"SPRING-LOADING" EXECUTIVE STOCK OPTIONS: AN ABUSE IN NEED OF A FEDERAL REMEDY

"Not the least misfortune in a prominent falsehood is the fact that tradition is apt to repeat it for truth."[1]

INTRODUCTION

Securities regulation plays a central role in the governance of American corporations. Responsibility for this regulation once fell solely upon the states, as corporate governance was historically absent from the federal scheme. Before the federal government ever passed securities legislation, the states had been regulating securities transactions for over twenty years by way of "blue sky laws."[2] By the time the first federal securities laws were enacted in 1933, every state but Nevada had a securities statute.[3]

However, with that first federal securities act, the Securities Act of 1933,[4] the landscape forever changed. Partly a response to the fraud that state securities laws had failed to curb, the introduction of federal securities regulation created a dual regulatory system balanced between the federal government and those of the states.[5] Moreover, the passage of time has seen a steady growth in federal securities regulation, to the point that some view it as unnecessarily overbroad.[6] This argument became especially prevalent in the 1990s, when federal securities laws came to preempt their correlative state counterparts in a number of key areas.[7]

1. Hosea Ballou, American theologian (1771–1852), *quoted in* THE GREAT QUOTATIONS 81 (George Seldes ed., 1960).

2. Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 111 (2004). These laws were "reportedly . . . aimed at unscrupulous stock promoters who 'would sell building lots in the blue sky.'" *Id.* at 111 n.14 (quoting LOUIS SLOSS & JOEL SELIGMAN, 1 SECURITIES REGULATION 36 (3d ed. 1998)).

3. *Id.* at 111–12.

4. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

5. Jones, *supra* note 2, at 111–12.

6. *See, e.g.*, Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 125 (1998) ("An acorn of vague language in the 1934 Act gradually became the sapling of equally vague but broader language in SEC Rule 10b-5 and finally a forest of federal anti-fraud law, with a large grove of insider trading law. This process happened partly because of judicial and bureaucratic incentives and politically powerful groups, and partly because the courts had developed no clear guidelines that might constrain the growth of the law."). *Id.*

7. *See* Jones, *supra* note 2, at 113–14.

The National Securities Market Improvement Act[8] of 1996 preempted states from enforcing their securities registration requirements.[9] In addition, the Securities Litigation Uniform Standards Act[10] of 1998 prohibited the vast majority of state law securities class action suits from being litigated.[11] While these preemptive laws altered the balance of federalism in securities regulation, the states have been left still free to enforce their securities laws against violators.[12]

Although many argue that the federal scheme reaches too far in scope, federal securities regulation is going nowhere any time soon. The reality is that the federal scheme has continued to increase with recent congressional reaction to corporate scandal.[13] Further, the Securities Exchange Commission (SEC), the Department of Justice (DOJ), the Internal Revenue Service (IRS), and private parties have relied extensively on federal securities laws to curtail corporate abuses.[14] As a result, academic commentary has begun to look beyond whether state or federal law should reign superior over corporate securities dealings and to focus on the proper allocation of regulatory authority.[15]

Assuming proper allocation of authority is a goal upon which many can agree, questions then arise regarding where the proper balance exists. Can the federal government simply pick and choose what it wishes to regulate, leaving to the states everything else? Where federal law may not recognize a cause of action for an apparently fraudulent securities practice, is it enough simply to dismiss the matter with recognition that the states can enforce their laws against it or that claimants may have a state forum for a breach of fiduciary duty claim? Does an entity such as the SEC not have an obligation at least to attempt enforcement through its rules, leaving interpretation of federal securities laws to the federal courts?

When the federal government decided to become the main regulator of securities abuses, it did not take responsibility for all "securities-related" fraud,

8. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

9. Jones, *supra* note 2, at 113.

10. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended at 15 U.S.C. §§ 77p(c), 78(b) (2006)).

11. Jones, *supra* note 2, at 113–14.

12. *Id.* at 114–15.

13. *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 953–54 (2003).

14. Most recently, this reliance has come in the context of the backdating of stock options. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1599 (2007).

15. Jones, *supra* note 2, at 108–09.

as the Supreme Court has noted.[16] However, occupying such a central role at least demands consistency. Consistency provides corporations with proper guidance, investors with the notice and information necessary for informed investment decisions, and litigants with appropriate expectations concerning potential claims. Further, when a federal actor like the SEC seeks to root out fraud through enforcement actions, it must enforce federal securities laws consistently for these same reasons. However, for one recently-exposed fraudulent practice, the SEC has done just the opposite.

"Spring-loading" describes the practice where a corporate executive receives stock options shortly before the release of favorable company news that is expected to raise the company's stock price.[17] It is a practice that uses material inside information so that its recipient will receive stock options at a lower, more advantageous price than if the market had knowledge of the information. However, federal actors, most vocally the SEC, have failed to recognize this practice as fraudulent. While the past few years have seen a rush of SEC enforcement actions to regulate the once-popular practice of backdating stock options,[18] the Commission has been idle regarding spring-loading.

This fervor for action on the backdating front while remaining virtually inactive on spring-loading raises questions that need answering. The backdating of stock options is shaping up to be nothing more than a historical footnote of fraudulent securities dealings.[19] However, the SEC's inaction and implicit acceptance of spring-loading have likely invited more widespread use of this practice.[20] As a result, it has begun to promulgate the prominent falsehood that spring-loading is benign and harmless. This reality begs the question: in what major way do backdating and spring-loading differ?

While the backdating of executive stock options involves a clear case of misrepresentation in that documents are altered to achieve instant financial gain, the spring-loading of executive stock options is a less-blatant form of deception. Spring-loading requires no alteration of documents. It simply involves withholding market-moving information from the public while executing a market transaction based on that very same information. Although to many spring-loading smacks of deception, this difference between the two practices may be a reason spring-loading has received less attention and why some support its use.

16. SEC v. Zandford, 535 U.S. 813, 820 (2002).

17. *See* Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007).

18. *See* Narayanan et al., *supra* note 14, at 1606–07.

19. *See, e.g.*, *id.* at 1640 (noting that the SEC's July 2006 disclosure rules "will almost certainly eliminate clandestine backdating or forward-dating").

20. *See infra* Part II.

Regardless of the reason, an anomaly exists. Spring-loading's supporters count a recent SEC Commissioner among their ranks,[21] while its detractors include a Delaware Chancellor.[22] Both are authorities on corporate law, yet somehow they see the practice in opposing lights. Granted, one is a federal actor, and one a state actor, but the difference lies beyond their respective roles. Further, this difference cannot be explained by mere deviation between federal and state law. Where one argues spring-loading "maximizes the effect of . . . options,"[23] the other has referred to it as "purposeful subterfuge."[24] Such comments strike deeper, more to an ideological chord.

This paper refutes the logic of spring-loading's supporters, seeing the practice as a deceptive and unnecessary form of executive compensation. It views the SEC's current position as spreading a false truth in corporate America that spring-loading is acceptable. Part I briefly explains executive stock options and spring-loading, charting the explosion in the use of executive stock options during the 1990s that eventually led to the emergence of spring-loading. Part II examines the lack of federal enforcement to date, noting the SEC's implicit acceptance of spring-loading in its newly created disclosure rules. Seeking consistency in federal securities fraud enforcement, Part III analyzes whether SEC Rule 10b-5 is amenable to a claim of spring-loading. Part IV examines recent state-level litigation, analyzing the Delaware Chancery's conclusion that spring-loading is a breach of fiduciary duty. Part V takes the view that the federal government should step forward to regulate spring-loading more strictly. To this end, it briefly examines a number of remedies the federal government could implement to suppress the practice of spring-loading.

I. THE EXPLOSION OF EXECUTIVE STOCK OPTIONS AND THE ADVENT OF SPRING-LOADING

In basic terms, an executive stock option[25] is a contract that grants its holder the right to purchase in the future a set number of shares of the

21. *See* Paul S. Atkins, Comm'r, U.S. Sec. and Exch. Comm'n, Speech by SEC Comm'r: Remarks Before the Int'l Corporate Governance Network 11th Annual Conference (July 6, 2006) [hereinafter Atkins Speech], *available at* http://www.sec.gov/news/speech/2006/spch070606psa.htm.

22. *See infra* note 209 and accompanying text.

23. Atkins Speech, *supra* note 21.

24. *See infra* note 234 and accompanying text.

25. This paper often uses the term "executive" stock option where it could use the term "employee" stock option because the focus is on executive compensation, rather than that of non-executive employees. However, the terms at times will be used interchangeably, recognizing that executive stock options are a subgroup of general employee stock options.

employer company's stock at a stipulated price.[26] This price is often called the exercise price, or "strike price," and the option to purchase company stock at this price lasts for a specified period of time.[27] If the market price of a company's stock rises and its employee exercises the option to purchase the shares, the employee receives a profit on the difference between the stock's market price and the lower exercise price paid for the shares.[28] There are numerous statutory and contractual limitations affecting when executive stock options can be exercised and their alienability in general,[29] but for purposes of this paper, a basic understanding of how they operate is sufficient.

Stock options have been issued to corporate executives as a form of compensation since at least the 1920s.[30] However, despite their appearance nearly ninety years ago, it was not until the 1990s that the use of executive stock options truly exploded.[31] This explosion was detonated with the stroke of a pen, when President Clinton signed into law the Omnibus Budget Reconciliation Act of 1993.[32] Largely a response to outcry regarding what many considered excessive corporate executive pay, Section 162(m) of the Act placed a one million dollar cap on the amount of executive salary that public companies may deduct as an operations expense.[33] However, it exempted from this cap certain categories of "performance-based" pay.[34] Notably, stock options meeting certain criteria were included in this category of performance-based pay and thus exempt from the salary cap.[35]

As a result of this exemption, boards of directors and compensation committees came to view stock options as a means by which they could compensate executives at similar levels to the past, without incurring a tax

26. Matthew A. Melone, *Are Compensatory Stock Options Worth Reforming?*, 38 GONZ. L. REV. 535, 539 (2003).

27. *Id.*

28. *See id.* at 539–40. For example, if an employee receives 2000 options at a strike price of $5.00, and then the market price of the company's stock rises to $10.00, the employee can exercise some or all of these options, paying $5.00 per share for stock that is worth $10.00 per share. Exercising all 2000 options for $10,000.00 would give the employee 2000 shares of the company's stock, worth $20,000.00, which the employee could then sell on the market.

29. *See, e.g.*, Jeremy Bulow & John B. Shoven, *Accounting for Stock Options*, J. ECON. PERSPECTIVES, Fall 2005, at 115, 116.

30. John Calhoun Baker, *Stock Options for Executives*, 18 HARV. BUS. REV. 106, 106 (1940) (noting that the use of stock options to compensate executives "became exceedingly popular during the 1920's").

31. *See* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, J. ECON. PERSPECTIVES, Summer 2003, at 49, 53.

32. Pub. L. No. 103-66, 107 Stat. 312 (codified as amended in scattered sections of the U.S. Code).

33. *See* I.R.C. § 162(m) (2000); Narayanan et al., *supra* note 14, at 1620.

34. Narayanan et al., *supra* note 14, at 1620.

35. *Id.*

disadvantage under the new law.[36] In 1992, stock options accounted for 24% of an average CEO's pay, with base salary comprising 38%.[37] Remarkably, by 2000, stock options' proportion had doubled, comprising 49% of CEO pay, while base salary had declined to 17%.[38] Even more striking, CEO pay grew from an average of $3.5 million in 1992 to $14.7 million in 2000.[39] This quadrupling in average pay was largely a product of the massive increase in stock options granted, which grew nine-fold, from an average of around $800,000 in 1992 to almost $7.2 million in 2000.[40]

The position of prominence that stock options came to hold in executive compensation led to large financial gains for executives in the bull market of the 1990s.[41] However, it was during this period of widespread use and a rising stock market that evidence of opportunistic behavior began to surface. As early as 1997, one empirical researcher, David Yermack, discovered abnormal company stock returns following the issuance of stock options to CEOs.[42] He posited that this "pattern of abnormal returns [was] consistent with CEOs receiving stock options shortly in advance of favorable news."[43] Yermack thought this practice, not yet termed "spring-loading," "seem[ed] to contravene federal securities laws and possibly expose managers and directors to legal liability."[44] He called it "a surrogate form of insider trading, albeit without the ordinary requirements of disclosure or risks of detection and prosecution."[45]

While this study hypothesized that CEOs influence compensation committees to grant them stock options just before positive company news is

36. *See* Hall & Murphy, *supra* note 31, at 49, 53.

37. Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 31 fig.3 (Harvard NOM Working Paper No. 04-28; ECGI - Finance Working Paper No. 44/2004, 2004), *available at* http://ssrn.com/abstract=561305.

38. *Id.* The remainder of CEO pay was comprised of bonuses and other forms of compensation. *Id.*

39. Hall & Murphy, *supra* note 31, at 51.

40. *Id.*

41. *See id.*

42. David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449, 450 (1997). Answering the possibility that post-grant-date market fluctuations and corrections prior to the options' exercise may mitigate any effect of favorably timed grants, Yermack found that the monetary advantage of a favorably timed grant becomes permanently embedded in the stock's price. *Id.* at 450, 455–57.

43. *Id.* at 450–51. Among other results, Yermack found that earnings announcements *after* a grant of executive stock options were more favorable than announcements *before* these grants. *Id.* at 464. Further, the jump in a stock's price was "markedly higher" for news announcements following unscheduled option grants as compared to scheduled grants. *Id.*

44. *Id.* at 451.

45. *Id.* at 470.

released,[46] other research found that "executives have the incentive, opportunity and ability to affect short-term stock prices by manipulating their communications with the market around the time of [scheduled] stock option grants."[47] One theory focused on the timing of *grants*,[48] while the other focused on the timing of *the release of news* around scheduled grants.[49] But despite the difference in focus, the basic premise of the theories was the same: the propitious timing of executive stock options on such a consistent basis was more than a coincidence.

However, although some in academia may have taken notice of this research, it largely evaded the legal landscape, the SEC's radar,[50] and the public consciousness until recently. It was only after Erik Lie's article exposing the practice of backdating stock options[51] that stock option manipulation gained notoriety.[52] Exposure of the backdating "scandal" has led to widespread action, including investigations by the SEC, the DOJ, the IRS, and multiple state attorneys general.[53] It has provided popular news media with seemingly endless material upon which scandal-hungry audiences have fed.[54] Further, it was this exposure of backdating, placing executive

46. Keith W. Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock Option Grants*, 7 J. CORP. FIN. 53, 56 (2001) (citing Yermack, *supra* note 42, at 449–76).

47. *Id.* at 73; *see also* David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73 (2000); Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83 (2000).

48. Aboody & Kasznik, supra note 47, at 74.

49. Yablon & Hill, *supra* note 47, at 90. In a careful analysis, Professors Yablon and Hill found that "all but the most egregious" manipulations in timing *the release of news* to influence stock option strike prices were either legal or not subject to effective legal limitations. *Id.* They found significant legal differences between pre-grant disclosures and post-grant disclosures. *See id.* at 97–103. This paper focuses on the post-grant disclosures inherent to the term "spring-loading." Yablon and Hill found more potential for a federal securities violation in these post-grant disclosures as opposed to pre-grant disclosures. *See id.*

50. The SEC has been at least marginally aware of such practices for some time, as former chief counsel Peter Romeo commented upon the matter in 1999. *See* Timothy D. Schellhardt, *Options Granted During Takeover Talks Are Boon for Executives at Fore Systems*, WALL ST. J., May 14, 1999, at C1. The comments came in response to Fore Systems, Inc.'s managers having received 1,300,000 options leading up to General Electric's acquisition of the company, which provided the managers with over $26 million in profits when the company was acquired. *See* Millionerrors Inv. Club v. Gen. Elec. Co. PLC, No. 99–781, 2000 WL 1288333, at *1–2 (W.D. Pa. Mar. 21, 2000). Romeo did not believe federal insider trading laws applied to the situation. *See* Schellhardt, *supra.*

51. Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005).

52. *See* Narayanan et al., *supra* note 14, at 1599.

53. *Id.*

54. *See id.*

compensation under a microscope, which finally focused spring-loading in the radar of the public eye.

"Spring-loading sounds like[] the type of thing you ask your kids not to do inside the house," jested SEC then-Chairman Christopher Cox at a corporate governance conference in late 2006.[55] Another commentator remarked that the term sounds "much like something from a diving meet."[56] These comments are indicative of the general perception that many are confused about what spring-loading *is*, not to mention its legal implications for corporations, boards, and executives. Therefore, this discussion first warrants a clear definition.

The Delaware Chancery has defined spring-loading as "making market-value options grants at a time when the company possesses, but has not yet released, favorable, material non-public information that will likely increase the stock price when disclosed."[57] This definition is both clear and sufficient, as it encompasses both (1) timing option grants so that they predate the release of favorable information and (2) postponing the release of favorable news until after scheduled option grants have occurred. A blatant example of this practice is provided by Cyberonics, a medical device maker that on June 15, 2004 granted 150,000 options to its CEO only a few hours after receiving FDA approval of its depression-treating surgical implant.[58] When news of the approval was released the next day, the company's stock price rose seventy-eight percent, providing the CEO with a one-day paper gain of nearly $2.3 million.[59]

Despite general agreement on what the practice entails, commentators differ in their assessment of spring-loading's legal implications. Observers like former SEC Commissioner Paul Atkins view the practice as relatively

55. Eric Dash, *Did You Hear the One About the S.E.C. Guy?*, N.Y. TIMES, Nov. 5, 2006, § 3, at 2. Cox also observed that "[b]ackdating sounds like something that you wouldn't want your daughter to do anywhere." *Id.*

56. Justin Fox, *Self-Deal? CEOs? Nahhh* . . . , FORTUNE, Nov. 27, 2006, at 95, 96.

57. Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007). Spring-loading's alter-ego, bullet-dodging, involves granting options just after negative company news is released to the public. *See id.* This practice achieves the same end result as spring-loading, as options are granted at a lower strike price than they would have been otherwise. *See id.* Bullet-dodging may raise similar legal issues as spring-loading, but views largely differ on this point. *Compare In re* Tyson Foods, Inc. (*Tyson I*), 919 A.2d 563, 593 (Del. Ch. 2007) (speaking of bullet-dodging as a breach of fiduciary duty akin to spring-loading and backdating), *with Desimone*, 924 A.2d at 944 (distinguishing spring-loading, akin to an in-the-money option grant, from bullet-dodging, where the market has already absorbed the negative information and thus involves a strike price at the stock's actual market price). A thorough discussion of bullet-dodging and its legal implications is beyond the scope of this article.

58. Barnaby J. Feder, *Questions Raised on Another Chief's Stock Options*, N.Y. TIMES, June 9, 2006, at C1.

59. *See id.*; Loren Steffy, *Losing Credibility Not an Option for Most Companies*, HOUS. CHRON., June 14, 2006, at B1.

unproblematic, even an effective means of executive compensation.[60] Others view spring-loading as a problem of corporate deceit in need of a remedy.[61] In addition, federal and state laws raise different legal issues, potentially arriving at different conclusions on spring-loading’s legality.[62]

II. FEDERAL REGULATORY IDLENESS

Although spring-loading strikes many as inherently deceptive, some see it differently. Then-Commissioner Atkins defended the legality of spring-loading in a speech before the International Corporate Governance Network in 2006.[63] Atkins noted that even if a factual nexus can be established between an option grant and the release of material inside information, the decision to grant the options should fall within the business judgment of a board of directors.[64] Further, he asserted that “[a]n insider trading theory falls flat in [the] context” of option grants since “there is no counterparty who could be harmed by an options grant.”[65]

Atkins’s position that spring-loading does not violate federal securities laws may lie behind the SEC’s virtual idleness on the regulatory front. It remains unclear whether future enforcement action will surface, and much will depend on the regulatory focus of the new chairman and commissioners in place. Confusingly, the SEC has in the past sent mixed signals concerning its intent. Where Atkins was vocal in his defense of spring-loading,[66] then-Chairman Christopher Cox once implied future enforcement actions.[67] Cox stated that “the SEC ‘is equally concerned with misbehavior in using inside information to time the granting of options [as with backdating]’” and that the Commission “will be very interested in . . . spring-loading.”[68] Further

60. *See, e.g.*, Atkins Speech, *supra* note 21.

61. *See, e.g.*, Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835, 888–89 (2004); Narayanan et al., *supra* note 14, at 1639–41.

62. *See* Anabtawi, *supra* note 61, at 888–89.

63. Atkins Speech, *supra* note 21.

64. *Id.* (“For example, a board may approve an options grant for senior management ahead of what is expected to be a positive quarterly earnings report. In approving the grant, the directors may determine that they can grant fewer options to get the same economic effect because they anticipate that the share price will rise. Who are we to second-guess that decision? Why isn’t that decision in the best interests of the shareholders?”).

65. *Id.* (“The counterparty here *is* the corporation—and thus the shareholders! They are intended to benefit from the decision.”).

66. *See supra* text accompanying notes 63–65.

67. Jonathan Peterson, *SEC Broadens Stock Option Investigation*, L.A. TIMES, June 20, 2006, at C1.

68. *Id.* Taking the middle ground, SEC Chief Economist Chester Spatt said he “personally” believes that companies should not practice spring-loading but that boards have a “proactive responsibility” in this area rather than the SEC. *See* Chester S. Spatt, Chief Economist & Dir., Office of Econ. Analysis, U.S. Sec. & Exch. Comm’n, Speech by SEC Staff: Economic Analysis

confusing matters, the SEC initially pursued Analog Devices, Inc. for spring-loading, and a tentative settlement was reportedly reached stating that Analog "failed to adequately disclose that it priced stock options before the release of favorable financial results."[69] However, for unknown reasons, the settlement never became final.[70]

Furthering its tacit approval, the SEC took no position on spring-loading's propriety while addressing the practice in its July 2006 executive compensation reporting requirements. The requirements mandate that companies include a Compensation Discussion and Analysis (CD&A) in forms filed with the SEC.[71] In the CD&A, a company must "explain all material elements of . . . compensation of . . . executive officers."[72] The rules include as an example, "depending upon the facts and circumstances,"[73] that a company may need to report "[h]ow the determination is made as to when awards are granted, including awards of equity-based compensation such as options."[74] However, in its release adopting the final rules in August of 2006, the Commission stated that:

> The Commission does not express a view as to whether or not a company may or may not have valid and sufficient reasons for such timing of option grants, consistent with a company's own business purposes. Some commentators have expressed the view that following these practices may enable a company to receive more benefit from the incentive or retention effect of options because recipients may value options granted in this manner more highly or because doing so provides an immediate incentive for employee retention because an employee who leaves the company forfeits the potential value of unvested, in-the-money options. Other commentators believe that timing option grants in connection with the release of material non-public information may unfairly benefit executives and employees.[75]

In essence, the release clarifies only that the SEC is uninterested in regulating spring-loading beyond requiring the disclosure of a "plan or

---

and Cost-Benefit Analysis: Substitutes or Complements? (Mar. 15, 2007), *available at* http://www.sec.gov/news/speech/2007/spch031507css.htm.

69. Kara Scannell et al., *Can Companies Issue Options, Then Good News?*, WALL ST. J., July 8, 2006, at A1.

70. Floyd Norris, *They Deceived Shareholders. Who Cares?*, N.Y. TIMES, Oct. 6, 2006, at C1.

71. 17 C.F.R. § 229.402(b) (2007).

72. *Id.* § 229.402(b)(1).

73. *Id*. § 229.402(b)(2).

74. *Id.* § 229.402(b)(2)(iv).

75. Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33-8732A, 71 Fed. Reg. 53,158, 53,163 (Sept. 8, 2006). One might question why the SEC goes to lengths here to explain the "incentive or retention" effects of spring-loaded options, *id.*, when fully-disclosed, in-the-money options have an identical effect and involve no mark of deceit.

practice" of compensating executives in this manner.[76] While noting that the existence of a spring-loading plan "would be material to investors and thus should be fully disclosed," the Commission stated that if such a plan exists, "the company should disclose that the board of directors or compensation committee may grant options at times when the board or committee is in possession of material non-public information."[77] The rules do not require disclosure of any material nonpublic information. They merely require disclosure that a company indeed grants stock options while in possession of material nonpublic information.[78]

Despite this reluctance to regulate, the SEC did investigate Cyberonics, which granted 150,000 options to its CEO within hours after receiving FDA approval of a medical device.[79] However, after the new rules, it looks as if the only SEC spring-loading enforcement on the horizon will be for a failure to disclose such practices. Under the new rules, if Cyberonics would have previously disclosed that it planned to act in the manner it did in the furtherance of effective incentive and retention compensation, the SEC would likely not consider the actions unlawful.

Although the SEC has not found that spring-loading violates its rules, a strong argument can be made that it indeed violates SEC Rule 10b-5 and the congressional intent behind federal securities legislation. If this argument can be made, then in the interest of protecting the investing public and the integrity of the markets, should the SEC not at least attempt an enforcement action, allowing the federal courts to decide? To this end, one must analyze whether a federal court could interpret spring-loading as a violation of Rule 10b-5.

III. SPRING-LOADING AND SEC RULE 10b-5

The only clear historical precedent for a Rule 10b-5 spring-loading claim comes from an SEC action in 1968.[80] In *SEC v. Texas Gulf Sulphur Co.*, the defendants were company executives who possessed inside information that their mining company had discovered substantially valuable mineral deposits in eastern Canada.[81] While in possession of this information, which would eventually shoot the company's stock price upward when released to the public, the defendants accepted stock option grants from an unwitting board of

76. *Id.*

77. *Id.*

78. *See* 17 C.F.R. § 229.402(b)(2)(iv) (2007). It seems that a company may merely include a statement in their 10-K stating something like the following: "In the interest of retaining top executives, our most valuable company asset, we will grant these executives stock options pursuant to a plan that is timed to maximize market incentives."

79. *See* Feder, *supra* note 58.

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

81. *Id.* at 843–44.

directors.[82] The company's stock price stood near $24.13 the day after the options were issued.[83] When the company released news of the substantial mineral deposits to the public roughly six weeks later, the stock jumped to $37.00, and it stood at $58.25 just a month later, an increase of over 140% from the options' strike price.[84]

The court held that by accepting the options while in possession of the material inside information, the officers had violated federal prohibitions against insider trading.[85] The court noted that "[s]uch inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected."[86] It required instead that corporate insiders with knowledge of material inside information disclose the information to the public or abstain from trading.[87] However, since the directors had no knowledge of the information when issuing the options, this holding is likely limited to a situation where directors are *unaware* of the material inside information. Federal courts have yet to address a federal law challenge involving directors *in possession* of material inside information who granted options to officers before the information was released.[88]

There is notable academic debate about whether spring-loading implicates federal insider trading liability under Section 10(b) of the Securities Exchange Act, and particularly under SEC Rule 10b-5.[89] Section 10(b) of the Securities Exchange Act makes it unlawful for a person:

---

82. *Id.* at 844.

83. *Id.* at 847.

84. *Id.*

85. *See Texas Gulf Sulphur*, 401 F.2d at 856.

86. *Id.* at 852.

87. *Id.* at 848. This notion was later altered to require disclosure only to those individuals to whom the insider owes a fiduciary duty. *See* Chiarella v. United States, 445 U.S. 222, 228–29 (1980).

88. Few private federal law claims alleging spring-loading have surfaced since the revelation of backdating. The only notable spring-loading challenge came as a sidelight in the high-profile backdating class-action suit involving Apple, Inc. *See* First Amended Shareholder Derivative Complaint at ¶¶ 2, 4, 133, *In re* Apple Computer Inc. Derivative Litig., No. C 06–4128 JF, 2007 WL 4170566, at *1 (N.D. Cal. Nov. 19, 2007). The claim alleged a violation of state and federal laws when Apple executives received over 2 million stock options the day before CEO Steve Jobs announced a major deal with Microsoft. *Id.* ¶ 133. After release of the news, Apple's share price rose forty-eight percent in two days. Dawn C. Chmielewski, *At Apple, Timing Led to Overnight Windfalls*, L.A. TIMES, Jan. 3, 2007, at A1. However, the defendants' motion to dismiss was granted on statute of limitations and heightened pleading grounds. *See In re Apple*, 2007 WL 4170566, at *5–8. While the decision focused almost purely on backdating, the statute of limitations analysis looks to preclude the spring-loaded grant in relation to the Microsoft news for Section 10(b) purposes. *See id.* at *5.

89. *See Tyson I*, 919 A.2d 563, 593 n.77 (Del. Ch. 2007) (citing multiple sources highlighting the academic debate).

> [t]o use or employ, in connection with the purchase or sale of any security . . . , 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.[90]

Pursuant to Section 10(b), the SEC established Rule 10b-5, which generally proscribes any act that "operate[s] as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[91] The rule has been described as a "long-arm provision in which the SEC forbids everything the statute gives it power to forbid."[92]

On its face, Rule 10b-5 may look to apply plainly to an act such as spring-loading, if only because the practice for many provokes notions of secrecy and deceit, and because it involves stock options, which are at least directly related to securities. However, a brief glimpse at Rule 10b-5 jurisprudence quickly dispels any notion of an easy fit.

To prove a claim under Rule 10b-5, courts generally require five elements: (1) fraud or deceit (2) by any person (3) in connection with (4) the purchase or sale (5) of any security.[93] Of these elements, the second presents the least room for argument regarding its application to spring-loading. The actors involved are certainly people, whether corporate officers or members of a board of directors. The other four elements warrant a more detailed discussion.

A. *Executive Stock Options as "Securities"*

The term "security" is defined in both the Securities Act of 1933[94] and the Securities Exchange Act of 1934.[95] In defining a security, scholars have noted

---

90. The Securities Exchange Act of 1934, Pub. L. No. 73-291 § 10, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78(a)–78(k)(k) (1982 & Supp. V 1987)) [hereinafter Exchange Act].

91. 17 C.F.R. § 240.10b-5 (2008). Rule 10b-5 states in full:

> 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 or any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (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.

92. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463 (1990).

93. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.4[2], at 380–81 (4th ed. 2002).

94. 15 U.S.C. § 77b(a)(1) (2006).

that the definitional language between the Acts is strikingly similar.[96] To this end, the Supreme Court has held that the definition of a security between the Securities Acts is "virtually identical and will be treated as such in our decisions dealing with the scope of the term."[97]

Few federal courts have addressed whether executive, or more generally employee, stock options fall within the definition of a "security" under the Securities Acts.[98] However, the courts that have reached the question have generally answered it in the affirmative, holding that executive stock options are "securities."[99] In the Securities Acts, the definition of a "security" includes "stock" among a list of items, and it then includes the "*right to . . . purchase*, any of the foregoing," directly implicating stock options.[100] Considering this clear inclusion of stock options in the statutory text, one available argument that executive stock options are not securities utilizes the introductory statutory language, which reads: "unless the context otherwise requires."[101] However, courts have readily denied the argument that the context requires treating an employee stock option as anything other than a security under the Acts.[102] Further, although the *Texas Gulf Sulphur* court did not explicitly address the definitional issue, it certainly must have assumed executive stock options were securities; otherwise, it could not have imposed Rule 10b-5 liability upon the defendants.[103]

Therefore, this paper moves forward with the assumption that executive stock options qualify as securities under the Acts. The discussion now turns to the remaining three elements: "fraud or deceit"; "in connection with"; and "purchase or sale."

95. *Id.* § 78c(a)(10) (2006). The Securities Act of 1933 and the Securities Exchange Act of 1934 will hereinafter be referred to collectively as "the Securities Acts," or simply "the Acts."

96. *See* Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 551 (2003).

97. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985).

98. Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195, 1234 n.211 (2003).

99. *See, e.g.*, Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 559 (2d Cir. 1985); Collins v. Rukin, 342 F. Supp. 1282, 1286–88 (D. Mass. 1982); *In re* Cendant Corp., 76 F. Supp. 2d 539, 545 (D.N.J. 1999).

100. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2006) (emphasis added).

101. *Id.* § 77b(a); *see* Bodie, *supra* note 96, at 558–59.

102. *See Yoder*, 751 F.2d at 560 ("We see no reason why 'the context requires' us to hold that an individual who commits herself to employment by a corporation in return for stock or the promise of stock should not be considered an investor."); *Collins*, 342 F. Supp. at 1287–88 ("[T]he Court declines to hold that the instant context, as a matter of law, requires that the explicit inclusion of stock options in the definitional sections of the 1933 and 1934 Acts be disregarded . . . .").

103. This observation also holds for the "purchase or sale" requirement. *See infra* note 189 and accompanying text.

B. Fraud or Deceit

Since executive stock options are legally securities, the analysis now moves to determine whether spring-loading constitutes fraud or deceit in connection with the purchase or sale of those securities. This section finds that spring-loading may constitute fraud or deceit in the context of Rule 10b-5, but the extent of disclosure required of corporations is largely unclear.

Supreme Court jurisprudence under Rule 10b-5 has developed the "disclose or abstain rule," which requires that an insider holding material inside information must either disclose the information prior to trading or abstain from trading until the information has been released.[104] This rule was originally articulated in *Texas Gulf Sulphur*,[105] and it was based on the premise that the investing public at large is "entitled to equal access to material information."[106] However, the Court has since scaled back the original rule's coverage. In *Chiarella v. United States*,[107] the Court imposed a threshold requirement that first there must exist a duty to disclose arising from a "'fiduciary or other similar relation of trust and confidence'" before the disclose or abstain rule applies.[108] The Court reiterated this requirement in *Dirks v. SEC*.[109]

The disclose or abstain rule forms the basis of the "classical theory" of insider trading liability.[110] The Court has also utilized an alternative theory in holding a party liable for insider trading, known as "misappropriation theory."[111] Misappropriation theory imposes Rule 10b-5 liability when a person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[112] These two theories are "complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities."[113]

Some commentators have argued that spring-loading, at least where a disinterested board is privy to the material inside information, is not a violation of misappropriation theory, and therefore not a violation of Rule 10b-5.[114] This perspective adheres to the analysis that although shareholders have no

104. *See* Anabtawi, *supra* note 61, at 860.
105. 401 F.2d 833, 848 (2d Cir. 1968).
106. Anabtawi, *supra* note 61, at 860.
107. 445 U.S. 222 (1980).
108. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(A) (1976)).
109. 463 U.S. 646, 654, 657–58 (1983).
110. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).
111. *Id.* at 652.
112. *Id.*
113. *Id.*
114. *See* Larry E. Ribstein, Options and Insider Trading, on Ideoblog, http://busmovie.typepad.com/ideoblog/2006/07/options_and_ins.html (July 11, 2006, 06:32 EST) (cited by Ch. Chandler in *Tyson I*, 919 A.2d 563, 593 n.77 (Del. Ch. 2007)).

knowledge of the inside information, they authorize the options grant through an informed board of directors, and thus no misappropriation occurs.[115] However, this analysis misses the mark, since it analyzes spring-loading under the wrong theory of liability. The Court in *United States v. O'Hagan*[116] plainly acknowledged that the "classical theory targets a corporate *insider's* breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the 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."[117] Under *O'Hagan*, since the parties involved in spring-loading are corporate officers and directors and thus corporate *insiders*, classical theory should be applied.

Professor Iman Anabtawi has analyzed whether under classical insider trading theory corporate executives and directors can be found to have breached a fiduciary duty when spring-loading.[118] Under *Dirks*,[119] the breach must stem from "some manipulation or deception" in order to violate Rule 10b-5.[120] *Dirks* followed *Santa Fe Industries, Inc. v. Green*,[121] which held that liability only follows from conduct that is "'manipulative or deceptive' within the meaning of [Section 10(b)]."[122] Thus, not every breach of fiduciary duty in relation to a securities transaction is a violation of Rule 10b-5.[123] As Professor Anabtawi suggests, difficulty lies in determining whether spring-loading satisfies the "fraud or deception" element because it is unclear where the source of the fiduciary duty lies.[124]

Without knowing the source of the fiduciary duty, one can discern neither what it includes, nor to whom it extends. The difficulty in determining the source of fiduciary obligation is a product of the Supreme Court's lack of

115. *See id.* (citing Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998)).

116. 521 U.S. 642 (1997).

117. *Id.* at 652–53 (emphasis added). In *O'Hagan*, a partner at a law firm learned of a client's upcoming tender offer for Pillsbury common stock. *Id.* at 647. He purchased call options and shares of Pillsbury stock while in possession of this information, thus misappropriating it. *Id.* at 647–48.

118. Anabtawi, *supra* note 61, at 859–81.

119. 463 U.S. 646 (1983).

120. Anabtawi, *supra* note 61, at 862.

121. 430 U.S. 462 (1977).

122. *Id.* at 473–74.

123. *Dirks*, 463 U.S. at 654.

124. Anabtawi, *supra* note 61, at 862. Anabtawi also notes the difficulty in defining the element of deception. *Id.* For a brief discussion of the difficult and unclear precedent in defining the element of manipulation or deception, see Joan MacLeod Heminway, *Martha Stewart Saved! Insider Violations of Rule 10b-5 for Misrepresented or Undisclosed Personal Facts*, 65 MD. L. REV. 380, 385 (2006).

clarity on the issue.[125] In *Santa Fe*, the Court spoke openly against the idea of a federal common law fiduciary duty because the "result would be to bring within [Rule 10b-5] a wide variety of corporate conduct traditionally left to state regulation."[126] Despite the Court's reluctance in *Santa Fe* to supplant state corporate law with Rule 10b-5, in *Chiarella*, *Dirks*, and *O'Hagan*, all decided after *Santa Fe*, the Court implied in its decisions a federal source of the fiduciary obligation.[127]

1. A State Common Law Source

State common law fiduciary duty principles include the duties of loyalty and care. If an officer engages in a self-interested transaction, that officer avoids violating the duty of *loyalty* as long as either (1) the transaction is approved by a disinterested decision-making body—independent directors or shareholders, or (2) if there is no disinterested approval, a court finds that the transaction was not unfair, thus cleansing any blemish the self-interestedness may cause.[128] The state common law duty of *care* incorporates the business judgment rule, "a presumption that in making a business decision, the directors of a corporation act on an informed basis, in good faith and honest belief that the action taken was in the best interests of the corporation."[129] This rule represents the "bedrock principle" that courts are reluctant "to substitute [their] judgment for that of a board if the board's decision can be attributed to any rational business purpose."[130]

In the context of spring-loading, disclosure is the key to fulfilling one's state fiduciary duty obligations.[131] Under duty of loyalty doctrine, as long as an officer discloses knowledge of material inside information to a disinterested board prior to accepting an option grant, the transaction, although "interested," satisfies the duty of loyalty.[132] In such a case, although the corporate officer is interested, the transaction is cleansed by disinterested board approval, and the officer will avoid liability. However, where a board of directors is *interested*, two outcomes are possible: either a court will find that the transaction was unfair and breached the duty of loyalty, or that the transaction was not unfair, and thus not a breach.[133] In the former scenario, both the officer and interested

125. Anabtawi, *supra* note 61, at 862.

126. Santa Fe Indus. v. Green, 430 U.S. 462, 478 (1977).

127. Anabtawi, *supra* note 61, at 863–64.

128. Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine*, 85 OR. L. REV. 993, 1016 (2006).

129. Moore Corp. Ltd. v. Wallace Computer Servs., 907 F. Supp. 1545, 1554 (D. Del. 1995) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

130. *Id.* (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

131. *See* Anabtawi, *supra* note 61, at 871.

132. *Id.*

133. *See supra* text accompanying note 128.

directors could face liability, while in the latter, no potential liability seemingly arises. Potential liability attaches to the officer *and* directors in the "interested board" scenario because "[c]orporate officers and directors . . . stand in a fiduciary relation to the corporation and its stockholders,"[134] satisfying the fiduciary relationship requirement of *Dirks*.

However, even where an officer fully discloses the information to a disinterested board, thus discharging that officer's duty of loyalty, the disinterested directors' fiduciary duty to shareholders remains at issue.[135] This duty turns upon directors' obligation to disclose certain information to shareholders, often referred to as the "fiduciary duty of disclosure."[136] Professor Anabtawi has asserted that the honesty requirement established in *Malone v. Brincat*[137] commands that a board of directors must disclose the material nonpublic information when communicating information to shareholders concerning a grant of options[138]:

> In other words, if and when a corporation, either voluntarily or pursuant to applicable disclosure requirements of the federal securities laws, disseminates information to its shareholders relating to the compensation of its executive officers in general or option awards in particular, it must, in order to comply with its state law duty of disclosure, do so fully and accurately.[139]

This assertion looks to have been largely accurate in the eyes of one Delaware Chancellor. Chancellor Chandler recently held in *In re Tyson Foods, Inc.*[140] that, in the context of spring-loading, where "a board of directors later concealed the true nature of a grant of stock options, [the court] may further conclude that those options were not granted consistent with a fiduciary's duty of utmost loyalty."[141] In addition, the business judgment rule will not protect a board of directors that engages in spring-loading, because "[w]here a board of directors intentionally conceals the nature of its earlier actions, it is reasonable for a court to infer that the act concealed was itself one of disloyalty that could not have arisen from a good faith business judgment."[142] However, the

134. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

135. *See* Anabtawi, *supra* note 61, at 868.

136. *See id.* at 870 (citing Lawrence A. Hamermesh, *Calling off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996)).

137. 722 A.2d 5, 10 (Del. 1998) ("[D]irectors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows *a fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty.").

138. Anabtawi, *supra* note 61, at 871.

139. *Id.*

140. *In re* Tyson Foods, Inc. (*Tyson II*), No. Civ.A. 1106-CC, 2007 WL 2351071, at *1 (Del. Ch. Aug. 15, 2007).

141. *Id.* at *5.

142. *Id.* at *4.

disclosure required by this Delaware case looks to be limited to the *fact* that options were spring-loaded, and it does not likely require dissemination of the actual material information.[143]

Therefore, under state law fiduciary duty requirements, when a board communicates with shareholders, it must inform them of the favorable timing of spring-loaded options grants.[144] Since federal securities laws require a corporation to disclose news of an option grant to the SEC, and thus shareholders, within two business days of the grant,[145] a board must disclose upon filing the report that the grant was favorably timed in order to avoid a breach of state law fiduciary duty.

2. A Federal Common Law Source

If the Supreme Court continues to stray from the *Santa Fe* premise that Rule 10b-5 should not be conflated with state law fiduciary duty ideals, then it may more explicitly find that federal common law provides the source of the fiduciary duty requirement of insider trading. Recall that *Chiarella*, *Dirks*, and *O'Hagan* all hinted at a federal common law source.[146] A brief look at federal insider trading jurisprudence leads to the notion that the disclose or abstain rule may provide the closest semblance of a federal common law fiduciary duty.[147]

There were two early justifications which led eventually to the disclose or abstain rule.[148] First, insider trading breached a fiduciary duty owed to shareholders.[149] Second, there was an inherent unfairness in utilizing confidential corporate information, intended for corporate purposes, in furthering self-serving ends.[150] After years of application of the disclose or abstain rule in the lower federal courts following the lead of the Second Circuit's 1968 *Texas Gulf Sulphur* decision, the Supreme Court finally endorsed the rule in 1990 in *Chiarella*.[151] In *Chiarella*, the Court noted that "[i]n *Cady, Roberts & Co.*, the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first

---

143. *See infra* notes 231–34 and accompanying text.

144. Anabtawi, *supra* note 61, at 871.

145. *See* Narayanan et al., *supra* note 14, at 1627 (discussing the SEC's amended disclosure rules in line with Section 403 of the Sarbanes Oxley Act).

146. *See supra* note 127 and accompanying text.

147. Theresa A. Gabaldon, *State Answers to Federal Questions: The Common Law of Federal Securities Regulation*, 20 J. CORP. L. 155, 198 (1995).

148. *Id.*

149. *Id.*

150. *Id.* at 198–99. *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961) ("A significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.").

151. Gabaldon, *supra* note 147, at 199 (citing Chiarella v. United States, 445 U.S. 222, 225–36 (1990)).

disclosed all material inside information known to him."[152] This clear language citing an SEC decision certainly looks to indicate a federal source of the duty to disclose or abstain.

Chiarella recognized that there exists a "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[153] Further, "[t]his relationship gives rise to a duty to disclose because of the 'necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders.'"[154] According to *Dirks*, this duty to disclose is not a general duty, but one arising from a fiduciary relationship.[155] Therefore, shareholders are the ones to whom disclosure is owed,[156] although the Court has suggested that adequate disclosure requires a broader, more public release of information in some circumstances.[157] The particular information that must be disclosed is "material nonpublic information," which describes "'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"[158]

Applying this framework to a spring-loading scenario, one must also bear in mind the policy considerations behind section 10(b) of the Securities Acts. The basic purpose behind the 1933 Act was to "'substitute' . . . 'a philosophy of full disclosure for the philosophy of *caveat emptor*.'"[159] In addition, a significant purpose behind the 1934 Act was a "renewal of investors' confidence . . . by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations."[160] Congress hoped that the 1934 Act would

152. *Chiarella*, 445 U.S. at 226–27 (citation omitted).

153. *Id.* at 228.

154. *Id.* at 228–29 (alteration in original) (quoting Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951)).

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

156. *Id.* at 653 n.10.

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

158. *Id.* at 654 (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)). The inquiry into whether information is "material" depends upon whether there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)). This inquiry involves a case-by-case factual analysis. *Id.* at 239.

159. Thel, *supra* note 92, at 415 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)). Some influential minds at the time criticized this full disclosure philosophy as still too narrow. *Id.* at 416.

160. H.R. Rep. No. 73-1383, at 13 (1934).

bring into "disrepute" the practice of an "unscrupulous insider . . . [using] inside information for his own advantage."[161]

With these purposes informing the analysis, it appears that an executive must disclose material nonpublic information in some manner prior to an option grant in order to discharge a federal fiduciary duty to disclose or abstain. Without disclosure of some substance, the executive will have utilized the information for his own advantage, something the 1934 Act sought to prohibit.[162] Further, this duty to disclose should reach as far as a duty to notify shareholders of the material information prior to receiving the grant, or to forego the grant altogether.[163]

Anabtawi has noted that the 1934 Act's philosophy of full disclosure looks to present the board with an obligation to "avoid making materially misleading statements in connection with a securities transaction."[164] But it seems that the disclose or abstain rule, in light of congressional intent, should take this obligation a step further to include materially misleading *omissions* as well. Candid disclosure is required because shareholders rely on board communications regarding executive compensation in making investment decisions.[165] Further, shareholders generally expect options to be used as an incentive for an executive to increase the corporation's stock price, rather than an in-the-money gift camouflaged as an incentive device.[166] Still, assuming the executive's duty of recent disclosure is discharged by mere disclosure of the information to the board, it remains unclear whether the board is required under the "fraud or deceit" element to disclose the material nonpublic information to shareholders prior to a spring-loaded grant.[167] A true "disclose or abstain" rule would demand as much. However, if the Supreme Court instead grants deference to the SEC's recent disclosure rules, a board would need only to disclose the existence of a general plan to spring-load options.[168]

Thus, under a federal common law fiduciary duty to disclose or abstain, an officer would need to disclose the material nonpublic information at least to the board, and potentially to shareholders, prior to receiving the grant. If the officer's duty does not extend to shareholders, then the "disclose or abstain" rule would require a board to disclose the material nonpublic information to shareholders before granting the would-be spring-loaded options. Since the SEC's inadequate disclosure rules directly conflict with a true "disclose or

161. *Id.*

162. *See id.* and accompanying text.

163. Anabtawi, *supra* note 61, at 875.

164. *Id.* at 880.

165. *Id.*

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

167. *See* Anabtawi, *supra* note 61, at 880.

168. *See supra* notes 76–78 and accompanying text.

abstain" rule, under a federal common law source of fiduciary duty, shareholders should receive the material inside information before options are granted.

3. Synthesizing the "Fraud or Deceit" Element

Outcomes will differ depending on what body of law federal courts view as the source of the fiduciary duty requirement. A state law source of fiduciary duty would only be breached if (1) an officer failed to disclose the actual information to the directors, (2) an interested or disinterested board failed upon communicating with shareholders to disclose that options were spring-loaded, or (3) an interested board approved spring-loaded options that a court later found to be "unfair." Alternatively, breach of a federal common law duty to disclose or abstain would occur (1) if an officer failed to disclose the material inside information to directors (and possibly shareholders), or (2) absent officer disclosure, if directors failed to disclose the material inside information to shareholders before granting the options. Unlike a state source, a federal source would require disclosure of the actual information, rather than a mere "plan" to spring-load.

In the end, the lack of clarity concerning the source of fiduciary duty of the "fraud or deceit" element favors more clear-cut jurisprudence. Further, the SEC's allowance of a mere disclosure of a "plan" to spring-load is directly contrary to the oft-mentioned "disclose or abstain" requirement of federal insider trading jurisprudence. Whether the Supreme Court or Congress delivers the clarity needed, the purposes of the original Securities Acts would be served best if the "disclose or abstain" rule were adopted as the federal standard. If this standard were adopted, disclosure of the material inside information would be required before granting options, and spring-loading would certainly constitute "fraud or deceit" under Rule 10b-5.

C. In Connection with the Purchase or Sale

Even if one accepts that spring-loading involves the requisite fraud or deceit, the action still only violates Rule 10b-5 if it is "in connection with the purchase or sale of a security."[169] The Supreme Court adopted a broad understanding of the "in connection with" requirement in *SEC v. Zandford*.[170] In *Zandford*, a securities broker sold securities in his client's account and seized the proceeds for his personal use.[171] The Fourth Circuit had held that the "in connection with" requirement was not satisfied because the broker had merely stolen assets from his client rather than having manipulated a particular

169. *See supra* note 91 and accompanying text.
170. 535 U.S. 813 (2002).
171. *Id.* at 815.

security.[172] However, the Supreme Court overruled the decision, focusing on the fact that the broker made the securities sales *so that* he could defraud his clients.[173] While careful to recognize that the term should not be read so generally as to "convert every common-law fraud that happens to involve securities into a violation of § 10(b),"[174] the Court stated that "[i]t is enough that the scheme to defraud and the sale of securities coincide."[175]

Still, there must be a legal "purchase or sale" of a security in order for the fraudulent action in connection with it to matter for Rule 10b-5 purposes.[176] The dividing line between whether a grant of employee stock options is a "purchase or sale" or a mere gratuity seemingly lies on the fault between broad-based employee option plans and options granted to high-level officers in return for employment.[177] The SEC stated in a 1980 release that regarding "stock awarded to, or acquired by, employees pursuant to individual employment arrangements, the staff generally has concluded that such arrangements involve separately bargained consideration, and that a sale of the stock has occurred."[178]

Courts have welcomed this interpretation in a line of cases beginning with *Collins v. Rukin*.[179] There, the court stated that where an employee is induced into employment through a "quid pro quo" involving the grant of stock options, a sale of securities takes place.[180] It distinguished between this type of transaction and one where stock options are granted without consideration in return.[181] Following this reasoning, in *Yoder v. Orthomolecular Nutrition Institution, Inc.*,[182] the court could find no reason why "an individual who commits herself to employment by a corporation in return for stock or the promise of stock should not be considered an investor."[183] In *Yoder*, a food allergist sold her business to the defendant and accepted a position of employment with the defendant, while the defendant promised to grant her stock in its company if certain sales levels were achieved.[184] Such an

172. *Id.* at 817–18.
173. *Id.* at 820.
174. *Id.* at 820.
175. *Zandford*, 535 U.S. at 822.
176. *See supra* note 91 and accompanying text.
177. *See* Bodie, *supra* note 96, at 560.
178. Employee Benefit Plans, Securities Act of 1933 Release No. 6188, 1980 WL 29482, at *15 n.84 (Feb. 1, 1980).
179. 342 F. Supp. 1282 (D. Mass. 1972).
180. *Id.* at 1289–91.
181. *Id.* at 1289.
182. 751 F.2d 555 (2d Cir. 1985).
183. *Id.* at 560.
184. *Id.* at 556–57.

arrangement met the requirement of a sale of securities in the eyes of the court.[185]

Even where stock options were part of an employment agreement with a current executive, rather than an agreement inducing someone to employment, the court in *Campbell v. National Media Corp.* held that the agreement constituted the purchase of securities.[186] Only where options are granted in broad measure to large numbers of employees, such as in employee stock ownership plans, have courts held that options fall outside Rule 10b-5's ambit.[187]

In light of these cases, a grant of spring-loaded options should amount to the "purchase or sale" of securities. Such a practice does not involve a broad-based option plan. Rather, it is calculated to induce or retain the employment of a select number of high-level executives. Further, under the *Campbell* line of reasoning, no distinction is drawn between options granted to a current executive or those used to attract a new executive. In addition, considering the strong bargaining position of high-level executives, options granted to these individuals are likely never granted without "separately bargained consideration," as the SEC once phrased the requirement.[188] If not attracting employment per se, they are a means of retaining productive officers, which can often hold more value for a company than finding new talent. Finally, the *Texas Gulf Sulphur* court imposed Rule 10b-5 liability for spring-loading, a decision it could not have reached without the assumption that options satisfy the "purchase or sale" requirement.[189] Thus, one may safely conclude that a grant of options to an individual or a small number of upper-echelon executives constitutes the "purchase or sale" of securities under Rule 10b-5.

Finally, the question remains whether the "in connection with" element is satisfied. Thinking logically, if granting executive stock options based on material nonpublic information can be considered fraud, and if an option grant to an executive constitutes the "sale" of a security, then the fraud and the security "sale" cannot be separated. Under *Zandford*, the "scheme to defraud and the sale of securities coincide,"[190] because the action of granting the options is both the fraud and the sale. More precisely, the action of granting

185. *Id.* at 561.

186. Campbell v. Nat'l Media Corp., No. Civ. A. 94-4590, 1994 WL 612807, at *3 (E.D. Pa. Nov. 3, 1994).

187. *See In re* Cendant Corp., 76 F. Supp. 2d 539, 544 (D.N.J. 1999) (distinguishing between options offered to an individual versus options offered to a member of a group of employees). For a thorough criticism of the individual versus broad-based option plan distinction, see Bodie, *supra* note 96, at 568–77 (arguing that the distinction is unwarranted and illogical).

188. *See supra* note 178 and accompanying text.

189. *See* Anabtawi, *supra* note 61, at 882 ("[W]ithout the benefit of that assumption, there could have been no fraud 'in connection with a purchase or sale,' as required by the Rule.").

190. SEC v. Zandford, 535 U.S. 813, 822 (2001).

the options while in possession of material nonpublic information is the fraud, while the mere grant of the options is the sale. Phrased either way, the "in connection with" element looks to pose no bar to a rule 10b-5 cause of action for spring-loading.

IV. IMPLICATIONS IN DELAWARE

Although the SEC's less-than-enthusiastic regulation of past undisclosed spring-loading is the extent of federal action thus far, the Delaware Chancery recently acknowledged a cause of action for spring-loading. In *Tyson II*, the court held that the practice is a breach of the fiduciary duties of good faith and loyalty.[191] In its decisions, the Chancery provided guidance on how Delaware courts may address future spring-loading claims. At the same time, it exposed the weakness of state common law fiduciary duty claims as a remedy to curb the practice of spring-loading.

In a shareholder derivative action, the plaintiffs alleged that Tyson Foods directors granted spring-loaded options to the company's executives on three separate occasions.[192] On March 29, 2001, Tyson's compensation committee granted a total of 350,000 options to three different directors at $11.50 per share.[193] The next day, Tyson publicly cancelled a $3.2 billion acquisition deal.[194] This news sent the company's stock price to $13.47 by the end of the day, more than a seventeen percent gain.[195] Directors received similar grants in October of 2001 and again in September of 2003.[196] On these two occasions, the grants closely preceded Tyson's public announcements that quarterly earnings would exceed Wall Street's expectations, propelling the company's stock price upward.[197] In addition, the plaintiffs asserted that the spring-loaded options amounted to unjust enrichment of their recipients, entitling the company to disgorgement of the unjustly obtained benefits.[198]

191. *Tyson II*, No. Civ.A. 1106-CC, 2007 WL 2351071, at *4 (Del. Ch. Aug. 15, 2007). The case settled in January of 2008. David Irvin, *Tyson to Pay $4.5 Million to Settle Suit*, ARK. DEM.-GAZETTE, Jan. 19, 2008, at D1. The settlement requires a number of reforms, including public disclosure six months in advance of the date when stock options will be priced. *Id.*

192. *Tyson II*, 2007 WL 2351071, at *1. Initially, four different grants were challenged, but one was subsequently cancelled by the company and rendered moot. *Id.* at *1 n.5.

193. *Tyson I*, 919 A.2d 563, 576 (Del. Ch. 2007).

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.* Coloring the background of these allegations was a 2004 SEC investigation into Tyson directors' perquisites. *Id.* at 579. These gratuities included the undisclosed personal use of corporate assets for the purchase of antiques, a horse, jewelry, artwork, and theater tickets. *Id.* In addition, Tyson family and friends were allegedly granted unlimited use of corporate aircraft, corporate vacation homes, chauffeurs, cooks, landscapers, and a boat crew, among other things. *Id.*

198. *Tyson I*, 919 A.2d at 580.

In a motion to dismiss, the court first held that the plaintiffs' spring-loading claims withstood a statute of limitations challenge.[199] The doctrines of equitable tolling and fraudulent concealment both tolled the statute of limitations, according to the court.[200] The plaintiffs alleged that the directors had knowingly issued spring-loaded options while publicly maintaining that the options were issued at market value.[201] The court noted that "[s]uch partial, selective disclosure—if not itself a lie, certainly exceptional parsimony with the truth—constitutes an act of 'actual artifice' that satisfies the requirements of the doctrine of fraudulent concealment."[202]

Further, since the defendants were fiduciaries, the doctrine of equitable tolling applied even if fraudulent concealment did not. The court noted that

> [i]t is difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at "market rate" and simultaneously withhold that both the fiduciary and the recipient *knew* at the time that those options would quickly be worth much more.[203]

Since this alleged conduct was a breach of the duties of loyalty and good faith, equitable tolling applied. Thus, the statute of limitations did not pose a problem for the plaintiffs.

Moving to the merits of the claim, the court first dismissed the spring-loading claims against directors who were not members of the compensation committee.[204] Since the plaintiffs conceded that the compensation committee had sole authority to grant the options, the claims necessarily were confined to those individuals.[205] Then, the court addressed the business judgment rule's application.[206] Since the plaintiffs did not allege a lack of independence, the court focused on whether the grants of options were within the bounds of the compensation committee's business judgment.[207] To this end, the plaintiffs needed to show that "the facts [were] such that no person could possibly authorize such a transaction if he or she were attempting in *good faith* to meet their duty."[208]

In answering the question, Chancellor Chandler noted that spring-loading presents a "much more subtle deception" than the "incontrovertible lie" of

199. *Id.* at 590.
200. *Id.*
201. *Id.*
202. *Id.*
203. *Tyson I*, 919 A.2d at 590–91.
204. *Id.* at 591.
205. *Id.*
206. *Id.* at 592.
207. *Id.* at 591–92
208. *Tyson I*, 919 A.2d at 592.

backdating.[209] Focusing on what exactly shareholders authorize in an incentive stock option plan, namely market-value option grants, the court recognized the inconsistency in seeking shareholder approval of such a plan, and then seeking to "undermine the very objectives approved by shareholders."[210] The duty of loyalty held by a director includes "the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary."[211] These alleged actions fell short of meeting the duty.

With the business judgment hurdle cleared by the plaintiffs, the court then phrased the precise substantive question: "whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he *knows* those shares are actually worth more than the exercise price."[212] The court's answer: "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 be acting loyally and in good faith as a fiduciary."[213]

The court noted that two specific allegations must be present in order to show that spring-loading is beyond the bounds of the business judgment of a disinterested independent board.[214] First, a plaintiff must plead that the options were granted pursuant to a shareholder-approved plan.[215] Second, a plaintiff must claim that the directors who approved the 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."[216] Having alleged these specifics, the plaintiffs had adequately alleged that "the Compensation Committee violated a fiduciary duty by acting disloyally and in bad faith with regard to the grant of options."[217]

Turning later to the unjust enrichment claims, the court left open the possibility that a claim of unjust enrichment could be proven on the alleged facts.[218] Since the spring-loading claims survived dismissal, directors on the compensation committee now faced potential liability. Stemming from such

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.* at 593.

213. *Tyson I*, 919 A.2d at 593.

214. *Id.*

215. *Id.*

216. *Id.* The court noted that shareholders may expressly empower a board of directors to spring-load, bullet-dodge, or even backdate options, and that actions pursuant to such empowerment would not violate relevant law. *Id.*

217. *Id.*

218. *Tyson I*, 919 A.2d at 602–03.

liability, an unjust enrichment claim "would allow the Court to force other directors to disgorge, for example, improperly spring-loaded options" from non-liable directors or officers.[219] The court could not rule out such a possibility.[220]

After the denial of the motion to dismiss, the outside directors of the compensation committee filed a motion for judgment on the pleadings.[221] Clearing up a misconception at the time of the motion to dismiss, the court now determined that the allegedly spring-loaded options were not *incentive* stock options, but *non-qualified* stock options.[222] This distinction was potentially pivotal. Under Tyson's shareholder-authorized stock incentive plan, incentive stock options were required to be issued at market value, while non-qualified stock options could be issued at below market value, at the compensation committee's discretion.[223] The court had based the motion to dismiss denial on the notion that the shareholder-approved stock option plan explicitly required a market-value grant.[224] Absent such an agreement, the question had now changed. Perhaps surprisingly to some, the result did not.

Taking a step back from the question of explicit shareholder authorization, the court returned to the comfortable terrain of the duty of loyalty. "The affairs of Delaware corporations are managed by their board of directors, who owe to shareholders duties of *unremitting* loyalty," the Chancellor began.[225]

> Loyalty. Good faith. Independence. Candor. These are words pregnant with obligation. The Supreme Court did not adorn them with half-hearted adjectives. Directors should not take a seat at the board table prepared to offer only conditional loyalty, tolerable good faith, reasonable disinterest or formalistic candor. It is against these standards, and in this spirit, that the alleged actions of spring-loading or backdating should be judged.[226]

Further, when directors seek shareholder approval for a stock option compensation plan, "they do not do so in the manner of a devil in a dime-store novel, hoping to set a trap with a particular pattern of words."[227] If the stock option plan had never been put to a shareholder vote, the spring-loading scheme would have constituted material information requiring disclosure when the grant was made public.[228] In consenting to the plan here, "shareholders did

219. *Id.* at 603.
220. *Id.*
221. *Tyson II*, No. Civ.A. 1106-CC, 2007 WL 2351071, at * 1 (Del. Ch. Aug. 15, 2007).
222. *Id.* at *2.
223. *Id.* at *2–3.
224. *Id.* at *3.
225. *Id.* (citing Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998)).
226. *Tyson II*, 2007 WL 2351071, at *4.
227. *Id.*
228. *Id.*

not implicitly forfeit their right to the same degree of candor from their fiduciaries."[229]

Looking to the two-part test it had applied in the earlier motion to dismiss, the court held that, although appropriate at the time, it was "couched in too limited a manner."[230] Even though the allegedly spring-loaded options were non-qualified and thus could be granted below market value, the court was "not convinced that allegations of an implicit violation of a shareholder-approved stock incentive plan are absolutely necessary for the [c]ourt to infer that the decision to spring-load options lies beyond the bounds of business judgment."[231] Rather, the court found that "where [it] may reasonably infer that a board of directors later concealed the true nature of a grant of stock options, [it] may further conclude that those options were not granted consistent with a fiduciary's duty of utmost loyalty."[232]

Here, the court could reasonably infer from the pleadings that the defendants intended to hide "a pattern of unfairly stocking up insiders' larders with option grants shortly before" the release of positive company news.[233] Considering the lack of disclosure paired with the scale and timing of the grants, an inference of "purposeful subterfuge" arose.[234] Such self-dealing, when accompanied by an attempt to hide it, was inconsistent with directors' fiduciary duty of loyalty.[235] Therefore, the directors' motion for judgment on the pleadings was denied.[236]

The court also noted that even with the appropriate disclosure, directors would still be subject to a "well-pled claim that the compensation awarded was actionably excessive because, for example, it involved self-dealing and was not fair to the corporation."[237] This description resembles a corporate waste claim, which involves "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[238] Largely a question of fact, it seems this inquiry would pivot upon how extreme the difference is between an option's strike price and its market price at the time of exercise. Still, it seems that waste might be an actionable claim in a scenario such as Cyberonics, for example.[239]

229. *Id.*
230. *Id.* at *5.
231. *Tyson II*, 2007 WL 2351071, at *5.
232. *Id.*
233. *Id.* at *6.
234. *Id.*
235. *Id.* at *5–6.
236. *Tyson II*, 2007 WL 2351071, at *6.
237. *Id.*
238. Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).
239. *See supra* notes 58–59 and accompanying text.

In summation, the Delaware Chancery has determined that spring-loading stock options can constitute a breach of fiduciary duty. However, since the court focused on the directors' attempts to hide the fact that they had spring-loaded the options, the decision looks only to require general disclosure to shareholders that a grant was favorably timed, or disclosure of a plan to time option grants in this manner. If true, this requirement would somewhat mirror the SEC's disclosure requirements, a less-than-ideal result. Therefore, like the federal forum, Delaware's corporate jurisprudence thus far does not provide a clear requirement prohibiting the use of material inside information to favorably time an option grant. Chancellor Chandler may fall on the preferable side of the ideological battle. But Delaware's common law, at least in his interpretation, does not require disclosure of material inside information before options are granted.

V. SOLUTIONS

Identifying a problem holds inherent value, but it remains incomplete without at least a brief look at potential remedies. As discussed *supra*, the federal government has come to occupy a central role in securities regulation, most notably in response to recent corporate scandal involving backdating. The federal government then, in the interest of consistency, should take the lead in remedying this problem, which closely resembles backdating's deception. Viable solutions exist that would provide this desired consistency, ensuring predictable reliance by corporations, investors, and litigants alike. Potential remedies include, but are certainly not limited to, the following: (1) litigation under Rule 10b-5 or section 10(b), (2) new legislation, (3) IRS enforcement, (4) monthly scheduled option grants, (5) a pre-grant disclosure rule, and (6) shareholder approval.

Litigation under Rule 10b-5 is at least a tenable option.[240] Although some commentators still argue that spring-loading presents no problem at all,[241] the Delaware courts have determined that spring-loading represents a breach of fiduciary duty analogous to backdating.[242] This state law determination could have significant federal impact from the standpoint of equating spring-loading with a fraudulent breach of fiduciary duty, since Rule 10b-5 requires a manipulative or deceptive breach of fiduciary duty.[243] Additionally, some commentators have noted that spring-loading could be treated as a violation of the general insider trading terms of section 10(b).[244] Arguments that the

240. *See supra* Part III.

241. *See supra* note 60 and accompanying text.

242. *See Tyson I*, 919 A.2d 563, 593 (Del. Ch. 2007) (referring to backdating and spring-loading together as disloyal and an exercise of bad faith).

243. *See supra* notes 119–22 and accompanying text.

244. *See* Narayanan et al., *supra* note 14, at 1641.

federal government should refrain from meddling in traditional state corporate law matters fall flat in light of extensive federal securities backdating litigation. Therefore, since spring-loading looks to raise a viable claim under federal insider trading laws, it should be tested by the SEC.[245]

If the courts determine that a spring-loading claim does not meet federal securities law scrutiny, then an obvious gap in federal law will have been exposed.[246] In that case, Congress should attend to the problem that the SEC has so far failed to fix. While the SEC's July 2006 disclosure rules require disclosure of a plan to spring-load options,[247] scholars have observed that while the rules "will almost certainly eliminate . . . backdating . . . , they do nothing to limit springloading."[248] In effectuating an original purpose of the Securities Acts, to renew shareholder confidence in corporate managers as "trustees for their corporations,"[249] federal law should address this practice that legislators naturally did not consider at the time of drafting.[250]

Next, the IRS could enforce tax violations to which spring-loading gives rise. Section 162(m) of the Internal Revenue Code requires that for stock options to be exempt from the $1 million executive compensation deduction cap, they must not be granted below market value, or "in-the-money."[251] Further, under section 422 of the Internal Revenue Code,[252] statutory "incentive stock options" (ISOs) receive highly favorable tax treatment over "nonstatutory stock options" (NSOs), subject to the same prohibition against in-the-money grants.[253] Finally, many executive stock options are NSOs designed to be exempt under Section 162(m), and if deducted, these NSOs are subject to 162(m)'s in-the-money grant prohibition.[254]

Since spring-loaded options are granted at a price that does not incorporate the material inside information that will raise the stock's market value, these options must be considered in-the-money. Hence, they should not be exempt

245. Note that the SEC has at times hinted that spring-loading is a problem worthy of enforcement. *See supra* notes 67–68, 79 and accompanying text.

246. With the current post-grant minimal disclosure requirement of *Tyson*, there is a gap in Delaware common law as well. However, with federal law preempting most private securities class-actions, the gap needs federal filling.

247. Narayanan et al., *supra* note 14, at 1640; *see supra* notes 74–76 and accompanying text.

248. Narayanan et al., *supra* note 14, at 1640.

249. *See supra* note 160 and accompanying text.

250. The first and only true spring-loading litigation under the Securities Acts came to light in 1968, over three decades after the Acts were passed. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

251. *See* Narayanan et al., *supra* note 14, at 1620. Under section 162(m), to be deductible the options also must be granted pursuant to a shareholder-approved plan, by an independent compensation committee, and subject to a "per-person per-period" limit. *Id.*

252. I.R.C. § 422 (2000).

253. Narayanan et al., *supra* note 14, at 1621.

254. *Id.*

from the $1 million deduction cap, nor should they qualify as ISOs and receive favorable tax treatment.[255] Therefore, if a company has deducted the value of spring-loaded options as a business expense under 162(m) or treated them as ISOs, the IRS could institute collection efforts against the appropriate parties owing taxes.[256] Such enforcement could serve to curb spring-loading since corporate and individual tax advantages would be forfeited.

Moving away from the penalty-enforcement front, the federal government should also consider closer regulation of stock option compensation practices. First, regularly scheduled, monthly option grants could largely eliminate the benefit of spring-loaded options.[257] For example, the benefit of a spring-loaded option in August will be counterbalanced by the higher price of the options granted in September, since the market will have adjusted to the now-public information.[258] Such a scenario would eliminate the incentive to spring-load options.[259] Second, a pre-grant disclosure rule could similarly reduce the benefit of spring-loaded options.[260] A pre-grant disclosure rule would require disclosure to shareholders, shortly in advance of an executive stock option grant, of the fact that the grant will soon occur.[261] This information would then be incorporated into the stock's price by the market, and the options' strike price would more closely reflect their fair market value.[262] However, a pre-grant disclosure rule would still not prevent the manipulative timing of the release of positive news just after the grant and negative news just before the grant. Although the former looks to hold more promise because it more fully eliminates the incentive to spring-load options, both regularly scheduled monthly grants and a pre-grant disclosure rule could serve as practical tools in limiting spring-loading.

255. *Cf.* Narayanan et al., *supra* note 14, at 1621 (making the argument regarding backdated rather than spring-loaded options). There are also potential implications under section 409(a), which would create further tax burdens if options are considered in-the-money. *See id.* at 1622.

256. Some commentators have noted the difficulty in determining the "true" market value of spring-loaded options on the day they were granted, presenting a potential problem for IRS enforcement. *See* Kara Scannell et al., *Can Companies Issue Options, Then Good News? – SEC Is Divided on Practice Known as 'Spring Loading'*, WALL ST. J., July 8, 2006, at A1. However, if the value can be determined, spring-loaded options could "come with the same tax 'parade of horrors' that follows backdated options." *Id.*

257. Narayanan et al., *supra* note 14, at 1640. Yermack also suggested regularly scheduled option grants. *See* Yermack, *supra* note 42, at 454. In addition, he proposed not granting options within a certain period around corporate earnings announcements. *Id.*

258. *See* Narayanan et al., *supra* note 14, at 1640–41.

259. *Id.* at 1640.

260. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 349 n.183 (1998).

261. *See id.*

262. *See id.*

The final—and potentially most obvious—solution is requiring shareholder approval. If a company wishes to spring-load options, nothing prohibits it from seeking express authorization from its shareholders. Under federal securities laws, such authorization would satisfy "disclose or abstain" requirements and erase some of the inferences of manipulation and deception. Further, it would effectuate more closely a purpose of the Securities Acts to provide full disclosure and renew investor confidence.[263] Under state corporate laws, shareholder authorization would conform to the duties of care and good faith held by directors. Therefore, a federal rule requiring shareholder approval of spring-loading could be the best solution of all.

Although there is no "silver bullet" solution to the problem of spring-loading, there are many potential avenues by which the practice could be largely eliminated. However, whether the answer involves enforcing existing laws, codifying new laws, or more closely regulating option-based compensation, the federal government should act to end this deceptive practice.

CONCLUSION

The federal government's central and largely preemptive role in regulating securities transactions comes with an obligation to police and limit securities abuses. However, if the federal securities laws are "designed to protect shareholders from trading on incomplete or inaccurate information,"[264] then the SEC is failing this goal in regard to spring-loading. Federal inaction runs the risk of perpetuating and repeating for truth the prominent falsehood that former Commissioner Atkins and others endorse—that spring-loading is an acceptable and efficient compensation practice.

On the federal front, spring-loading looks to satisfy the major elements of a Rule 10b-5 claim. It does depend upon the source of fiduciary duty involved, but under a true "disclose or abstain" rule, disclosure of material inside information should be disseminated to shareholders before options are granted. Absent such disclosure, directors, and potentially executives, will have run afoul of Rule 10b-5 and should face liability. However, the SEC's reluctance to enforce federal insider trading prohibitions against spring-loading, paired

263. David Yermack disagrees. He wrote that "[e]ven if stockholders acquiesced in the opportunistic timing of CEO stock option awards, considering it an implicit form of compensation, such arrangements would contravene the spirit and possibly the letter of the federal securities laws." *See* Yermack, *supra* note 42, at 471.

264. Yablon & Hill, *supra* note 47, at 92. Yablon and Hill note that "[t]here is much language in the debates prior to passage of those statutes and in later case law to the effect that the federal securities laws were designed to prevent the kinds of abuses of naive investors that took place during that period." *Id.* at 92 n.36.

with its tacit approval of the practice, have thus far stifled the possibility of regulatory action under federal securities laws.

At the state level, the Delaware Chancery has determined that spring-loading constitutes a breach of fiduciary duty. This determination should alert directors to potential liability, regardless of the federal implications. However, it looks as though Delaware law merely requires disclosure of the fact that options were spring-loaded *after* the grant has already taken place in order for directors to discharge their fiduciary duty to shareholders. Thus, Delaware common law, and likely the common law of most other states, fails to provide an adequate remedy.

Therefore federal enforcement and reform are necessary in order to curb spring-loading's continuation. There exist many potential cures, including litigation and enforcement under existing federal securities laws; passage of new legislation; a regularly scheduled, monthly option grant requirement; a pre-grant disclosure requirement; and simple shareholder approval. With manifold possibilities, the only real obstacle to a solution is reluctance. A new presidential administration now controls, and a different SEC chairman sits at the helm.[265] Amidst widespread public outcry against abuses and excess in executive compensation,[266] the time is ripe for a solution. If federal authorities and legislators miss the mark, then the practice of spring-loading will persist. If these actors rise to meet their responsibilities, however, then spring-loading will fade in stature to represent little more than a colorful corporate buzzword of the past.

MATTHEW E. ORSO[*]

265. Zachary A. Goldfarb, *Schapiro's SEC Expected to Step Up Enforcement*, WASH. POST, Feb. 4, 2009, at D1.

266. *See* Eric Dash, *Reduced Exit Packages Urged for Ousted Executives*, N.Y. TIMES, Sept. 10, 2008, at C4 ("Outsize[d] executive pay has been a hot-button issue, resonating with Democratic and Republican voters."); Jeffrey Goldfarb et. al., *Bankers to Learn What "Malus" Is*, N.Y. TIMES, Nov. 17, 2008, at B2 (describing UBS's restructured executive compensation plan amidst "regulatory pressure and public outcry"); Greg Griffin, *More Fallout from Bailout Plans; Anger at CEO Pay Resurfaces; Democrats Want Limits on Executive Compensation at Rescued Companies*, DENVER POST, Sept. 28, 2008, at K1.

* J.D. Candidate, Saint Louis University School of Law, 2009; B.A., University of Dayton, 2001. I thank my family, especially my wife Jenny and our two children, Jack and Edie, for their continuous love, patience, and support of my endeavors in the law. I further thank Professor Matthew T. Bodie, whose guidance and suggestions were invaluable throughout the writing process.