after the release of some eye-catching academic studies, a number of SEC speeches, and the adoption of new rules regarding executive compensation and disclosure, has still not let up. See Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005); Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271, 271–95 (2007); Christopher Cox, Chairman, Sec. & Exch. Comm'n Speech Addressing SEC Open Meeting (July 26, 2006), available at <http://www.sec.gov/news/speech/2006/spch072606cc.htm>; Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Speech Before the Int'l Corporate Governance Network 11th Annual Conference (July 6, 2006), available at <http://www.sec.gov/news/speech/2006/spch070606psa.htm>; see also SEC Final Rule: Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158 (effective Sept. 8, 2006), available at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>; see, e.g., Ben Stein, *Has Corporate America No Shame? Or No Memory?*, N.Y. TIMES, Oct. 29, 2006, § 3, at 3 (critiquing the evolution of corporate America as an atmosphere increasingly lacking integrity and responsibility as its executives lobby “to keep themselves at the trough,” bathe in lavish compensation packages, and, most of all, contribute to ongoing corporate scandals).

uncertainties of the time.² Stock options, initially created to align managerial and stockholder interests, have become the primary reason for the tremendous disparity in compensation across corporate officeholders.³ This Note sheds light on the issues surrounding deceptive stock options trading practices, namely spring-loading, and suggests that this practice, albeit imperfect, is legally justifiable.

Spring-loading is nevertheless worthy of greater caution in a business market rife with deception, fraud, and scandal.⁴ The safeguard perhaps best suited for this practice is, in the end, simply a matter of greater disclosure to the shareholders. Also, a more thorough understanding of the rules and regulations currently protecting investor confidence, along with strict Securities and Exchange Commission (“SEC” or “Commission”) enforcement, ultimately should serve as the best preventative medicine. Further, a company’s board of directors (“board”) must recognize that deference to its business judgment, while respected, is not simply a shroud meant to protect it unconditionally, and abuse of such deferential treatment can indeed have dire consequences for the corporation.⁵

Part I of this Note discusses the nature and practice of granting stock options as an alternative basis for compensating company executives, and introduces a number of practices and related controversies involving the manipulation of stock option grant dates.

Part II discusses current securities laws and regulations that have direct implications on controversial manipulation practices, namely spring-loading, their relationship to one another, and the concept of insider trading.

2. SARGENT & HONABACH, *supra* note 1, § 4:1.

3. *Id.* The purpose underlying stock option grants was to offer a motivational incentive to directors of a business by linking executive pay with company performance. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138–53. Pioneered by venture capitalists over forty years ago, optimists hoped that stock options “would result in a new owner class of employees who would be given an incentive to maximize the value of the company’s stock.” Atkins, *supra* note 1.

4. See generally *infra* notes 16–26 and accompanying text.

5. See WALL ST. J., Options Scorecard, <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html> (last visited Apr. 28, 2008) (listing of over one hundred companies that have already “disclosed government probes, misdated options, restatements and/or executive departures.”).

Part III examines the legality of spring-loading under federal securities laws, rules and regulations, and court opinions on insider trading. Part IV examines recommended changes in the granting of stock options and proposes a solution of additional disclosure to shareholders of information regarding a board's stock grant practices. Further guidance from the SEC in the form of new rules and regulations mandating more thorough disclosure to shareholders, or clarifying existing rules and regulations, on issues relating to spring-loading may also be necessary.

I. THE RISE OF STOCK OPTION AWARDS

A. *Stock Options: The Birth of a New Breed of Executive Compensation*

Stock options are simply “option[s] to buy or sell a specific quantity of stock at a designated price for a specified period regardless of shifts in market value during the period.”⁶ Upon the actual purchase at a specified price, generally referred to as the “exercise” or “strike” price,⁷ the recipient is said to have “exercised” the option.⁸ By allowing the recipient (“grantee”) of options to exercise them at a pre-determined price, the grantee is presumed to have greater incentive to pursue long-term growth prospects for the firm, which translates into greater corporate profits.⁹ However, this mode of compensation has not been without critics.¹⁰

6. BLACK'S LAW DICTIONARY 1459 (8th ed. 2004). Note that “stock option” encompasses incentive stock options (“ISOs”) as well as employee (or “executive”) stock options (“ESOs”). *Id.*; see also *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 504 (3d Cir. 1988) (“The option contract gives its owner the right to buy (call) or sell (put) a fixed number of shares of a specified underlying stock at a given price (the striking price) on or before the expiration date of the contract.”).

7. See, e.g., BLACK'S LAW DICTIONARY 1227 (8th ed. 2004). This is generally the price at which the owner of an option can purchase (“call”) or sell (“put”) the underlying stock. *Id.*; see also The Options Industry Council, Options Glossary, <http://www.888options.com/help/glossary> (last visited Apr. 28, 2008).

8. See BRUCE R. ELLIG, THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION 301, 357 (2002).

9. *Id.* at 357–58.

10. See Jensen & Murphy, *supra* note 3, at 149 (“Stock options are an increasingly important component of executive compensation packages, and their value relates directly to changes in share price. However, holding a stock option does not provide the same incentives as

Compensation decisions at the executive level typically rest with the board.¹¹ The board, however, is often free to delegate its responsibilities to committees, such as a compensation committee.¹² The compensation committee, charged with the ultimate responsibility of administering option-based compensation packages for its employees, can have considerable discretion as to the timing of such grants.¹³

Accordingly, corporate executives are finding new and interesting ways to capitalize on corporate incentive plans, especially in recent years, through the opportunistic timing of option grants.¹⁴ However, just because there's smoke surrounding many of these practices does not mean there's fire—especially with regard to the practice that regulators and others have coined “spring-loading.”¹⁵

owning a share of stock—a distinction sometimes overlooked by compensation practitioners.”). See also Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got Here, What Are the Problems, and How to Fix Them* 18–29 (Harvard Bus. Sch., Working Paper No. 04-28, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305 (follow up article written by, among others, Jensen and Murphy, nearly fifteen years after their 1990 article, noting that the compensation contracts in corporate America “have become so extreme and so abusive that they call into question the integrity of important parts of the remuneration process and the fiduciary responsibilities of boards and remuneration committees.”).

11. See, e.g., MODEL BUS. CORP. ACT §§ 2.05, 3.02 (1984) (noting that every corporation shall hold an organizational meeting to elect a board of directors and describing the corporation's general power to fix the compensation of directors, officers, employees, and agents of the corporation).

12. See, e.g., DEL. CODE ANN. tit. 8, § 141(c) (2006).

13. See Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835, 843 (2004) (“A non-periodic [stock option] award . . . can be made at any time the compensation committee selects. Consequently, the timing of these awards is subject to discretion.”).

14. For a discussion regarding how certain corporate practices of recent years have effectuated a new breed of securities law and an argument for further use of a strong-SEC model of enforcement, see Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 784 (2006) (“‘Timing opportunism’—the tendency of companies to bestow stock options upon officers immediately before good news is disclosed or after bad news is disclosed—is not only widespread and increasing, but also more common in companies in which directors receive a larger proportion of their pay in the form of options.”) (citing Gretchen Morgenson, *Are Options Seducing Directors, Too?*, N.Y. TIMES, Dec. 12, 2004, at BU1).

15. “Spring-loading” is the act of granting stock options immediately preceding the release of potentially positive news, thereby influencing the value of the company's stock. See *infra* note 38 and accompanying text; see also *Backdating to the Future*, WALL ST. J., Oct. 12, 2006, at A18. The ball is still up in the air as to whether the practice known as “spring-loading” is illegal. *Id.* There has been recent case law, however, that bodes well for proponents of the practice. See *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007); *In re Computer Sciences*

B. Scandals Involving Manipulation of Stock Option Grants Begin to Emerge

On September 6, 2006, the Senate Committee on Banking, Housing and Urban Affairs convened to discuss the manipulation of stock option grants provided to corporate employees.¹⁶ This issue had monopolized the time of SEC Commissioners and staff attorneys over the previous months and stimulated the government into action.¹⁷ What emerged was one of the “broadest corporate scandals in decades,”¹⁸ which has, to date, placed over one-hundred companies under federal scrutiny for potential securities violations.¹⁹ Among

Corporation Derivative Litigation, No. CV 06-05288, 2007 WL 1321715 (C.D. Cal. Mar. 26, 2007); Tyson Foods, Inc., 919 A.2d 563 (Del. Ch. 2007).

16. The SEC, numerous academics, members of the Justice Department, stock analysts, newspaper reporters, and daily commentators quickly coined particular terms for the practice of manipulating stock option grants, namely “backdating,” “spring-loading,” and “bullet-dodging.” See, e.g., Angela G. Savino & Russell A. Witten, *Timing of Option Grants and Directors’ and Officers’ Liability*, N.Y. L.J., July 28, 2006, at col.4.

17. See *Stock Options Backdating: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs* [hereinafter *S. Comm. Hearing*], 109th Cong. (2006) (statement of Sen. Richard C. Shelby, Member, S. Comm. on Banking, Hous., and Urban Affairs), available at <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=a249d197-312a-46c2-8da3-3b504efeb589>; see also Andrew Clark, *Academic Rocks Corporate America by Revealing Boardroom Reward Ploys*, GUARDIAN (London), July 10, 2006.

Dr. [Erik] Lie, a 37-year-old academic who has enlivened his personal website with the Viking cartoon Hagar the Horrible, . . . sent his work to the [SEC], which described it as ‘interesting.’ Since then, the SEC has interviewed him and, with the [U.S. DOJ], has opened a wide-ranging inquiry into the way options are handled.

Id. See also John C. Coffee, Jr., *The Dating Game*, 29 NAT’L. L.J., Sept. 4, 2006, at col.1, in which Coffee, professor at Columbia University Law School, suggests that as the backdating scandals shrink under the spotlight, other practices, including the “selective release of positive and negative information in order to whipsaw the corporation’s stock price” (referring to spring-loading) will become a “more promising tactic that leaves far fewer footprints.” *Id.*

18. James Bandler & Kara Scannell, *In Options Probe, Private Law Firms Play Crucial Role*, WALL ST. J., Oct. 28, 2006, at A1.

19. *Id.* At this point, the scrutiny has intensified to such a degree that the SEC and other federal authorities have found it necessary to outsource a large part of their investigatory work to law firms. *Id.* Over 150 companies have, to date, reported internal probes into possible stock option manipulation schemes, at least 130 of those companies are facing federal investigation, at least 42 executives and directors have resigned, including 10 Chief Executive Officers, 5 of these executives have been charged criminally with federal securities violations, with one of those (Gregory Reyes) being convicted after a criminal trial, and nearly 70 companies have admitted overstating balance sheet profits by \$5.3 billion due to misdated options. *Id.*; see also Options Scorecard, *supra* note 5; Economist, Aug. 9, 2007 ed., at Business 54 (noting that as of August 9, 2007, sixteen executives at eight firms have been charged criminally, and alluding to

those that have most noticeably found themselves caught in the SEC's net of enforcement are Brocade Communications Systems, Inc.,²⁰ Comverse Technology, Inc.,²¹ Analog Devices, Inc.,²² Home Depot, Inc.,²³ Apple, Inc.,²⁴ and Cyberonics, Inc.²⁵ Investigations into

the possible prosecution of Apple, Inc.'s own Steve Jobs). The Wall Street Journal also won the Pulitzer Prize for public service on April 16, 2007 for its investigative journalism with regard to the stock options scandal. Katharine Q. Seelye and James Barron, *The Wall Street Journal Wins 2 Pulitzer Prizes*, N.Y. TIMES, Apr. 17, 2007, at B8.

20. Brocade Communications Systems, Inc. is one of the few companies that the SEC has filed formal charges against. See Complaint, SEC v. Reyes et al., (No. C 06 4435), available at <http://www.sec.gov/litigation/complaints/2006/comp19768.pdf> Brocade settled with the SEC, however, on May 31, 2007, paying fines of \$7 million for its alleged role in backdating options. See N.Y. TIMES, *infra* note 177. Interestingly enough, Gregory Reyes, former Chief Executive Officer of Brocade, was found guilty on August 7, 2007 of ten counts of conspiracy and fraud in San Francisco federal court over his improper backdating of stock options, making Reyes the first CEO to be convicted after a full criminal trial since this broad enforcement cleanup began. See Karen Gullo, *Former Brocade Chief Convicted in Backdating Fraud*, BLOOMBERG.COM, Aug. 7, 2007, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=axrdiw3I4dmk&refer=home>. Reyes was later sentenced on January 16, 2008 to twenty-one months in prison and ordered to pay a fine of \$15 million. Jordan Robertson, *Ex-Brocade CEO Sentenced to 21 Months*, FOXNEWS.com, available at <http://www.foxnews.com/wires/2008Jan16/0,4670,BrocadeStockOptions,00.html> The case is U.S. v Gregory Reyes, 06-0556, U.S. District Court, Northern District of California (San Francisco). See also Peter Lattman, *Jury Finds Brocade Ex-CEO Guilty on Backdating Charges*, WALL ST. J., Aug. 7, 2007 (noting how the conviction of Reyes was an important indicator of whether juries feel backdating is worthy of prison time, and speculating on further probes to come).

21. Comverse Technology, Inc. involves an even more pervasive attempt by corporate management to manipulate the executive compensation system, and provides, arguably, an even better story. Charles Forelle et al., *A Fugitive's Haven in Africa Turned Out to be Anything But*, WALL ST. J., Sept. 28, 2006, at A1. Kobi Alexander, the Chief Executive Officer of Comverse, disappeared in July, 2006 after getting wind of the SEC's formal probes of the leading telecom software producer. *Id.* In Sept., 2006, Alexander was found and arrested in Nambia. *Id.* Alexander, while he currently remains free on bail, awaits extradition to the United States where he faces a thirty-two count indictment for his alleged role in an ongoing scheme of backdating options unlawfully. See *'Kobi' Alexander Extradition Case Postponed*, Reuters, June 8, 2007, available at <http://www.cnbc.com/id/19107264>; see also *Alexander Extradition Proceeding Postponed; Former Comverse CEO Arrested in September*, INT'L HERALD TRIB., Feb. 25, 2008 (Alexander's new extradition hearing is currently set for June 26, 2008).

22. Floyd Norris, *They Deceived Shareholders. Who Cares?*, N.Y. TIMES, Oct. 6, 2006, at C1. In late 2005, the SEC appeared poised to pounce on Analog Devices over spring-loaded options that had been granted just prior to its 1999 and 2000 releases of favorable financial results. *Id.* However, after the company announced that it had reached a tentative settlement with the SEC, the case collapsed and the settlement was never completed for reasons yet unknown. *Id.*

23. See Options Scorecard, *supra* note 5.

24. See Nick Wingfield & Steve Stecklow, *Apple's Options Probe Could Raise Conflicts*, WALL ST. J., Oct. 11, 2006, at A3; Holman W. Jenkins, Jr., *A Typical Backdating Miscrime*, WALL ST. J., Oct. 11, 2006, at A15; Options Scorecard, *supra* note 5. Apple's own CEO, Steve

the current scandals continue to this day, and there is no telling when the SEC or Justice Department will deem its job complete.²⁶

The committee hearing on September 6th was preceded by the adoption of new SEC rules requiring public companies to disclose thoroughly their awards of in-the-money options²⁷ to executives.²⁸ During the hearing, Senators heard from numerous individuals on the issues of stock options backdating²⁹ and spring-loading,³⁰ including SEC Chairman Christopher Cox, who has been particularly outspoken on what he believes are nothing more than “poisonous”

Jobs, however, “has so far escaped any direct prosecution by federal regulators.” Nicholas Rummell, *Backdating Action Ebbing for Enforcers: Despite Monster’s Rearing its Ugly Head, the Scandal Over Option Grant Rigging is Seen Ending With a Whimper*, FINANCIALWEEK.COM, May 5, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080505/REG/500788054>.

25. See S. Comm. Hearing (statement of Christopher Cox, Chairman, Sec. & Exch. Comm’n), available at <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=a249d197-312a-46c2-8da3-3b504efeb589>; Alix Nyberg Stuart, *The Spring-loaded Options Trap*, CFO MAGAZINE, Sept. 1, 2006, available at <http://www.cfo.com/article.cfm/7851837>.

26. See Options Scorecard, *supra* note 5. The Wall Street Journal continues to update the extensive list of companies currently under SEC and Justice Department scrutiny for past stock-option grant practices. *Id.* See also Catherine J. Serafin & Andrew M. Reidy, *Taking Stock*, CORPORATE COUNSEL, Nov. 2006, available at <http://www.law.com/jsp/cc/previousIssuesTOC.jsp> (follow “Click to see November 2006 Table of Contents” Hyperlink; then follow “Taking Stock” hyperlink). See also Gullo, *supra* note 20. The conviction of Reyes on August 7, 2007, and his later sentencing on January 16, 2008, may well pave the way for an onslaught of criminal prosecutions and push current investigations forward. *Id.*; *But see* Rummell, *supra* note 24; Holman W. Jenkins, Jr., *One Last Backdating Whipping Boy?*, WALL ST. J., Apr. 30, 2008, at A15 (expressing doubts as to the appropriateness of bringing criminal charges without some national standards for prosecuting backdating cases). Most recently, Monster Worldwide Inc.’s former president and COO, James J. Treacy, was charged in federal court with securities fraud and conspiracy in connection with backdating stock options. Mark Maremont & Kevin Kingsbury, *Ex-President of Monster Is Charged: Treacy is Accused of Having Hand in Backdating Plan*, WALL ST. J., May 1, 2008, at C3. Additionally, the SEC brought charges against two former Monster executives, including Treacy, for their alleged participation in secretly backdating stock options. Press Release, Sec. & Exch. Comm’n, SEC Charges Two Former Monster Worldwide Executives for Backdating Options (Apr. 30, 2008), available at <http://www.sec.gov/news/press/2008/2008-68.htm>.

27. “In-the-money” options are those in which the options’ strike price, or the stated share price for which underlying stock may be purchased (“call”) or sold (“put”) by the option grantee upon exercise of his option contract, is below the market price of the underlying asset. See, e.g., BLACK’S LAW DICTIONARY 1127–28 (8th ed. 2004).

28. See SEC Final Rule, *supra* note 1.

29. See S. Comm. Hearing, *supra* note 25 (statement of Erik Lie, Assoc. Professor of Fin., Univ. of Iowa).

30. *Id.*

and deceptive practices that disrupt investor confidence.³¹ Despite the recognition that there are currently no black-letter legal definitions for these various manipulative practices, Congress may postpone establishing new legislation³² because the SEC appears already to have sufficient enforcement mechanisms in place.³³ Regardless of whether Congress decides to introduce more clarity into the current law, the SEC stands poised to continue its ongoing investigations into the manipulative practices of public companies: namely the

31. Christopher Cox, Chairman, Sec. & Exch. Comm'n, Remarks at Press Conference on Actions Against Brocade Communications Systems (July 20, 2006), available at <http://www.sec.gov/news/speech/speecharchive/2006speech.shtml>.

[O]ptions backdating strikes at the heart of investor confidence in our capital markets. It deceives investors and the market as a whole about the financial health of companies that cheat in this way. It understates a company's compensation expenses and overstates the company's income. It is poisonous to an efficient marketplace. The [SEC] is committed to bringing it to an end nationwide.

Id. Although Chairman Cox's remarks are well-taken, many would likely oppose his blanket statements regarding backdating's "poisonous" nature. *See, e.g., infra* notes 81–83 and accompanying text. Interestingly enough, even Chairman Cox acknowledges that backdating, in some circumstances, is perfectly legal. *See S. Comm. Hearing, supra* note 25 (statements of Sen. Jim Bunning, Member, S. Comm. on Banking, Hous., and Urban Affairs, & Christopher Cox, Chairman, Sec. & Exch. Comm'n).

32. *See S. Comm. Hearing, supra* note 31 (statements of Sen. Jim Bunning, Member, S. Comm. on Banking, Hous., and Urban Affairs, & Christopher Cox, Chairman, Sec. & Exch. Comm'n):

Bunning: . . . Should backdating be prohibited?

Cox: Well, that's entirely dependent on whether Congress has first defined what it means by backdating, since, at least under present circumstances, *not only is backdating in some cases legal, but what we all think we agree on when we talk about backdating is, sort of, ill defined.* . . .

Bunning: Well, that's the question: Should we define it?

Cox: . . . [I]f . . . we agreed that it was unethical, injurious to shareholders, violated our norms of disclosure and so on; then, I think a statutory prohibition, although it may be belts and suspenders, would be completely in order.

Id. (emphasis added).

33. *See S. Comm. Hearing, supra* note 25 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n). Cox notes later in his testimony before Senator Allard that although "backdating thus far is not defined in the law, . . . [the SEC is] able to use preexisting legal concepts without difficulty in these cases." *Id.* In fact, he states that "all of the elements of backdating that make it abusive and illegal backdating are clearly defined in the law right now . . . [s]o I don't think we have any trouble bringing these cases." *Id.* This, however, is not to say that spring-loading can be dealt with under current law. *See Norris, supra* note 22 and accompanying text.

backdating, spring-loading, and bullet-dodging of executive option grants.³⁴ What follows is a brief discussion of these individual practices.

Backdating has been adopted as the pet-name for manipulating the date of stock option grants to inflate artificially the exercise price of the options, which allows the recipient of the options to receive an immediate windfall.³⁵

It is not too difficult to see why many individuals, including members of the SEC, have labeled the practice objectionable and unethical, if not outright illegal.³⁶ However, a consensus has developed—even among academics who originally exposed the scandals—that the practice of backdating stock option grants is not illegal per se as long as certain conditions are met: (a) the executive compensation documents must not be fraudulent; (b) the practice must be clearly communicated to the company's shareholders; (c) the premium must be properly reflected in the company's earnings statements; and (d) the premium must be properly reflected in the company's taxes.³⁷

Spring-loading is the act of granting stock options preceding the release of potentially positive news, which may influence the value of the company's stock.³⁸

34. See *supra* notes 16–26 and accompanying text.

35. See, e.g., Erik Lie, *Backdating of Executive Stock Option (ESO) Grants*, <http://www.biz.uiowa.edu/faculty/elielie/backdating.htm> (last visited Apr. 28, 2008). As an example, if Company A's board of directors wishes to retain a particular CEO, it may draft an agreement whereby the CEO, also the options grantee, is issued on Dec. 1, 2007, an option to purchase 250,000 non-qualified shares, exercisable at a date on which the price was \$50. However, if Company A's stock is trading at \$85/share as of Dec. 1, 2007, the grant date, what the company has done is backdate the strike price of the options to a point in the past where the price was particularly low, thereby allowing the CEO to profit simply because the prescribed exercise price was not set equal to the stock price on the grant date. For all intents and purposes, the CEO just received an instant premium of \$35/share. Because the exercise price predates the grant price, thereby providing the grantee an instant premium, these grants are designated "in-the-money." See *supra* note 27. Conversely, grants in which the strike price is set equal to the stock price on the grant date are referred to as "at-the-money" grants. See, e.g., BLACK'S LAW DICTIONARY 1226 (8th ed. 2004).

36. See Cox, *supra* note 31.

37. See Lie, *supra* note 35.

38. *Id.* To provide an example, suppose again, that Company A's board of directors wishes to retain a particular CEO, so it drafts an agreement whereby the CEO, also the options grantee, is issued on Nov. 29, 2007 an option to purchase 250,000 shares of Company A's stock at the closing price on that day of \$50/share. However, the board does so with the knowledge

Bullet-dodging is the term that has been used to describe the act of granting stock options after the release of negative news in order to prevent a loss in value of the equity in the underlying security for the option.³⁹

While backdating has received arguably more widespread attention than the other two practices, the legalities of spring-loading appear to be more nuanced and open to interpretation given existing statutory law, SEC rules and regulations, and common law developments over the past half-century. Accordingly, historic developments in the law of securities will provide the blueprints necessary for a proper analysis of spring-loaded option grants.

II. HISTORY IN THE MAKING: A PERSPECTIVE ON INSIDER TRADING LAW AS IT RELATES TO THE GRANTING OF STOCK OPTIONS

A. *The Rise of Securities Regulation Laws*

Federal regulation of securities transactions is not a novel concept in American law.⁴⁰ In addition to finding historical context in the laws of England,⁴¹ federal securities laws in the United States initially developed primarily out of an effort to bring uniformity to the many conflicting philosophies embodied in state regulatory schemes.⁴² In fact, it took the wave of early corporate reforms and ultimately the

that it plans on voting on a share repurchase agreement that is likely to pass on Dec. 1, 2007. The chance, therefore, of an upsurge in stock price is fairly strong. After the Dec. 1 announcement, the stock of Company A rises to \$55/share. If the CEO were to exercise his options that day (although it is very unlikely that the options agreement would allow such a move), he would receive an immediate bonus of \$5/share.

39. *Id.*; Eric Dash, *Spring-Loading*, N.Y. TIMES, Dec. 24, 2006, § 4 (describing “bullet-dodging” as “the delaying [of] an options grant until just after the release of bad news to take advantage of an expected lower price.”).

40. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1 (5th ed. 2003). “The Securities Act of 1933 did not spring full grown from the brow of any New Deal Zeus. It followed a generation of state regulation and several centuries of legislation in England.” *Id.* Indeed, the problems at which modern securities regulation is directed “are as old as the cupidity of sellers and the gullibility of buyers.” *Id.*

41. From the “Bubble Act” of 1720 to the Directors Liability Act of 1890, legislators pushed through Parliament a number of statutes designed to elicit heightened disclosure and limit acts of corporate fraud and scandal. See LOSS & SELIGMAN, *supra* note 40, at 2–3.

42. See Wisconsin Dep’t of Fin. Inst., *A Brief History of Securities Regulation*, <http://www.wdfi.org/fi/securities/regexemp/history.htm> (last visited Apr. 28, 2008).

abrupt end of the prosperous market of the 1920s, culminating in the stock market crash in October 1929, to precipitate the first of many federal securities laws.⁴³

Accordingly,⁴⁴ Congress adopted the Securities Act of 1933 (“Securities Act”),⁴⁵ followed by the Securities Exchange Act of 1934 (“Exchange Act”).⁴⁶ The Exchange Act created the first federal administrative securities enforcement body, the Securities and Exchange Commission.⁴⁷ Congress gave the SEC the general oversight responsibility of vigorously enforcing the laws of the federal legislature on issues relating to the securities industry.⁴⁸ The primary goals of this legislation were to “promote fair and full disclosure of all material information relating to the markets,”⁴⁹ as well as “[t]o provide fair and honest mechanisms for the pricing of securities [and] to assure that dealing in securities is fair and without undue preferences or advantages among investors.”⁵⁰ The improvident dealings of earlier investors were simply too much for the market to continue bearing their unsuspected costs.⁵¹

43. See LOSS & SELIGMAN, *supra* note 40, at 35; see also *infra* note 44.

44. For an interesting re-visitation on how a number of power brokers and other individuals brought sweeping changes to the American financial markets, see Lee Conrad et al., *One Hundred Fifteen Years of Innovation*, U.S. BANKER, May 1, 2006. Financial expert, Martin Mayer, explained that “[during] the last years of the 1920s, everything was pretty scandalous. Everybody rubbed everybody else’s backs.” *Id.*

45. The Securities Act of 1933 has also been referred to as the “Truth in Securities Act.” 15 U.S.C. §§ 77a–77aa (2006); U.S. Sec. & Exch. Comm’n Homepage, *Laws That Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml#secact1933> (last visited Apr. 28, 2008).

46. 15 U.S.C. §§ 78a–78j (2006).

47. 15 U.S.C. § 78d (2006).

48. Mark J. Astarita, *Introduction to the Securities Laws—The NASD, the SEC, the States, and Much More*, <http://www.seclaw.com/seclaw.htm> (last visited Apr. 28, 2008).

49. *Id.*

50. H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.), as reprinted in 1975 U.S.C.C.A.N. 321, 323.

51. H.R. REP. NO. 73-85, at 2–3 (1933). The country had witnessed what legislators concluded was a “complete abandonment of many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise,” and a “wanton misdirection of the capital resources of the Nation.” *Id.* See also LOSS & SELIGMAN, *supra* note 40, at 7. Scandals, with clear underpinnings of illegal and unethical practices, including corporate fraud, were not alone combated by the initial enactment of such laws. *Id.* In fact, Congress now administers eight statutes dealing with the regulation of securities. *Id.* at 45.

Many of the laws, however, proved to be fruitless in combating some of the largest abuses, including notable corporate and accounting scandals, which arose around the turn of the century.⁵² Notorious cases such as Enron and WorldCom were the necessary spark that ignited the gunpowder of public outcry and political recourse.⁵³ The Enron and WorldCom debacles fomented a new era of securities law and regulation, culminating in the Public Company Accounting Reform and Corporate Responsibility Act⁵⁴—otherwise known as the Sarbanes-Oxley Act (“SOX”)—the passage of which is lauded by many as the “single most important piece of legislation affecting corporate governance, financial disclosure, public accounting and regulators since the inception of U.S. securities laws in 1933.”⁵⁵ Two of the main goals SOX proposed to accomplish were greater corporate oversight and disclosure, as well as stricter liability

52. See, e.g., John Paul Lucci, *Enron—The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211 (2003) (arising from the lack of legal remedies supplied by existing laws, rules and regulations was the Sarbanes-Oxley Act, which has nevertheless had its own problems and difficulties, especially for foreign companies).

53. See, e.g., Thomas G. Bost, *Corporate Lawyers After the Big Quake: The Conceptual Fault Line in the Professional Duty of Confidentiality*, 19 GEO. J. LEGAL ETHICS 1089, 1102 (2006) (noting that the Sarbanes-Oxley Act was passed less than seven months after the Enron bankruptcy); ARTHUR LEVITT, TAKE ON THE STREET 150–52 (2003) (discussing how investors lost upwards of \$60 billion, and how approximately five-thousand Enron employees lost their jobs and some their entire retirement savings and pension plans). The problems created by the Enron debacle have left many of those individuals still looking for jobs. See Simon Romero, *Hard Times Haunt Enron’s Ex-Workers*, N.Y. TIMES, Jan. 26, 2006, at C. For more information relating to the Enron debacle, see BETHANY MCLEAN & PETER ELKIND, SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003).

54. Pub. L. No. 107-204, 116 Stat. 745 (2000) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2006)). The final bill was a result of Conference Committee reconciliation between the bills passed by Rep. Oxley (H.R. 3763) on April 25, 2002, by a vote of 334 to 90, and Senator Sarbanes (S. 2763) on June 18, 2002, by a vote of 17 to 4. JOHN T. BOSTELMAN, SARBANES-OXLEY DESKBOOK §§ 2–31 (2003). On July 25, 2002, both houses of Congress voted on the final bill with almost unanimous approval with votes of 423 to 3 in the House and 99 to 0 in the Senate. *Id.* The bill was signed into law by President George W. Bush on July 30, 2002 after he concluded that it contained “the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt.” Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1. The result of the final law was two separate certification sections, including a civil provision, Public Company Accounting Reform and Corporate Responsibility Act § 302, 15 U.S.C. § 7241 (2000), and a criminal provision, Public Company Accounting Reform and Corporate Responsibility Act § 906, 15 U.S.C. § 1350 (2000).

55. SARBANES-OXLEY COMPLIANCE JOURNAL, <http://www.s-ox.com/corp/subscribe.html> (last visited Apr. 28, 2008).

for securities fraud violations.⁵⁶ In addition, the SEC was hoping to align more effectively the interests of shareholders and directors.⁵⁷ Included in this broader notion of investor protection were further safeguards against what has been referred to as “insider trading.”⁵⁸

The concept of insider trading has both a unique and troubled history.⁵⁹ Prior to the enactment of the Securities Act, the government had no ideal way of combating securities fraud except by criminal prosecution through a violation of or conspiracy to violate the mail fraud statute.⁶⁰ The “grandfather” of SEC fraud provisions, section 17(a) of the Securities Act, paved the way for future regulation of improper officer profiting due to the use of inside information, including sections 9(a) and 10(b) of the Exchange Act,⁶¹ with the

56. See LOSS & SELIGMAN, *supra* note 40, at xxxv.

57. See Atkins, *supra* note 1. “The importance of having the interests of those who manage property on behalf of owners aligned with the interests of owners is a key thread underlying [SOX], which Congress adopted and the SEC implemented in the wake of the corporate scandals of the early part of [the twenty-first century].” *Id.* SOX “takes steps to strengthen the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders’ interests.” *Id.*

58. See Fin. Mgmt. Ass’n. Int’l. (FMA), *Insider Trading Post Sarbanes-Oxley: No Such Thing as a Free Lunch?*, <http://www.fma.org/SLC/Papers/InsiderTradingpaper011606.pdf> (last visited Apr. 28, 2008).

59. See Thomas C. Newkirk, Assoc. Dir. of Enforcement Div., Sec. & Exch. Comm’n, & Melissa A. Robertson, Senior Counsel of Enforcement Div., Sec. & Exch. Comm’n, *Insider Trading—A U.S. Perspective* (Sept. 19, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm>. Originally, section 16 of the Exchange Act, which dealt directly with insider trading, was the last of the provisions activated by registration. LOSS & SELIGMAN, *supra* note 40, at 675. However, an in-depth discussion of section 16, which was designed primarily to curtail short-swing speculation by corporate managers and directors in possession of information known only to these select insiders, is beyond the scope of this Note. Note also that section 16 applies only to directors or officers of the corporation and those holding greater than ten percent of the stock in the company. Newkirk & Robertson, *supra*.

60. 18 U.S.C. § 1341 (2006); see also 18 U.S.C. § 1343 (2006) (the analogous statute dealing with fraudulent interstate communications via wire, radio or television).

61. LOSS & SELIGMAN, *supra* note 40, at 902. Section 10(b) of the Exchange Act, states in part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) 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 as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2000) (emphasis added).

latter addressing the concept of insider trading indirectly.⁶² Section 10(b) of the Exchange Act prohibits the use of fraudulent schemes or devices in connection with the purchase or sale of securities.⁶³ To implement the statute, the SEC enacted Rule 10b-5,⁶⁴ providing the basis for the private cause of action for securities fraud.⁶⁵ Although the transgression of insider trading stems primarily from section 10(b) of the Exchange Act and Rule 10b-5,⁶⁶ defining the true embodiment of “insider trading” has remained a complicated and

62. See Newkirk & Robertson, *supra* note 59. In the context of section 10(b) of the Exchange Act, although the concept of insider trading only arises indirectly, this section is nonetheless the provision used most readily by the courts in determining violations under the Exchange Act. See, e.g., KATHLEEN F. BRICKEY, CORPORATE AND WHITE COLLAR CRIME 168 (4th ed. 2006) (“[I]nsider trading is neither defined nor expressly forbidden by statute or regulation. Instead, [courts] reach insider trading activities through a general antifraud provision, § 10(b) of the [1934 Act], together with SEC Rule 10b-5.”).

63. See *supra* note 61. See also *In re Cendant Corp. Sec. Litig.*, 76 F. Supp. 2d 539 (D. N.J. 1999); *Kennilworth Partners L.P. v. Cendant Corp.*, 59 F. Supp. 2d 417 (D.N.J. 1999); *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 47 F. Supp. 2d 546, 552 (D.N.J. 1999).

64. 17 C.F.R. § 240.10b-5 (2003).

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud, . . .

(c) To 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 the purchase or sale of any security.

Id. (emphasis added). The Rule was patterned after section 17(a) of the Securities Act. BNACPS No. 13-3 § IX, at 8; see also ARNOLD S. JACOBS, THE IMPACT OF RULE 10B-5 (rev. ed. 1997); ARNOLD S. JACOBS, 5 LITIGATION AND PRACTICE UNDER RULE 10B-5 § 3.01(d) (2d ed. rev. 1990); WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS 449 (6th ed. 2006) (noting that “§ 10(b) is not self-executing—it did not prohibit anything until the SEC adopted rules implementing it. Our attention therefore turns to Rule 10b-5—easily the most famous, and arguably the most important, of all the SEC’s many rules.”).

65. Although section 10(b) does not expressly provide for a private right of action, the Supreme Court has confirmed the existence of such a right. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (“Although § 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established.”); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *In re Cendant Corp. Litig.*, 60 F. Supp. 2d 354, 367–68 (D.N.J. 1999).

66. As Rule 10b-5 is coextensive with section 10(b) of the Exchange Act, each can be referred to interchangeably. See *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002).

arduous task for the courts.⁶⁷ No doubt, “[s]ecurities regulation remains a work in progress.”⁶⁸

B. A Body of Case Law Begins to Emerge

Insider trading predates the Securities Acts.⁶⁹ Before the corporate and accounting scandals of the late twentieth and early twenty-first centuries, the SEC anticipated a rebirth of insider trading that had plagued the SEC in the 1980s.⁷⁰ The steady enactment of laws poised to reduce the amount of corporate abuse in securities transactions, while contributing to significant legal milestones in defining the scope of 10b-5 insider trading violations,⁷¹ left the courts with broad discretion in defining what is meant by the term and what it necessarily encompasses.⁷² In fact, it is the breadth of the various anti-fraud provisions, most notably section 10(b) of the Exchange

67. Bruce Carton, *The Elusive Law of Insider Trading*, SEC. LITIG. WATCH, Aug. 10, 2004, http://blog.issproxy.com/slw_archive/2004/08/. “Although insider trading is sometimes loosely defined as any trading based on ‘material, nonpublic information,’ the legal definition flowing from case law is much more complicated and relies heavily on concepts such as fiduciary duty and the ‘familial duty of trust and confidence.’” *Id.* Carton also suggests that a “more direct use of the law to achieve society’s goals in this area would be for Congress to identify what is legal insider trading and what is not, and to articulate the distinction in a coherent statute.” *Id.*

68. LOSS & SELIGMAN, *supra* note 40, at 8.

69. *See* Newkirk & Robertson, *supra* note 59; *Strong v. Repide*, 213 U.S. 419 (1909) (holding that a director of a corporation who was aware that the value of his stock was primed to rise and who bought stock from an outsider without disclosing these material facts committed fraud).

70. “Today, we are seeing a resurgence of the insider trading of the 1980s. The United States is again experiencing a ‘merger mania.’” Newkirk & Robertson, *supra* note 59 (citing Oliver August, *Insider Dealing Returns Thanks to Merger Mania*, TIMES (London), August 17, 1998, Business Section).

71. *See* Newkirk & Robertson, *supra* note 59.

72. Robert C. Rosen, *An Accountant’s Guide to the SEC’s New Insider Trading Regulations (Accountant’s Liability)*, CPA JOURNAL, Feb. 1993, available at <http://www.nysscpa.org/cpajournal/old/13808667.htm> (“Despite the recent decline in hostile takeover and merger activity that so characterized the roaring 1980s, illegal insider trading in today’s market is still a key focus of SEC enforcement efforts, . . . [and] as one commentator aptly described it, insider trading is exceedingly ‘murky.’”). *See also* Newkirk & Robertson, *supra* note 59 (“[W]e have relied largely on our courts to develop the law prohibiting insider trading. While Congress gave us the mandate to protect investors and keep our markets free from fraud, it has been our jurists . . . who have played the largest role in defining the law of insider trading.”).

Act, that “leaves much room for interpretation and the flexibility to meet new schemes and contrivances head on.”⁷³

There is general consensus, however, that in order for a Rule 10b-5 violation to occur, a plaintiff must prove the following: (1) a misstatement or omission; (2) of a material fact; (3) with scienter; (4) in connection with the purchase or sale of a security; (5) upon which plaintiff reasonably relied; and (6) that reliance proximately caused injury to plaintiff.⁷⁴ There are generally two cited theories for establishing insider trading liability: one encompassing actions of true “insiders,”⁷⁵ while the other deals specifically with corporate “outsiders,”⁷⁶ including “tippees”⁷⁷ and “misappropriators.”⁷⁸ The “classical theory” of insider trading targets an insider’s breach of duty of loyalty to the shareholders with whom the insider transacts.⁷⁹ The “misappropriation theory” extends the rules against trading on the basis of material, nonpublic information to “outsiders.”⁸⁰

73. Newkirk & Robertson, *supra* note 59. Note, however, the Commission’s candid acknowledgment on the imperfections in this area— “[T]he development of insider trading law has not progressed with logical precision as the reach of the anti-fraud provisions to cover insider trading has expanded and contracted over time.” *Id.*

74. See *Kline v. First Gov’t Sec., Inc.*, 24 F.3d 480, 487 (3d Cir. 1994); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989) (citing *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 942–43 (3d Cir. 1985)).

75. A true “insider” is defined as a “person who has knowledge of facts not available to the general public.” BLACK’S LAW DICTIONARY 810 (8th ed. 2004).

76. As opposed to a true “insider,” an “outsider” does not stand in any particular fiduciary relationship with the company whose stock is being traded, nor do they have any particular inside knowledge of the company’s operations and information by nature of their position. See, e.g., *United States v. O’Hagan*, 521 U.S. 642 (1997). However, this is not to say that an “outsider” is unable to violate Rule 10b-5 based on the newly adopted theory of misappropriation. *Id.* at 642–44.

77. A “tippee” is defined as a “person who acquires material nonpublic information from someone in a fiduciary relationship with the company to which that information pertains.” BLACK’S LAW DICTIONARY 1522 (8th ed. 2004). For a specific discussion of “tippee” liability for 10b-5 violations, see *Dirks v. SEC*, 463 U.S. 646 (1983). See also George F. Gabel, Jr., *Who May Be Liable Under “Misappropriation Theory” of Imposing Duty to Disclose or Abstain from Trading Under § 10(b) of Securities Exchange Act of 1934 and SEC Rule 10b-5 (17 CFR § 240-10b-5)*, 114 A.L.R. FED. 323 (1993).

78. See *O’Hagan*, 521 U.S. at 652 (“The ‘misappropriation theory’ holds that a person . . . violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”).

79. *Id.* at 652–53; see also Gabel, *supra* note 77, at 323 (1993) (“The classical theory of ‘insider trading’ provides that a person violated Rule 10b-5 by buying or selling securities on the basis of material, nonpublic information.”).

80. *O’Hagan*, 521 U.S. at 652–53 (The “misappropriation theory outlaws trading on the

Insider trading laws, however, are not without their critics.⁸¹ There is a camp of experts who argue that insider trading is a long-standing, effective, and legitimate form of compensating corporate employees, which has the ultimate goal of benefiting shareholders.⁸² In fact, some argue that penalizing or prohibiting the practice can ultimately harm shareholders.⁸³ The SEC recently recognized the burdens financial penalties tend to impose on shareholders—the very people penalties are designed to protect.⁸⁴ Perhaps one of the biggest criticisms leveled against insider trading regulation involves its relative subjectivity. Before any individual can be found guilty of a 10b-5 securities fraud violation, the SEC must prove the “standing” requirement that the infraction took place “in connection with the purchase or sale of any security.”⁸⁵ Many critics point to this as the ultimate intellectual bankruptcy of insider trading regulation—some people who do have inside knowledge may nevertheless benefit from having such material, non-public information.⁸⁶ Lastly, arguments

basis of nonpublic information by a corporate ‘outsider’ in breach of a duty owed not to a trading party, but to the source of the information.”).

81. A number of notable practitioners in the field of securities and antitrust law have argued that strict reliance on antifraud provision in these Acts may result in the unfair penalization of traders whose conduct comes close to the amorphous line that separates illegality from legality. Dennis J. Block & Jonathan M. Hoff, *Renewed Interest in Defining Insider Trading*, N.Y. L.J. June 14, 1990, at 5, 5 (1990). See also Steve Thel, *Section 20(d) of the Securities Exchange Act: Congress, The Supreme Court, the SEC, and the Process of Defining Insider Trading*, 69 N.C. L. REV. 1261 (1991) (“Not everyone thinks insider trading is unfair . . . and even if insider trading in standardized options is inappropriate, recent Supreme Court decisions, particularly *Chiarella v. United States* [445 U.S. 222 (1980)], can be read to pose serious doctrinal obstacles to any effective prohibition of such trading.”).

82. See, e.g., Henry B. Manne, *INSIDER TRADING AND THE STOCK MARKET* (1966) (arguing that insider trading increases the efficiency of the securities markets by producing desirable incentives for corporate management); see also BRICKEY, *supra* note 62 (“[I]nsider trading proponents argue that it should remain unregulated because it promotes market efficiency.”).

83. See Atkins, *supra* note 1.

84. Press Release, Sec. & Exch. Comm’n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), available at <http://www.sec.gov/news/press/2006-4.htm> (“If the victims are shareholders of the corporation being penalized, they will still bear the cost of issuer penalty payments. . .”).

85. 17 C.F.R. § 240.10b-5(c) (2003).

86. Consider the following example: Suppose the director of publicly-held XYZ Corporation owns 50,000 shares of XYZ stock. After some careful tax planning, the director realizes that he should sell some of these shares. He determines that he will sell one-half of his 50,000 shares. The next morning, the director attends a board meeting at which time the board votes on a share repurchase agreement. Because the company has a lot of cash on hand at the

based on freedom of speech and impermissible censorship have been evoked by advocates of the practice as a means for its vilification.⁸⁷

The debate is complicated by the fact that neither Congress nor the SEC has established a workable definition of insider trading in the federal securities statutes.⁸⁸ It is clear that the SEC is forcefully pursuing those who have engaged in egregious violations of section 10(b) of the Exchange Act, which ultimately prohibits the employment of “any manipulative or deceptive device” in connection with the purchase or sale of securities.⁸⁹ However, it remains to be seen whether a more formal definition of insider trading will develop.

Herein lies the ultimate problem: not all actions that would fall under the typical definition of trading on “material, nonpublic information” are illegal per se.⁹⁰ The scope of what constitutes “illegal insider trading” is often amorphous and hard to define clearly, as both the Exchange Act and SEC Rule 10b-5 are framed in

moment, the agreement is approved. Such agreements are known by those in the industry to drive stock prices up. Therefore, the director changes his plan and decides not to sell those shares.

In this example, the director was surely privy to inside, non-public, material information. Nevertheless, he will not be held accountable for an insider trading violation under the securities fraud statutes because he does not meet the “standing” requirement. 17 C.F.R. § 240.10b-5 (2003) (referring to the clause, “in connection with the purchase or sale of any security.”); *see also* *Blue Chip Stamps v. Maner Drugstores*, 421 U.S. 723 (1975). Some would surely think this result inimical to the purposes underlying the securities regulations.

87. Robert W. McGee & Walter E. Block, *Information, Privilege, Opportunity and Insider Trading*, 10 N. ILL. U. L. REV. 1, 18 (1989) (“The free speech aspect of insider trading has been neglected. To the extent the SEC prevents individuals from speaking, or threatens to punish them for speaking, or tells them how to speak or what to say, it places a chilling effect on the right of free speech.”).

88. *See* BRICKEY, *supra* note 62; Thel, *supra* note 81, at 1262. Note, however, that the House committee report on the Insider Trading Sanctions Act of 1984, an amendment to the Exchange Act that gave the SEC the authority to ask courts to impose penalties on illegal traders and on those who pass on private information to third parties, Pub. L. No. 98-376 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.) (1984)), broadly portrayed the term as one “used to refer to trading in the securities markets while in possession of ‘material’ information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public.” H.R. REP. NO. 98-355, at 2 (1984). Also, for a discussion on “materiality,” *see* *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

89. 15 U.S.C. § 78j(b) (2000).

90. *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 232–33 (1980). The question is not whether there exists insider trading, but rather whether there exists illegal insider trading. *See also* DONALD C. LANGEVOORT, *INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION*, § 5 (West Group Securities Law Series Vol. 18, 1991).

broad terms and contain blurred lines of legal demarcation.⁹¹ Therefore, the question remains as to where the line should properly be drawn.

In *Cady, Roberts & Co.*,⁹² the Commission established the initial fundamental standards governing insider trading under Rule 10b-5.⁹³ The main premise of the case, which has survived in modified form, was that insiders possessing material, nonpublic information have an obligation to release this information or to abstain from trading.⁹⁴ In the opinion, the Chairman indicated that insiders “must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.”⁹⁵ However, even these requirements do not define which persons occupy “special relationship[s] with a company and [are] privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.”⁹⁶

Nearly seven years later, the Second Circuit, in *SEC v. Texas Gulf Sulphur Co.*,⁹⁷ crafted a landmark decision, that acted as a launch pad for the courts in interpreting the anti-fraud provisions of the securities laws, including section 10(b) of the Exchange Act and SEC Rule 10b-5.⁹⁸ Although the court was not faced with the sole question of who owed whom a duty of effective disclosure, its response in dicta to this question is instructive. The Second Circuit noted that “[a]n

91. See Thel, *supra* note 81.

92. 40 S.E.C. 907 (1961).

93. *Cady, Roberts* was the first decision whereby the SEC identified insider trading as a type of securities fraud coming within its broad rules. *Id.*

94. *Id.* at 910–11 (noting that the field of securities requires special regulation in an attempt to prevent “fraud, manipulation or deception”). See also *SEC v. Materia* 745 F.2d 197, 203 (2d Cir. 1984) (“[O]ne who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5.”).

95. *Cady, Roberts*, 40 S.E.C. 907, at 911. What is intriguing about this opinion, however, is the tribunal’s contention that the action of the board—reducing a quarterly dividend—was a “material fact which *could be expected to have an adverse impact* on the market price of the company’s stock.” *Id.* (emphasis added). The requisite acknowledgment, intentional or unintentional, of an “adverse impact” by the SEC seems to presume that, unless insiders can expect that the company’s value will suffer, their retention of material information might nonetheless be justified. *Id.* at 911–12.

96. *Id.* at 912 (“Intimacy demands restraint lest the uninformed be exploited.”).

97. 401 F.2d 833 (2d Cir. 1968).

98. *Id.*

insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises *only* in 'those situations which are essentially *extraordinary* in nature and which are *reasonably certain to have a substantial effect* on the market price of the security if disclosed'.⁹⁹

This standard, however, appears to conflict somewhat with the court's later statements, which dictate that if a fact in the "reasonable and objective contemplation" of an individual insider can have an effect on the value of a corporation, it should be disclosed.¹⁰⁰ In other words, must the effect be "substantial," and must the situation be "extraordinary" in nature? Regardless, the court makes clear that the parties must be on "equal footing," and it was surely the intent of Congress that all members of the investing public assume identical market risks.¹⁰¹

Although *Texas Gulf Sulphur Co.* embraced a number of different issues, one is of primary importance here: namely, whether insiders may accept stock options without disclosing material information to the issuer.¹⁰² In short, the court's answer appears to be, "yes."¹⁰³ The problem in *Texas Gulf Sulphur Co.* was that the top officers of the company, who stood in a fiduciary position, did not properly inform the Stock Options Committee of the board ("Compensation Committee") or the board itself of the material, nonpublic information that they possessed before the issuance of such option grants.¹⁰⁴ Therefore, the court implied that as long as the Compensation Committee had been privy to the same material information as the directors or officers receiving such grants, the duty of disclosure had not necessarily been breached.¹⁰⁵

Judge Friendly, in his concurring opinion, took an even more lenient view of the matter. He distinguished between minor and

99. *Id.* at 848 (emphasis added). This is quite a standard, and appears to be in line with the language of the Commission in *Cady, Roberts*, albeit not limiting the effect to a situation that is necessarily "adverse." See *supra* note 95.

100. *Tex. Gulf Sulphur Co.*, 401 F.2d at 849.

101. *Id.* at 852.

102. *Id.* at 856-57.

103. *Id.*

104. *Id.* at 856.

105. *Id.* at 856-57 ("[A]s [the members of top management] did not disclose such information to the Options Committee we direct rescission of the option[s] they received.").

senior officers with regard to their disclosure duties, affording less deference to senior officers—as for them, “silence, when there is a duty to speak, can itself be a fraud.”¹⁰⁶ Some would argue, however, that this notion appears at odds with the purpose and judicial interpretations which include a fiduciary duty of loyalty to shareholders.¹⁰⁷ The Supreme Court has not yet spoken directly to the validity of this proposition, and it remains unclear as to whether the Second Circuit was indeed supporting an unconditional notion that stock option grants traded with knowledge of material, nonpublic information by both the option grantee and the Compensation Committee are legally justified.¹⁰⁸

Over the years, the Supreme Court has established a number of guiding principles for securities cases, which have produced a large and uncertain body of law. In 1976, the Court determined that “scienter” was indeed a necessary element of a 10b-5 cause of action.¹⁰⁹ The Court relied heavily on the word “manipulative” found in Rule 10b-5, which it stated “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”¹¹⁰ Then, in 1980, the Court handed down *Chiarella v. United States*,¹¹¹ establishing that trading on material, nonpublic information is not, in itself, enough to

106. *Tex. Gulf Sulphur Co.*, 865 (Friendly, J., concurring).

107. Corporate officers owe their shareholders a duty of loyalty, which is to say, as the court in *Texas Gulf Sulphur Co.* put it, that these types of “benefits, in essence, are forms of secret corporate compensation, . . . derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives.” *Id.* at 851.

108. Even the CFA Centre for Financial Market Integrity, which has openly criticized such manipulative practices, including spring-loading, suggests that SOX protections do not, in fact, address spring-loading, nor do the SEC’s new compensation disclosure requirements prohibit the practice. Kathy Valentine & Jessica Galehouse, *CFA Centre Calls For Greater Scrutiny of ‘Spring-Loading’ Practices, Restricted Stock Grants, Off-Balance-Sheet Reporting*, CFA Institute, Sept. 6, 2006, available at http://www.cfainstitute.org/aboutus/press/release/06releases/20060906_01.html. “[The Centre] would encourage a closer look at whether officers and directors in control of the options grant process should be barred from participating in any spring-loaded grants, just as they would be prohibited from trading in any other company securities while in the possession of inside information.” *Id.*

109. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976) (“In this opinion the term ‘scienter’ refers to a mental state embracing intent to deceive, manipulate, or defraud.”).

110. *Id.* at 199 (emphasis added).

111. 445 U.S. 222 (1980).

trigger liability under the anti-fraud provisions of Rule 10b-5.¹¹² In other words, there is a duty, on the part of those accused, to those complaining of insufficient disclosure.

Three years after *Chiarella*, the Court addressed the trading liability of “tippees” in *Dirks v. SEC*.¹¹³ The Court held that disclosing confidential corporate information is not necessarily inconsistent with the duty insiders owe to shareholders.¹¹⁴ The information, of course, must be material and nonpublic; however, the Court acknowledged that whether information will be viewed as such is often unclear, and “[w]hether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure.”¹¹⁵ The Court rejected the SEC’s argument that allowing such a “proper purpose” standard would lead to fabrications of legitimate business actions by corporate insiders.¹¹⁶

The Court’s latest dealing with issues of insider trading came in 1997 when it officially accepted the “misappropriation” theory of insider trading.¹¹⁷ In *United States v. O’Hagan*, the Court determined that a person “commits fraud ‘in connection with’ a securities transaction . . . when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of information.”¹¹⁸ Therefore, the misappropriation theory protects “the integrity of the securities markets against abuses by ‘outsiders’ to a corporation who have access to confidential information that will

112. *Id.*

113. 463 U.S. 646 (1983). In *Dirks*, the Court established that “tippees” were liable only if (a) they knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and (b) the tipper received a direct or indirect personal benefit from the disclosure. *Id.* at 656; *see also supra* note 77 (defining “tippee”).

114. 463 U.S. at 661–62.

115. *Id.* at 662. As a follow up, the Court noted that “[a]bsent some personal gain, there has been no breach of duty to stockholders.” *Id.*

116. *Id.* at 663. The SEC’s argument was that, “if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information.” *Id.* The Court rejected this notion, concluding that the SEC was “unduly concerned.” *Id.*

117. *United States v. O’Hagan*, 521 U.S. 642 (1997).

118. *Id.* at 652. *O’Hagan* established two main principles: (1) to establish a criminal violation of Rule 10b-5, the government must prove that a person “willfully” violated the provision; and furthermore (2) a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the Rule. *Id.* at 644.

affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."¹¹⁹ The Court's overriding defense of this interpretation of the Exchange Act was its belief that the Act itself had the "animating purpose" of "insur[ing] honest securities markets and thereby promot[ing] investor confidence."¹²⁰ Certainly, the nebulous progression of insider trading law over past decades provides room for further development and compromise. However, the nature of such developments in terms of the specific corporate practices discussed above remains uncertain.

C. The Relationship Between Aggressive Stock Option Grants and Manipulative or Deceptive Trade Practices

Whether a corporate insider must make particular disclosures is not as clear cut¹²¹ as simply applying the "disclose or abstain" rule¹²² with regard to material, nonpublic information. In fact, the limits and duties of disclosure imposed upon an insider "cannot be confined to an objective rule, but must be fashioned *case by case*. . . ."¹²³ The practice of granting lucrative stock options to employees thus presents an interesting case for discussion in the context of appropriate disclosure to shareholders.

Many of this country's top businesses have noticed that their executive compensation practices have come under an intense regulatory spotlight.¹²⁴ As previously discussed, three such practices are: (1) backdating, (2) spring-loading, and (3) bullet-dodging.

119. *Id.* at 653. But, again note the reference to certainty in affecting stock prices; for example, information that "will affect" the price of securities. In addition, the court brings up the notion of harm done to investors, but unlike the *Cady, Roberts* opinion, it appears that "harm" can be attributable not only to an adverse impact on price but also lost opportunity. *Id.*

120. *Id.* at 658.

121. *See generally supra* notes 69–120 and accompanying text (presenting, *inter alia*, case law on the subject of non-disclosure and insider trading).

122. *See supra* note 94 and accompanying text.

123. 69A AM. JUR. 2D *Securities Regulation—Federal* § 1533 (2006) (citing *Kohler v. Kohler Co.*, 319 F.2d 634, 637–38 (7th Cir. 1963)) (emphasis added).

124. *See* Michael T. Burr, *Option Angst: GCs Face Tough Questions as the Options-Dating Scandal Grows*, INSIDE COUNSEL, Aug. 6, 2006, at 32, col.1 ("The first major scandal of the Sarbanes-Oxley era is upon us."). "The [SEC's] inquiry [into manipulative options dating] has turned into the country's biggest investigation of corporate malfeasance since an inquiry into

Businesses can do two things when granting stock options: grant options to executives or other employees at a strike price that is set to equal the market price of the underlying stock on the grant date, which is typically referred to as an “at-the-money” grant, or alternatively, backdate the stock by matching the options with past dates when the market price was at an all-time low, thereby overstating the value of the options.¹²⁵ Because the option value is higher when the exercise price is lower, it stands to reason that executives prefer to be granted options when the stock price is at its lowest.

Dubbed the “cause du jour of federal regulators,”¹²⁶ no other issue in the entire history of the SEC has generated as much comment as the backdating issue.¹²⁷ As a result, the SEC voted to approve the issuance of a notice of proposed rulemaking, initiating the requisite solicitation period for opinions regarding the need for further disclosure of executive compensation practices.¹²⁸ Six months later,

improper mutual fund trading three years ago led to \$4.3 billion in penalties.” *Apple Shares Drop on News of Restatement*, INT’L HERALD TRIB., Aug. 4, 2006, available at <http://www.iht.com/articles/2006/08/04/business/apple.php>. According to Damon Silvers, associate general counsel at the AFL-CIO, “[t]his thing is going to get bigger before it gets smaller,” and former SEC enforcement attorney, J. Bradley Bennett, stated, “My sense is that almost every securities lawyer in America is working on one of these types of cases.” *Stock-Option Probe Collides With Cleanup Claims*, CHI. TRIB., Aug. 4, 2006. Some attorneys believe that the new rules adopted by the SEC in the summer of 2006 involving these manipulative practices are unlikely to present any fundamental change in corporate compensation, but such views are few and far between. See Tom Flower, *Big Changes on the Way in Reporting Pay, Perks: SEC Requires Full and Clear Disclosure*, HOUS. CHRON., Aug. 6, 2006.

125. See Lie, *supra* note 35 and accompanying text (providing an additional example of how backdating operates).

126. See Stuart, *supra* note 25.

127. See Cox, *supra* note 1. The “veritable wellspring of national interest and opinion” was tapped by the issues arising from executive compensation and disclosure rules, and with a record of over 20,000 comments submitted to the SEC in response to its recent notice of proposed rulemaking regarding the need for further disclosure, “it is now official that no issue in the 72 years of the Commission’s history has generated such interest.” *Id.* See also S. Comm. Hearing, *supra* note 17 (statement of Sen. Paul S. Sarbanes, Member, S. Comm. on Banking, Hous., and Urban Affairs).

128. See Press Release, Sec. & Exch. Comm’n, SEC Votes to Propose Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (Jan. 17, 2006), available at <http://www.sec.gov/news/press/2006-10.htm>; SEC Proposed Rule: Executive Compensation and Related Person Disclosure, Securities Act Release No. 8655, Exchange Act Release No. 53,185, Investment Company Act Release No. 27,218, 71 Fed. Reg. 6542 (proposed Jan. 27, 2006), available at <http://www.sec.gov/rules/proposed/33-8655.pdf>.

the Commission approved the final rule.¹²⁹ So far, the SEC crackdown has led to both civil and criminal actions against a number of companies, most notably Brocade Communications Systems, Inc., which ended in the first conviction related to backdating resulting from a criminal trial, and Comverse Technology, Inc., with continuing investigations to date of over 130 other companies.¹³⁰

Many law firms, seeing the potential to profit in this highly speculative and uncertain area of law, have exploited the opportunities the current situation presents.¹³¹ The ruckus was spurred, in large part, by academic studies of finance professors.¹³² After being tipped-off about the possibility of fraudulent backdating of stock option grants more than a year before this controversy came to a head, the SEC has been more than “eager to widen its investigation into what it calls secret executive compensation”¹³³

129. See SEC Final Rule, *supra* note 1; see also *S. Comm. Hearing* (statement of Christopher Cox). “The SEC’s brand new executive compensation rules now require a complete quantitative and narrative disclosure of a company’s executive compensation plans and goals.” *Id.*

130. Steve Stecklow, *Outside Directors Are Cited in Study Over Backdating*, WALL ST. J., Dec. 18, 2006, at A10. “More than 130 companies are under investigation by U.S. authorities for backdating or otherwise manipulating stock-option grants, the biggest corporate fraud probe in decades.” *Id.* See also *S. Comm. Hearing* (statement of Christopher Cox), *supra* note 25. (“At [this] time, we have to expect other enforcement actions will be forthcoming in the future.”). “The SEC is not going to use the force of its enforcement division to play gotcha with such instances, but we are very deeply and seriously concerned about serious, intentional abuses. And those are the kinds of cases that we’re going after.” *Id.*

131. See, e.g., Press Release, Duane Morris LLP, Duane Morris LLP Announces Formation of Stock Options/Incentive Compensation Task Force (July 31, 2006), available at <http://www.duanemorris.com/pressreleases/pressrelease2259.html>.

132. Philip G. Berger, Eli Ofek & David L. Yermack, *Managerial Entrenchment and Capital Structure Decisions*, 52 J. FIN. 1411, 1411–38 (1997); Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 802–12 (2005); Heron & Lie, *supra* note 1. SEC Chairman, Christopher Cox, admitted to the Senate Committee on Banking, Housing, and Urban Affairs that “the SEC began working with academics to decipher market data that provided the first clues [that] something fishy was going on.” *S. Comm. Hearing* (statement of Christopher Cox), *supra* note 25; *Educator’s Work Exposes Option Scandal*, WASH. POST, Sept. 22, 2006. “[Erik Lie has] uncovered a scandal that has just mushroomed,” stated former SEC attorney and Professor of Law at the University of Michigan, Adam C. Pritchard. *Id.* “He recognized something there that needed looking into. I don’t think you can understate what he’s done.” *Id.*

133. See Elizabeth MacDonald & Erika Brown, *Thumbs on the Scale*, FORBES, Nov. 28, 2005. According to Chairman Cox, “No shareholders should need a machete and pith helmet to go hunting for what a CEO makes,” and the goal of the SEC’s new rules governing compensation disclosure is for such compensation to be described “not in an impenetrable

It generally has been accepted, however, that backdating is not a *per se* violation of the law.¹³⁴ The granting of options is a perfectly legitimate form of compensation, and there is nothing inherently wrong with choosing any particular date or using any particular methodology for determining an option's strike price, provided that full and fair disclosure is made to shareholders and proper accounting procedures are followed, which includes following properly the IRS guidelines regarding taxable earnings.¹³⁵ Rather, the problem with backdating, as can clearly be seen in the cases of Brocade and Comverse,¹³⁶ is that such steps have not always been taken.

Spring-loading and bullet-dodging, however, offer another, more legally enigmatic aspect to stock grant manipulation. Originally hypothesized by Professor Yermack in his 1997 study of peculiar stock price patterns around executive stock option grants,¹³⁷ the concept of timing option grants to occur prior to the release of expectedly good news or after the release of potentially damaging news has since won such practices the pet names "spring-loading" and "backdating," respectively.¹³⁸ Unlike its backward-looking parallel, spring-loaded options are generally priced at the date of the grant, or "at-the-money." The catch here is that companies are hoping to build quick gains or savings into these grants through the release of positive or negative news, such as upbeat earnings forecasts or reported negative restatements.¹³⁹ There is a fierce division among the public over the practices of spring-loading and bullet-dodging, with critics arguing these practices either are or closely resemble illegal insider trading.¹⁴⁰ However, these practices are not without

thicket of details, as the case is today, but rather in clearly presented tables, and plain English descriptions." Phillippa Maister, *SEC's New Disclosure Rules Contain Several Surprises*, DAILY REPORT, July 28, 2006, at 6.

134. See Lie, *supra* notes 35, 37 and accompanying text.

135. See Lie, *supra* note 35; see also *S. Comm. Hearing* (statement of Christopher Cox), *supra* note 25.

136. See *supra* notes 20–21.

137. Berger, Ofek & Yermack, *supra* note 132.

138. See Lie, *supra* note 35. While bullet-dodging is related to spring-loading, this Note will focus almost exclusively on the practice of spring-loading.

139. See Kara Scannell, Charles Forelle & James Bandler, *Can Companies Issue Options, Then Good News?—SEC is Divided on Practice Known as "Spring Loading;" Critics See "Insider Trading,"* WALL ST. J., July 8, 2006, at A1.

140. *Id.*; Richard Hans, partner at Thatcher Profitt & Wood in New York, is adamant that

their fierce defenders.¹⁴¹ Therefore, the debate over these option-timing techniques is left to traverse an open and uncertain trail,¹⁴² and in the end, the courts may be the ultimate arbiters.¹⁴³

D. Tying It All Together

While releasing material, non-public information shortly before or shortly after potentially good or bad news might at first glance appear to have transparent illegal implications, such is far from clear. Currently, the SEC does not prohibit spring-loading.¹⁴⁴ There is no

“[spring-loading] is insider trading at its most basic level, and most people understand that.” Michael T. Burr, *Option Angst*, INSIDE COUNSEL, Aug. 6, 2006, at col. 1. Unfortunately, the issue is not as clear cut as Mr. Hans would have the public believe, as the debate over spring-loading is ongoing and unresolved, with prominent individuals on both sides of the fence. *Id.*; Vinson & Elkins, V&E Securities Litigation E-Lert: Options Backdating Update, July 26, 2006, http://www.velaw.com/resources/resource_detail.asp?rid=322803901&rtype=pub; United States: Stock Blot, LAWYER, Aug. 21, 2006, available at 2006 WLNR 14494791; Stuart, *supra* note 25.

141. See Helen Shaw, *Atkins Warns of Overreaction in Options Furor*, CFO MAG., July 7, 2006. Atkins stated emphatically at a conference before the International Corporate Governance Network that it would not only be difficult to prove that a board had awarded options in anticipation of positive news likely to increase share value, but there might be legitimately good reasons for doing so, the main one being that the business judgment of the board should not be second-guessed by the courts or the SEC. *Id.* See also Atkins, *supra* note 1. “Stock options have been one of the main reasons that innovative corporations have flourished.” *Id.*

142. See United States: Stock Blot, *supra* note 140 (“Despite the trend towards greater transparency, there is still plenty of room for disagreement about options, as the debate about spring-loading illustrates.”). Kirk Hanson, the internationally-known arbiter of business ethics, expressed sympathy for the executives who believed that “rigging the price of stock options had become an acceptable and necessary practice in the battles to recruit employees during the tech boom.” Mark Schwanhauser, *Ethics Expert Blasts Execs in Options Scandal*, SAN JOSE MERCURY NEWS, Aug. 27, 2006, Business Section. Hanson emphasized that he was “unclear where the line is drawn,” and expressed the understanding that there may be no legal problem with spring-loading. *Id.*

143. Professor Erik Lie, although under the belief that spring-loading constitutes only a small portion of the cases in his current studies, made clear that the issue of spring-loading and its legality has yet to be tested in the courts. See, e.g., Marcy Gordon, *Stock Option Cases Complex*, ALB. TIMES UNION, Aug. 27, 2006, Business Section. It is also interesting to note that some commentators have expressed the view that as more people begin to shy away from the practice of backdating, it will simply be replaced by practices that are perhaps more economically promising and which leave “fewer footprints,” such as spring-loading and bullet-dodging. Coffee, *supra* note 17. See also *S. Comm. Hearing*, *supra* note 29 (statement of Erik Lie) (“As the problem of backdating is eliminated, the problems of spring-loading, bullet-dodging and manipulation of the information flow might become more prominent. Thus, it is critical to clarify whether these alternative strategies are legal.”).

144. *S. Comm. Hearing*, *supra* note 29 (statement of Erik Lie). “The SEC, as Chairman

consensus that has emerged from the cacophony of scholars, practitioners, regulators, lawmakers, and the like as to whether spring-loading is an illegal practice muddled by insider trading violations.¹⁴⁵ Nor is it clear whether executives or board members knowingly believed that the actions they took would come under such enforcement scrutiny.¹⁴⁶

As the debate moves forward, it is critical that both the proponents and opponents of this practice are aware of the laws affecting insider trading and what, if any, implications this body of law will have on the practice. Accordingly, Part III will analyze the issue of spring-loading from an insider trading perspective based on the general antifraud provisions.

III. ANALYSIS

Those who argue that spring-loading is an illegal practice based on violations of Rule 10b-5 and section 10(b) of the Exchange Act do so by claiming that the company has acted on information not available to the general public at the time the options were granted.¹⁴⁷

Cox mentioned, requires now that there be full review and report of [certain] issues by the compensation committee, but it does not prohibit spring-loading.” *Id.*

145. While some SEC Commissioners, including Chairman Cox, have indicated their distaste for spring-loading, others have expressed the view that it is clearly a legal practice, and what is more, it can actually help investors. *S. Comm. Hearing* (statement of Christopher Cox), *supra* note 25 (“[B]ecause spring-loading . . . refers to timing option grants to occur just before expected good news, it is bound up with concepts of insider trading.”). *But see* Paul S. Atkins, Comm’r, Sec. & Exch. Comm’n, MONDAQ, July 20, 2006 (opining that a company which grants options just before it issues material non-public information which causes its share price to rise is not engaging in prohibited insider trading because “there is no counterparty who could be harmed by [such] an options grant.”).

146. As Chairman Cox made clear in his testimony before the Senate Banking, Housing and Urban Affairs Committee, “[I]n some cases, people have black hearts. In other cases, they’re pure as the driven snow and they made mistakes and it was all an accident. And then there’s everything in between.” *S. Comm. Hearing* (statement of Christopher Cox), *supra* note 25.

147. Vinson & Elkins, *supra* note 140. *See also S. Comm. Hearing, supra* note 25 (statement of Lynn Turner, Dir. of Research, Glass Lewis Co.) (“I know some people have said spring loading is not illegal. . . . I couldn’t disagree more with those who’ve said [this]. As we’ve gone through filings, we’ve yet to see a filing that has properly made those disclosures. We’ve often heard, ‘Well, it’s not illegal if,’ but we’ve never seen the ‘if.’”). However, one must not mistakenly assume that absent evidence of proper disclosure, the practice is illegal. *See, e.g., id.; supra* note 146; *infra* notes 148–207 (discussion of case law on insider trading in relationship to spring-loading).

In addition, critics have argued that such practices over-compensate company insiders, reduce incentives for insiders to seek good stock performance, or encourage under-disclosure of compensation amounts because of the short-term pricing benefits inherent in these practices.¹⁴⁸ Lastly, opponents claim that spring-loading sets the exercise price lower than what the fair market value of the stock truly is, which makes it an unfairly valued option for purposes of tax and accounting treatment.¹⁴⁹

What will ultimately make this type of practice illegal insider trading, however, will hinge on whether those privy to the material and inside information breached their duty of disclosure.¹⁵⁰ Assuming a grant of stock options satisfies the 10b-5 test that there be a “purchase or sale”¹⁵¹ of a “security,”¹⁵² the question remains as to whether management employed “any device, scheme, or artifice to defraud” or engaged “in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”¹⁵³

Cady, Roberts established that a breach of an insider’s duty of disclosure “may be viewed as a device or scheme, an implied misrepresentation, and an act or practice, violative of all three subdivisions” of Rule 10b-5.¹⁵⁴ However, the Court has since made

148. See Vinson & Elkins, *supra* note 140.

149. *Id.*

150. The “party charged with failing to disclose market information must be under a duty to disclose it.” *Chiarella*, 445 U.S. at 229 (quoting *Frigitemp Corp. v. Fin. Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975)). The duty to disclose arises from a relationship of trust between a corporation’s shareholders and its employees. If there were no relationship of trust between the options grantor and the other party to the transaction, the grantor would appear to have no specific duty to disclose or abstain. *Id.* See also Arthur Fleischer, Jr., Robert H. Mundheim & John C. Murphy, Jr., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973) (examining the responsibility of corporations to disclose market information).

151. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). In short, if you have not sold or purchased securities, you do not have standing to sue under Rule 10b-5. *Id.* This is the result of the rule’s “standing” requirement that the fraudulent activity be “in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5 (2003).

152. See *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 505 (3d Cir. 1988) (stating that the amendments to the Exchange Act make clear that options are securities).

153. 17 C.F.R. § 240.10b-5 (2003).

154. *Cady, Roberts & Co.*, 40 S.E.C. 907, 910–13 (1961). See also *United States v. O’Hagan*, 521 U.S. 642, 660 (1997) (stating that the breach of one’s fiduciary duty to disclose

clear that “the 1934 Act cannot be read ‘more broadly than its language and the statutory scheme reasonably permit.’”¹⁵⁵ Clearly, directors have a fiduciary duty to shareholders,¹⁵⁶ but the Court clarified in *Chiarella* that there first needs to be identified a relationship between the parties that could give rise to a duty of disclosure.¹⁵⁷ Therefore, questions still remain as to how a director can satisfy that duty,¹⁵⁸ and upon satisfaction of such a duty, whether he will be relieved from liability insofar as insider trading is concerned.

Texas Gulf Sulphur Co., which the Supreme Court has cited repeatedly for its groundbreaking analysis on insider trading, is especially important in the context of analyzing spring-loaded options.¹⁵⁹ The first issue is to decide when, if ever, directors have a duty to disclose information they hold in their possession.¹⁶⁰ According to the Court in *Texas Gulf Sulphur Co.*, such disclosure is only necessary “in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed.”¹⁶¹

information is what creates the “deception” inherent in the concept of “deceptive nondisclosure.”).

155. *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980) (quoting *SEC v. Sloan*, 436 U.S. 103, 116 (1978)) (“Section 10b-5 is aptly described as a catch-all provision, but what it catches must be fraud.”).

156. *Dirks v. SEC*, 463 U.S. 646, 655 (1983).

157. *Chiarella*, 445 U.S. at 231–33. *See also Dirks*, 463 U.S. at 667 n.27. “*Chiarella* made it explicitly clear there is no general duty to forgo market transactions ‘based on material, nonpublic information.’” *Id.* (quoting *Chiarella*, 445 U.S. at 233).

158. Note, however, that breach of a duty alone will not satisfy a 10b-5 claim. *Dirks*, 463 U.S. at 654. There must also be some type of “manipulation or deception.” *Id.*

159. *See generally supra* notes 97–108 and accompanying text.

160. *See SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d. Cir. 1968).

161. *Id.* (quoting Fleischer, *Securities Trading and Corporate Information Practices: The Implication of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965)). What is somewhat perplexing about the *Texas Gulf Sulphur* decision, however, is that this language is not particularly coterminous in its scope to language later used by the court—“The basic test of materiality . . . is whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question.” *Id.* at 849 (citing RESTATEMENT OF TORTS § 538(2)(a) (1938)). “This, of course, encompasses any fact ‘which in reasonable and objective contemplation *might* affect the value of the corporation’s stock or securities’” *Id.* (citing *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965)). What “might” have an effect on stock price is certainly at odds with the notion that only “situations which are essentially extraordinary in nature” and will very likely have a “substantial effect” on market price are regulated by Rule 10b-5.

Therefore, the fact that management has information that might potentially affect stock price may not automatically compel disclosure if, in its business judgment, it decides such information will probably not affect the stock price.¹⁶²

A. Discretionary Authority to Issue Stock Options as a Basis for Relief from Liability

The first complication will simply be proving the causal chain between the rise or fall in stock prices and the release of information. This causal link, however, is beyond the scope of this Note. The second complication entails whether it is within the discretion of the managers based on the protections of the business judgment rule to release the alleged material information. *Dirks* espoused the notion that, in addition to a breach of fiduciary duty, there must also be some “manipulation or deception”¹⁶³ arising from the “inherent unfairness involved where one takes advantage” of “information intended to be available only for a corporate purpose and not for the personal benefit of anyone.”¹⁶⁴ According to the Court, the laws were clear attempts to combat practices with no other purpose than to gain “secret profits.”¹⁶⁵ More recently, in *O’Hagan*, the Court stated that the entire basis for requiring disclosure of misappropriated, nonpublic information is that such a practice “deceives the source of the information and harms members of the investing public. . . .”¹⁶⁶

162. If a board, before granting options, knows that the company recently adjusted upward its reserves of crude oil by an estimated 5%, is that material? What if that percentage was increased by increments of 1% for the same question? This begs the question—when would it become “material” enough in the business judgment of the board so that it would have to be revealed? What about the same question when the crude oil price is at \$60 per barrel in declining increments of \$1 per barrel? It is not altogether clear whether the board will lose the protection of the business judgment rule in judging whether information is material given the almost infinite variations of the facts similar to those described herein.

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

164. *Id.* But, notice the Court’s continued emphasis on the idea that a duty to disclose is not, by any means, unconditional—“Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence . . .” *Id.* at 658.

165. *Id.* at 654 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 916 (1961)).

166. *United States v. O’Hagan*, 521 U.S. 642, 643–44 (1997) (emphasis added).

However, the practice of spring-loading options does not necessarily harm the investing public.¹⁶⁷ First, stock options are not an end, in and of themselves, but rather a means for maximizing shareholder wealth. Indeed, stock options attract good people and provide incentives for those individuals to commit tirelessly to improving company wealth.¹⁶⁸ Although options can represent a cost to shareholders based on their dilution effect, what many critics assail as the anathema of executive compensation is actually a way for many companies without sufficient cash reserves to appeal to or retain promising employees, officers, and directors.¹⁶⁹ Additionally, options do not require resources to be drained from other areas of the business, which can allow the corporation to pay lower salaries to the option grantees, thus offsetting any alleged gain.¹⁷⁰ After all, any gain received is ultimately no more than a gamble, subject to market forces. In the end, options may save a company (and therefore its shareholders) money that would otherwise be necessary to expend on corporate salaries.¹⁷¹

Knowing this, the spring-loading of options does not appear necessarily to be a practice worthy of such disparagement. The board may have determined, by granting options ahead of potentially positive earnings, that it can grant fewer options and get the same “bang for the buck.”¹⁷² This presents no diminution in the value received by shareholders; if anything, it will inure to the benefit of

167. See Atkins, *supra* note 1.

168. *Id.* “Key to the success of the budding corporation is the ability to attract and retain good talent,” and stock options offer an outlet for companies without sufficient cash reserves to justify salaries they can ill-afford. *Id.*

169. *Id.*

170. *Id.* “[G]ranting options does not require resources to be diverted from other aspects of the business.” *Id.*

171. *Id.*

172. *Id.* In fact, the reality of the situation is that the company may ultimately save money, depending on the movement of share price. If the stock price declines before the vesting period ends, the grantee may forego exercising his options, thereby creating a theoretical gain in equity based on having balanced the option grants with a lower base salary. See also *Backdating to the Future*, *supra* note 15 (“[O]ther things being equal, granting options at a lower price allows the company to issue fewer options.”). The Journal provides a telling analogy to restricted stock, which, for all intents and purposes, is a stock option with a strike price of zero. *Id.* No one would argue that restricted stock is “unfair” simply because its exercise price happens to be zero, because “[r]estricted stock merely allows a company to offer similar compensation with a somewhat different risk-reward balance.” *Id.*

the corporation if the grantee fulfills his duties to maximize shareholder value. Additionally, there is savings to the company if the board decides to grant lower salaries, taking into consideration likely changes in the stock price.¹⁷³ Ultimately, “it takes fewer well-timed options to make an employee happy, and the company does not need to burn cash.”¹⁷⁴

Moreover, because options typically do not vest for long periods, the potential for unfair advantages is severely limited.¹⁷⁵ An added incentive may provide the inducement needed for these individuals to achieve wealth-maximization. Fear of executives skirting their duties after reaping enormous profits seems particularly misplaced.¹⁷⁶ Rather, taking into consideration the long vesting periods of these options, it would appear more likely the case that the higher the strike price of the option, the greater the chances the stock will fall over time, assuming of course that cyclical market trends persist. Therefore, keeping the stock price high is even more of an issue for executives with spring-loaded grants, vis-a-vis those receiving backdated options, thereby providing even greater incentive to work industriously for the company and its shareholders.

A particularly telling case regarding the question of whether spring-loaded options tend to offer “unfair” benefits involves

173. See Atkins, *supra* note 1. This is likely to be the case “precisely because there is a greater chance of the options being worth something and achieving their intended objective.” *Id.*

174. *Id.* Some have argued that in order to eliminate practices such as the backdating and spring-loading of options, the SEC should promulgate rules and regulations setting up pre-set, scheduled times whereby options can be granted and/or exercised. See Coffee, *infra* note 216. Any such rigid schedule, however, would defeat the opportunistic advantages as seen by many companies trying to compete with their more liquid competitors. See Atkins, *supra* note 1.

175. *Backdating to the Future*, *supra* note 15 (“Keep in mind that executive stock options generally vest over a period of years, far too long for a momentary blip in the stock price to equate to a guaranteed profit.”).

176. One must concede, however, that exorbitant profits verging on the ludicrous are not altogether absent from corporate America. See Mark Maremont & Charles Forelle, *Bosses’ Pay: How Stock Options Became Part of the Problem*, WALL ST. J., Dec. 27, 2006, at A1, A6 (providing a list of executives who have profited the most from stock options from the years 1992–2005, including Lawrence Ellison of Oracle and William McGuire of UnitedHealth Group, each of whom have made approximately \$344 million and \$1.031 billion, respectively). However, many of those who have reaped huge returns are implicated in illegal activity, including unlawful backdating. *Id.* This is not necessarily telling of the effect of spring-loading on corporate salaries or accumulated benefits. *Id.*

Brocade Communications Systems, Inc., which is one of the few companies to date that the SEC has charged with manipulative stock options practices in the wake of this scandal.¹⁷⁷ Only one executive, however, exercised any of the options he was granted after the company's 1999 IPO, again amplifying the notion that spring-loaded (as well as backdated) options are "anything like a surefire road to riches."¹⁷⁸

In addition, it is unclear whether the business judgment rule will provide protection to those individuals claimed to have possessed material, nonpublic information. The rule itself provides a very powerful presumption favoring corporate managers in their use of discretion when carrying out operations of the business.¹⁷⁹ In order for the presumption to survive, (a) the board must have made a decision to act or refrain from acting on a particular matter, (b) a majority of the board must have had no financial interest in the ultimate decision, (c) the board must have carefully considered the issue and all information reasonably available to them, and (d) the decision must have been made in good faith or under the belief that it was appropriate and in the best interest of the company.¹⁸⁰

The compensation committee is often an arm of the board operating under delegated authority;¹⁸¹ as such, there is action on the part of the board. No member of the compensation committee should have any financial interest in the grant of the options, at least no more than anyone else.¹⁸² Hypothetically speaking, the board would

177. See *supra* notes 20–21 and accompanying text. On May 31, 2007, Brocade, along with Mercury Interactive, became the first two companies to pay fines (\$7 million and \$28 million, respectively) in settlement of federal accusations of civil fraud in connection with its alleged backdating of stock options. 2 *Companies Settle Charges of Backdating*, N.Y. TIMES, June 1, 2007, at C8.

178. *Backdating to the Future*, *supra* note 15.

179. See 63 Bruce A. Toth & Jason L. Booth BNA CORPORATE PRACTICE SERIES, § 4 (updated 2d ed. 2001) (providing a presumption that in making a decision, the directors acted "on an informed basis, in good faith and in honest belief that the action taken was in the best interests of the company.") (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); see also *Smith v. Van Gorkum*, 488 A.2d 858, 872 (Del. 1985).

180. Toth & Booth, *supra* note 179.

181. See, e.g., *supra* note 12.

182. Consider this example: The board of publicly-held Corporation X consists of both inside and outside directors. The corporation has organized a compensation committee, which makes decisions involving the compensation of its executives. Executive A has knowledge that the corporation is likely to resume business in one of its key areas of operation. The committee

carefully consider the issue, and after balancing the risk of losing a promising executive versus compensating him, they may choose the latter. It would appear that such a decision was made under a good faith belief that it was in the best interests of the company. Therefore, the committee would have satisfied its obligations under the business judgment rule, and its decision to grant options, at whatever price and at whatever time, would appear to be within the ultimate discretion of the board. In other words, as long as the decision was made in good faith for the ultimate benefit of the company and its shareholders, there is no basis for anyone to second-guess the business judgment of the board or its compensatory wing.¹⁸³ Without “self-dealing,” there presumably wouldn’t be a conflict of interest that would raise an issue of the board’s breach of its fiduciary duty of loyalty.¹⁸⁴

Again, the board may consider that by spring-loading an executive’s or employee’s options, it can not only grant fewer options but lower salaries to get the same, if not better, economic effect.¹⁸⁵ The board, which is ultimately in the position to judge best the needs of the corporation, has thereby exercised its good faith judgment. It may be done to avoid losing key employees; it may be considered a bonus for work well-done; it may be incentive to acquire more attractive recruits. The fact is, whatever prompted the decision made

is aware of this fact. Nonetheless, the committee grants a block of options to Executive A a few days before the news becomes official because he has expressed recent displeasure with the corporation, and since his work has been stellar—he single-handedly brought the company out of a severe rut by closing numerous loss-making facilities—the board wishes to retain him. Upon the release of the news, the stock rises in price.

No doubt, everyone, including the stockholders have an interest in the transaction because Executive A is a productive worker, and if he continues on this track, the company is likely to become more profitable as long as he is kept happy enough to remain with the corporation. *See, e.g.,* R. FRANKLIN BALLOTTI & JESSE A. FINKELSTEIN, *THE DEL. LAW OF CORP. AND BUS. ORG.* § 4.38[B], at 4-43 (3d ed. 2007), *available at* WL DELCBO § 9.30.

183. *Id.* (recognizing that the rule protects a decision, “[h]owever controversial, unpopular, or even wrong such a decision might turn out to be.”); *see also* *Cohen v. Ayers*, 449 F. Supp. 298 (N.D. Ill. 1978) (holding that the decision of the salary and supplemental compensation committee to administer stock option plans, where certain interested officers and directors were recipients of such options, was not subject to independent review of the court because the board acted independently in granting the options).

184. *See* BALLOTTI & FINKELSTEIN, § 4.10, at 4-221, 4-226 (“[T]he general concept underlying the duty of loyalty [is] that a director refrain from self-dealing.”).

185. *See supra* notes 169–71 and accompanying text.

in good faith, it is a decision based on the board's business judgment, which is almost always respected.¹⁸⁶

In addition, critics of spring-loaded options who decry such practices as running afoul of insider trading violations must recognize that boards will necessarily, and should, use all of the information they have on hand in making option grants. Not doing so could justifiably be deemed negligent. This is an important point, mainly because there is no counterparty to the transaction that is harmed by the option grants. The counterparty, if any, is the corporation itself, and therefore the shareholders. But, they are precisely the ones who are meant to benefit from these decisions.¹⁸⁷ Why would the board, in its business judgment, grant options that would necessarily harm the corporation of which many of them are likely a part? Last, one cannot escape the fact that boards are almost always in possession of material, non-public information, and it would, therefore, be difficult to require them to refrain unconditionally from granting options when in possession of such information.¹⁸⁸

The *Texas Gulf Sulphur Co.* Court recognized that the timing of disclosures is purely a matter for the business judgment of corporate officers.¹⁸⁹ This is the case as long as a corporate purpose is served and management has not dealt "personally" in the securities of the corporation or "give[n] to outsiders confidential information not

186. See Atkins, *supra* note 1. "Who are we to second-guess [the] decision [of the board under these circumstances]? Why isn't that decision in the best interests of the shareholders?" *Id.* The shareholders entrust the board with this discretion precisely because they understand that "[d]eciding to whom and when to grant these options is a complicated calculus that is fraught with uncertainty since one never knows what will happen to the stock price." *Id.* That is why, "[a]s with other business decisions, it is protected by the business judgment rule." *Id.* See also *Backdating to the Future*, *supra* note 15 ("Maybe these managements were trying to fulfill an important business purpose— attract and retain key talent in a competitive labor marketplace . . .").

187. See Atkins, *supra* note 1. Critics would likely argue that the true benefactors are the option grantees, not the shareholders. However, this is a mistaken presumption, because although the grantee is a benefactor, the ultimate reason for the grants is to benefit the corporation by acquiring, retaining, or otherwise supporting employees of the business who are there with one job—to maximize shareholder wealth. *Id.*

188. *Id.* This goes to the issue of bullet-dodging as well, for no one would argue that a board is guilty of insider trading when it forgoes granting options because it possesses knowledge of impending bad news. *Id.*

189. 401 F.2d 833, 850 n.12 (2d Cir. 1968).

generally available to all of the corporation's stockholders and to the public at large."¹⁹⁰

Most recently, the Delaware Court of Chancery, in *In re Tyson Foods, Inc.*, sanctioned the use of spring-loading as long as it is carried out in good faith pursuant to the board's business judgment.¹⁹¹ *Tyson Foods* involves, inter alia, company directors' alleged spring-loading of options by distributing them to key employees shortly before the release of positive information.¹⁹² Although the court denied defendants' motion to dismiss this count of plaintiff's complaint, the court specifically did so because defendants had in place a shareholder-approved incentive option plan, which defendants had violated by authorizing options inconsistent with this plan.¹⁹³ Accordingly, absent an agreed-upon plan between executives and shareholders such as the one present in *Tyson Foods*, it appears that

190. *Id.*

191. *In re Tyson Foods, Inc.*, 919 A.2d 563, 592 n.75 (Del. Ch. 2007).

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 . . . might wish to issue options with an exercise price below 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 such a decision, *were it made honestly and disclosed in good faith, would be within the rational exercise of business judgment.*

Id. (emphasis added).

192. *Id.* at 575–77.

193. *Id.* at 592–93.

It is inconsistent with such a duty for a board of directors to ask for shareholder approval of an incentive stock option plan and then later to distribute shares to managers in such a way as to undermine the very objectives approved by shareholders. . . . A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot . . . be said to [have acted] loyally and in good faith as a fiduciary.

Id. It is also important to note that the Delaware Court of Chancery was not addressing the specific issue of insider trading as it relates to spring-loading. *Id.* "The question before the Court is not . . . whether spring-loading constitutes a form of insider trading as it would be understood under federal securities law." *Id.* Rather, the court was only addressing the issue of whether the directors had violated their duties as fiduciaries of the corporation. *Id.*

spring-loading may withstand the test of the business judgment rule.¹⁹⁴

Finally, the *Dirks* test, determining whether disclosure is a breach of one's fiduciary duty, was whether the insider would benefit personally, either directly or indirectly, from such disclosure.¹⁹⁵ Therefore, as long as management either (a) has not personally benefited from the issuance of such information, or (b) has not given such information to outsiders for their benefit, a cause of action does not lie.¹⁹⁶

B. To Whom Must Disclosure Be Conferred?

Even assuming, *arguendo*, that the information is material and must be disclosed despite any objections based on the business judgment of the managing directors, the next issue that arises is to whom the directors must disclose this information. Again the "duty to disclose or abstain does not arise from the mere possession of nonpublic market information," but rather from the existence of a fiduciary relationship.¹⁹⁷ Although it is clear that corporate officers owe a fiduciary duty to their shareholders, this relationship may not be implicated in the situation of granting stock options. Courts have recognized that, as long as there is (a) disclosure to a disinterested board, and (b) fair dealings, there is no breach of fiduciary duty of loyalty.¹⁹⁸

194. *Id.* The Court set out a two-part test, under the factual circumstances of the case, for whether a spring-loaded option issued by a disinterested and independent board would nevertheless fall beyond the bounds of business judgment: Plaintiff must show: (1) that the "options were issued according to a shareholder-approved employee compensation plan," and (2) that the "directors [who] approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent *otherwise valid shareholder-approved restrictions* upon the exercise price of the options." *Id.* (emphasis added). It was the existence of the "otherwise valid shareholder-approved restrictions," however, that made the spring-loaded options in *Tyson Foods* improper, not solely the fact that the directors possessed material, non-public information, which they knew would potentially impact the share price. *Id.*

195. *Dirks v. SEC*, 463 U.S. 646, 662 (1983).

196. *See, e.g., Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) (holding that it is impermissible for corporate officers and directors to use their fiduciary positions to further their own personal interests).

197. *Dirks*, 463 U.S. at 647 (citing *Chiarella v. United States*, 445 U.S. 222, 222 (1980)).

198. *See In re eBay, Inc. S'holders Litig.*, No. C.A.19988-NC, 2004 WL 253521 (Del. Ch.

It can be argued that spring-loaded stock options do not fail the proscriptions of Rule 10b-5, as long as any information that may be material or not within the immediate reach of the public is nonetheless disclosed properly to a disinterested board. Essentially, the group making the awards, whether it's the board or a committee of the board, would be fully informed about the material information that may affect the price of its securities, and, therefore, would not defraud the public by setting the price or postponing the release of any news. Alas, the issue of timing these grants is merely the result of the board's or committee's decision about the proper structuring of employee compensation, which falls squarely within the board's discretion pursuant to the business judgment rule.¹⁹⁹

This notion is certainly not an unfair reading of the law as it exists today. *Texas Gulf Sulphur*, in fact, dealt in part with the precise issue of stock option grants.²⁰⁰ The problem for those who accepted the stock options in *Texas Gulf Sulphur* was that none of the individuals informed the Stock Option Committee of the material, inside information.²⁰¹ The Court failed to address disclosure of the options to shareholders or the public in general, as it did in its analysis of the other corporate directors who engaged in insider trading of the actual stocks.²⁰² What is more surprising is the Court's statement with regard to non-members of top management. For these individuals, the Court held that there was no duty to disclose their knowledge of the material, inside information before accepting their options.²⁰³

Texas Gulf Sulphur can be read as stating that disclosure to the Compensation Committee or board alone is necessary but not sufficient to eliminate a violation of insider trading.²⁰⁴ However, this

Feb. 11, 2004).

199. Although the business judgment rule originated in the Delaware Chancery courts, the rule has steady application across almost all jurisdictions, and in federal diversity cases, the courts will apply the substantive rules of the state in which the case arises. *See Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938).

200. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 856 (2d Cir. 1968).

201. *Id.*

202. *Id.* at 847–57.

203. *Id.* at 857.

204. It is interesting to note that the court in *Texas Gulf Sulphur* opines that “adequate incentives for corporate officers may be provided by *properly administered stock options* and employee purchase plans of which there are many in existence.” *Id.* at 851 (emphasis added). The question still remains, and one which has been left unresolved by the courts—what is

would be ignoring the Court's basis for rescinding the options received by the grantees; namely, that they had not disclosed the material information they possessed to the grantors of the options—in other words, those with whom they stood in a fiduciary relationship.²⁰⁵

The Court in *Texas Gulf Sulphur*, through a hypothetical analysis, recognized an important difference between stocks and options, a distinction that has direct implications on practices such as spring-loading.²⁰⁶ While stocks can be bought and sold on the open market at-will, option grants often will contain conditions whereby the holders of such grants may only exercise the options at certain times.²⁰⁷ In a situation where disclosure to the grantors of the options might jeopardize corporate security, the Court found that it may be desirable for the board or committee “not to require that an insider possessed of undisclosed material information reject the offer of a stock option, but only to require that he abstain from *exercising it* until [a certain time].”²⁰⁸ The Court implicitly acknowledges the fact that options can be granted with conditional exercise dates, whereby it remains nearly impossible for an individual to reap any definite reward from the discretionary timing of options.

Spring-loading option grants admittedly seem antithetical to the purposes of the federal securities laws, but this does not make them illegal. The board, in its discretion, has decided that granting options before a release of information that may boost stock prices is beneficial for the corporation. Based on the longstanding deference afforded members of the board in making critical business decisions under the business judgment rule, provided there exists a knowledgeable compensation committee or board acting in good faith, such a decision should not be second-guessed. In addition, as long as the board or compensation committee has been privy to the same information as the option grantee, there is no breach of duty of loyalty based on non-disclosure. What is more, unlike the practice of

considered a “properly administered stock option?” Perhaps it is simply one administered pursuant to a board's good faith business judgment.

205. *Id.* at 857.

206. *Id.* at 857 n.24.

207. *Supra* note 175 and accompanying text.

208. *Tex. Gulf Sulphur*, 401 F.2d at 857 n.24 (emphasis added).

backdating, which allows the grantee of the stocks to receive an immediate windfall, albeit only on paper, from the manipulation of the exercise date of the grant, there is no such similar windfall created by spring-loading options because the committee may build in an exercise date years into the future, during which time the price of the stock might experience any number of changes.²⁰⁹

The remarks of Judge Friendly, concurring with the majority in *Texas Gulf Sulphur*, supply additional credence to the practice of spring-loading, provided there exists disclosure to an informed board.²¹⁰ Judge Friendly expressed the issue not solely in terms of whether disclosure existed between an informed board and the grantee, but also whether the option price would likely result in a substantial windfall in the short term, which would be unfair to the corporation.²¹¹ Again, because employee stock options typically vest over three to five years, the ability of an employee to exploit short-term differences between the exercise and market prices is thereby reduced. Additionally, the court in *Texas Gulf Sulphur* was speaking to the situation of timing the sale of options at a percentage below their true worth,²¹² which is more akin to options backdating than spring-loading. Therefore, the practice of spring-loading options appears, for the most part, to be legally innocuous, a notion not lost by the absence of any SEC enforcement action to date.

209. See *Martino-Catt v. E.I. duPont Nemours and Co.*, 317 F. Supp. 2d 914, 923 (S.D. Iowa 2004) (“A receipt of stock options that do not vest immediately is inherently risky. By the time the options vest, their value may be much greater than anticipated, much less than anticipated, or somewhere between those two points.”); see also *In re Tyson Foods, Inc.*, 919 A.2d 563 (Del. Ch. 2007).

210. Providing further support for the legality of practices such as spring-loading, Judge Friendly opined in his opening remarks that the situation where information surely to augment the price of a corporation’s stock is known to the grantee but unbeknownst to the grantor would be a rare occurrence indeed. *Tex. Gulf Sulphur*, 401 F.2d at 864 (Friendly, J., concurring). What is more, Judge Friendly provides a cautious reminder that the framers of the Exchange Act might not have intended section 10(b) to provide a remedy for situations long handled by derivative actions based on state law waste of corporate assets. *Id.* at 865 n.1.

211. *Id.* at 865.

212. *Id.*

IV. RECOMMENDATIONS FOR CHANGE AND IMPROVEMENT

Despite open disagreement among the legal and financial communities over the legality of spring-loading, there is indeed a particularly strong argument for its legal validity based on current law.²¹³ The current onslaught of corporate investigations will likely continue for some time as even more companies provide financial restatements and corrected earnings reports to regulators. Many seem too eager to jump on the bandwagon of disapproval at what appears to these critics, albeit legally permissible, to be an ethically unsound practice. However, others hesitate to erect the gallows prematurely.²¹⁴ Rather, what is needed is careful consideration of the actual practice of awarding stock options, including its purposes and effects, in order to deliver a solution short of regulatory overburden as may be the case with parts of SOX.²¹⁵

One proposal involves a reduction in executive discretion over the timing of these option grants.²¹⁶ Professor John Coffee contends that the simplest means of restricting this objectionable practice is to “require public corporations to issue options only on a scheduled basis—that is, on the same date each year or at least on a date announced several months in advance.”²¹⁷ Coffee bases the solution on empirical evidence suggesting that more manipulation surrounds the use of unscheduled as opposed to scheduled options.²¹⁸ This response would effectively eliminate the ability to exploit market conditions by awarding grants prior to the release of potentially beneficial news. Without the ability to grant the options, he presumes the advantage is lost, at least through intentional manipulation.²¹⁹

213. See generally *supra* notes 163–212 and accompanying text (analyzing the impact, if any, of insider trading law and the business judgment rule on the practice of spring-loading option grants).

214. Most notably, SEC Commissioner Paul Atkins has been at the forefront of those cautioning hasty disapproval of these practices. See generally Atkins, *supra* notes 167–74.

215. See Aaron Lucchetti, *Why Spitzer is Backing Study That Endorses Less Regulation*, WALL ST. J., Jan. 23, 2007, at C3 (expressing concern that SOX may be drawing business away from U.S. markets to those in London, where regulation is perceived to be more business-friendly).

216. John C. Coffee, *Insider Trading: Can It Ever Be Stopped?*, 236 N.Y. L.J. 5, 6 (2006).

217. *Id.*

218. *Id.*

219. *Id.* Of course, it is still possible that the select dates on which the SEC allows for the

Ultimately, Coffee's solution shifts the business of the SEC away from increasing penalties for illegal activity to "mandating preventive controls."²²⁰ Albeit a practical and not altogether unrealistic solution to a difficult problem, such a measure may well result in the elimination of the benefits from timing options altogether. One of the main purposes of options, at least in theory, is to provide an alternative means of compensation for companies that either lack or do not desire to expend the capital necessary to acquire and keep corporate talent.²²¹ If the ability of a board to grant options within their business judgment is restricted, the theoretical benefit resulting from this practice is limited, if not eliminated.

An alternative that would allow management to keep its discretionary authority, yet would also restrict the board from abusing its privileged position in corporate office by reaping excessive profits, is simply formulating new rules mandating thorough disclosure to shareholders of information about option grants, including dates of the grants, and letting the analysts sort it out. This approach is similar to the idea behind the SEC's newest rules,²²² which require disclosures on Form 8-K within four business days of option grants.²²³ The problem, however, is that no one is likely to know for some time whether or not the SEC's newly-adopted set of rules will be a success in combating practices such as spring-loading.²²⁴ And, though the new rules do require companies to answer

granting of options coincides with a date on which an executive would have otherwise granted the option ahead of the release of positive news. However, this would result through chance alone, unless of course the manipulation was created artificially.

220. Coffee, *supra* note 216.

221. See generally *supra* notes 169–76, 185 and accompanying text.

222. See, e.g., SEC Final Rule, *supra* note 1; see also Eric Dash, *Pay Rules Adopted by S.E.C.*, N.Y. TIMES, July 27, 2006, at C (detailing the adoption of the SEC's newest and most sweeping set of rules, which "make it easier to see how much top executives are paid and to discourage manipulation of stock option grants."). Lucian A. Bebchuck, Professor of Law at Harvard and the co-author of a leading book on executive pay, commented: "The new rules will greatly improve the quality of information [available to investors]. Now, there is the question of giving shareholders the power to make effective use of information, which is the other leg of improving executive compensation." *Id.*

223. SEC Final Rule, *supra* note 1.

224. Dash, *supra* note 222.

[M]any have adopted a wait-and-see attitude until the rules are put into effect. The law of unintended consequences seems to be the governing rule of executive pay, and past attempts at improved disclosure have led to more creative forms—and often-higher

a series of questions if they decide to make option grants ahead of the release of material, nonpublic information, which seems intended to curb practices such as spring-loading, some corporate governance advocates nevertheless feel that “some of the final rules were watered down,” and “did not go far enough.”²²⁵ As such, clarification of the existing rules, and perhaps further enforcement mechanisms mandating disclosure may be the ultimate solution to the problem.

Sometimes the simplest solution is indeed the best solution. The current rules may or may not resolve the ethical conundrum surrounding the practice of spring-loading.²²⁶ With improved disclosure, however, those who are directly affected by any malfeasance by the board and who ultimately control the fate of the corporation based on whether they choose to invest or not invest, will be better able to judge for themselves whether the board’s decision-making capabilities with regard to executive compensation have been compromised. The board would still retain the deference afforded by the business judgment rule, but it would at least be less credulous in its decisions to make controversial stock grants. All things considered, the more information present, the better the opportunity to guard against any perversion of the business judgment rule by the board, and the more informed shareholders will be as to whether a particular company is worth the risk of investment, at least in theory.²²⁷

levels of compensation. Regulators again emphasized their goal was to improve disclosure, not curb executive pay.

Id.

225. *Id.*

226. One would at least hope that it would stymie the tide of current dissatisfaction over these practices. Even if a “knowing board is just granting a bonus in the form of clearly valuable options, rather than in cash that could be needed for other purposes. . . , the fact remains that shareholders were told the options were granted at market value—not at values that insiders knew would be well below market value once the news came out. The shareholders were, in other words, deceived by their directors.” Norris, *supra* note 22. If the problem herein lies with the board’s duties of disclosure, such duties should be clarified, and, if necessary, new rules composed.

227. See Dash, *supra* note 222. Also, as the court noted in *Tyson Foods*, “it is conceivable that a director might show that shareholders have expressly empowered the board of directors (or relevant committee) to use . . . spring-loading . . . as part of employee compensation, and that such actions would not otherwise violate applicable law.” *In re Tyson Foods, Inc.*, 919 A.2d 563, 593 (Del. Ch. 2007). Where such empowerment is absent, more thorough disclosure would allow shareholders the choice of taking their business elsewhere.

Disclosure is surely the linchpin of securities law regulation,²²⁸ and it stands to reason that either Congress, or the SEC through enabling legislation, will look more closely at the issue of spring-loading to determine whether further laws, rules, or regulations will be necessary.²²⁹ This would certainly save the time, money, and effort of proceeding with enforcement actions against companies that may have potentially spring-loaded stock grants, although it would certainly deprive both critics and proponents of this practice a final determination of its legality based on existing law²³⁰—an unsatisfying result indeed.

Notwithstanding the position that spring-loading is not illegal per se, boards no doubt have measured the public pulse and may well follow the spirit of full disclosure. In the end, however, it appears clear that the decision rests within the board's business judgment under the protection of that well-weathered rule.²³¹

CONCLUSION

Although the practice of spring-loading stock option grants seems to pass muster for both regulatory and interstitial bodies of law, the wide-spread frenzy from the investigations of backdating will no doubt move boards to re-examine these practices under the protections afforded by the business judgment rule. As more companies come under investigation, however, the chances of legislative or administrative action are presumably greater, while the

228. See *supra* notes 49, 56 and accompanying text.

229. It would surely be unsatisfying for some if the Commission determined that, based on its interpretation of existing law, that its newest rules are satisfactory in this regard. See Norris, *supra* note 22 (While “[i]t seems possible that the Commission will decide to let bygones be bygones, . . . [i]f the S.E.C. does not bring spring-loading cases, it could indicate the Commission, sensing hostile political winds, is shying away from strong enforcement. That would be sad.”); see also Bunning & Cox, *supra* notes 32–33 and accompanying text.

230. Indeed, no one is sure what the courts today would do with the spring-loading issue if it were confronted. Norris, *supra* note 22 (“Because of the evolution of the law in recent decades, [it is unclear] how such a case [like *Texas Gulf Sulphur*] would come out if litigated today.”). The courts do, however, appear to be reacting, as can be seen in the Delaware Chancery Court's recent opinion in *Tyson Foods*. See *supra* notes 191–94 and accompanying text.

231. For an example, see *supra* note 182 and accompanying text; see also *supra* notes 191–94.

possibility of an eventual solution via the Supreme bench becomes more improbable. Perhaps the most settling solution, although conceivably too optimistic, is for corporate America to practice more caution when making judgment calls on issues that are likely to rouse the animus of non-insiders. Yet, once the dust settles, it is paramount that a cool-headed legal examination of the board's duties and responsibilities not further confine or over-burden its job of running the business, which undoubtedly will prevent increased and unnecessary costs to shareholders.