WHAT THEY DON'T KNOW CAN HURT THEM: CORPORATE OFFICERS' DUTY OF CANDOR TO DIRECTORS

BY SHANNON GERMAN*

ABSTRACT

The duty of candor has developed significantly over the past century of Delaware corporate jurisprudence. As the duty currently stands, corporate directors and officers owe a duty to disclose material information to the shareholders. In light of recent corporate scandals—most notably those involving options backdating—a significant gap has appeared which could be aptly filled by an expansion of the duty of candor so that corporate officers owe a duty to disclose material information to the directors. If the duty of candor were expanded to encompass corporate officers' communications with directors, then directors would be better suited to fulfill their fiduciary duties. Using Desimone v. Barrows *as a case study, this article summarizes the current state of the duty of candor in Delaware case law and suggests an expansion of that duty. After review of the options backdating cases, this article concludes that an internal duty of candor would have provided a way for shareholders to bring derivative suits on behalf of the corporation against the officers who knowingly engaged in the deceptive behavior. Imposing liability for a breach of an officer's duty of candor to the corporation would provide a remedy for the corporation—and its shareholders—for the alleged wrongdoing.*

I. INTRODUCTION

Gururaj "Desh" Deshpande and Daniel Smith founded optical networking firm Sycamore Networks, Inc. (Sycamore) in 1998. The company went public in 1999, at the height of the tech boom. The initial public offering (IPO) was the fourth largest of all time. At its peak in 2000, Sycamore's stock traded close to $190 a share on the NASDAQ Global Select Market. By 2001, the price had dropped to $10 a share. The stock was trading under $3 as of December 2008. At that time, the company had a market capitalization of approximately $800 million.

---

*2008-2009 Law Clerk to the Honorable Randy J. Holland of the Supreme Court of Delaware. J.D., *magna cum laude*, Georgetown University Law Center, 2008; M.J. (Journalism), University of Maryland, 2002; B.A. (English), *with distinction*, University of Delaware, 2001.
Thank you to Professor Donald C. Langevoort for his guidance with this article.

Deshpande and Smith are members of Sycamore's board of directors and together they own one-third of its common stock. Chairman Deshpande owns 16.5% of the common stock and receives no compensation for his duties as chairman other than reimbursement of expenses. CEO and President Smith owns 15.5% of the common stock, receives a salary of $100,000, and has not received a bonus or stock option grant since Sycamore went public. Deshpande and Smith have been described as "unassuming individuals."[1] They work out of Sycamore's modest suburban Boston headquarters with bare walls and windowless offices.[2] After the IPO, Smith continued to drive a ten-year-old Volvo station wagon.[3] Deshpande was described as "surprisingly frugal."[4]

Despite their modesty, Deshpande and Smith are very successful. Deshpande had a net worth of $412 million in 2006.[5] When Sycamore's stock was at its peak in 2000, Deshpande was worth $13 billion[6] and deemed "The World's Richest Indian."[7] Smith had a net worth of $210 million in 2006.[8] At Sycamore's peak, Smith's stake was worth $2.7 billion.[9] Deshpande says he is willing to take risks because he has experienced business failures.[10] Smith loves "the chaos and uncertainty and adrenaline of working for small companies."[11]

As it turns out, Deshpande and Smith had no idea that Sycamore's CFO Frances Jewels was taking some risks of her own. Sycamore's board of directors had delegated to Jewels the authority to grant options to employees and executive officers pursuant to the company's shareholder-approved option plan.[12] Jewels deliberately backdated various option grants to appear as if they had been granted on the lowest trading day of the quarter, providing the recipients with an instant and substantial paper gain.[13] She concealed the backdating from the board with the help of the company's

---

[1]Paul C. Judge, *The Savvy Behind Sycamore*, BUS. WK., Dec. 20, 1999, at 150.

[2]*Id.*

[3]*Id.*

[4]Keith Kalawsky, *The Money Tree: Gururaj Deshpande*, CANADIAN BUS., Aug. 7, 2000, at 38.

[5]Francis Storrs, *The 50 Wealthiest Bostonians*, BOSTON MAG., Mar. 2006, http://www.bostonmagazine/articles/the_50_wealthiest _bostonians.

[6]*Id.*

[7]Kalawsky, *supra* note 4.

[8]Storrs, *supra* note 5.

[9]*Id.*

[10]Vincent Ryan, *Anatomy of an Entrepreneur*, TELEPHONY, Apr. 10, 2000, at 36.

[11]*Id.*

[12]Desimone v. Barrows, 924 A.2d 908, 919-21 (Del. Ch. 2007).

[13]*Id.* at 922.

director of human resources, Stephen Landry.[14] Jewels repeatedly instructed Landry to alter and falsify documents to corroborate the falsified dates of the option grants.[15] Once the options backdating was revealed, Sycamore had to restate its earnings for 2000 to 2003 because most of the options had been accounted for in the company's financials as having been granted at fair market value on the date of the grant—when they really were granted at a later date than had been reported.[16] On the actual grant dates, the fair market value of Sycamore's stock was higher than the improperly reported date.[17] Because the options were actually granted "in the money" as opposed to "at the money," the grants had to be reported as an expense on the company's balance sheet, resulting in reduced earnings.[18]

In 2006, a Sycamore shareholder brought a derivative action on behalf of Sycamore alleging that the board of directors breached its fiduciary duties in allowing the grants to occur.[19] That case, *Desimone v. Barrows*,[20] comes from a line of opinions from the Delaware Court of Chancery addressing options backdating and other option grant manipulation that occurred at various corporations and garnered much attention in 2006. The cases deal mostly with the fiduciary duty of loyalty and address the duty of disclosure owed by the board of directors to the corporation's shareholders. Without evidence that the board was aware of the improper option grants or intentionally deceived shareholders, the Delaware Court of Chancery would dismiss the complaint because the shareholder-plaintiff failed to meet its burden of pleading that the board acted in bad faith—and breached its duty of loyalty. As a result, the corporation received no redress for the harm caused by the corporate officers' misconduct.

The Delaware courts characterize the duty of candor as a duty owed by the board of directors to provide information to shareholders. Extending the duty of candor to impose on corporate officers a duty to provide information to the board of directors would give the corporation a way to seek redress for harm caused by misconduct within the corporation of which the board was not aware, such as the case at Sycamore. Such a duty would deter corporate officers, like Sycamore CFO Jewels, from engaging in deceptive actions and from hiding those actions from the board. It would

---

[14] *Id.* at 921-22.
[15] *Id.* at 922.
[16] *Desimone*, 924 A.2d at 923.
[17] *Id.*
[18] *Id.*
[19] *Id.* at 913.
[20] For a comprehensive analysis of the case, see *infra* Part III.B.

also enable the board to better fulfill its own fiduciary duties to the corporation, particularly its duty of oversight.

In Part II, this article discusses the development of Delaware's duty of candor and summarizes the state of the duty as it now exists in Delaware. Part III explains how the Delaware Court of Chancery has addressed the practice of options backdating among various Delaware corporations. It emphasizes that the court focused mostly on the knowledge and bad faith of the board, and ignored the culpability of the officers. Finally, this article concludes that corporate officers must owe a duty of candor to the board and explains the implications of the duty with regard to the type of claim, remedy sought, and demand excusal.

II. THE FIDUCIARY DUTY OF CANDOR IN DELAWARE

A. *The Origins of the Duty of Candor*

Delaware case law and commentary refer to the fiduciary duty of candor as a duty that flows from the directors to the shareholders. It is not clear whether the duty originates from statute or common law.[21] Either way, the possible origins of the duty do not focus solely on the relationship between directors and shareholders, indicating that it could be expanded beyond its current application.

Some commentators believe the duty came from an earlier version of the Delaware General Corporation Law (DGCL) that provided:

> If the directors or officers of any corporation organized under the provisions of this Act, shall knowingly cause to be published or given out any written statement or report of the condition or business of the corporation that is false in any material respect, the officers and directors causing such report or statement to be published or given out, or assenting thereto, shall be jointly and severally, individually liable for any loss or damage resulting therefrom.[22]

That provision was repealed in 1967 with the wholesale revisions to the DGCL.[23] The statute has been interpreted to measure the directors' duty

---

[21]Lawrence A. Hamermesh, *Calling Off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1104-12 (1996).

[22]21 Del. Laws, c. 273, § 19 (1899).

[23]Hamermesh, *supra* note 21, at 1104.

to provide information to the shareholders by a fraud standard.[24] Commentators have noted, however, that the statute does not actually create a fiduciary duty to shareholders but simply codifies common law fraud.[25] Because both creditors and investors could hold the directors and officers liable, the statute arguably did not require the existence of a fiduciary relationship.[26]

It is also suggested that the concept of a duty of candor owed to shareholders derived from state proxy regulation.[27] Prior to federal regulation of proxy solicitations, challenges to proxy solicitations were commonly brought under state law.[28] The Delaware Court of Chancery discussed disclosure requirements in this context as early as 1946.[29] In *Empire Southern Gas Co. v. Gray*,[30] the court enjoined the use of misleading proxy materials by a group of managers because the proxy materials incorrectly suggested that the solicitations were authorized by the board of directors.[31] The court explained that the proxy solicitor held the "burden of candor."[32] Yet, *Empire Southern* and other similar cases focus on the duty to avoid committing common law fraud when soliciting proxies. That duty does not bear on whether there is a fiduciary relationship between the parties.[33] The duty applies equally to directors and officers as it does to "dissident or insurgent proxy solicitors."[34]

The fiduciary duty of candor owed to shareholders could have derived from fiduciary principles in the common law fraud standard. In 1870, the Delaware Court of Chancery, in articulating the common law doctrine of fraudulent misrepresentation, explained that there is only a duty to disclose facts that may influence the adverse party to a transaction when there is a fiduciary relationship between the parties or where the party making the statement has unique knowledge unavailable to the beneficiary.[35]

---

[24] *Id.* at 1104 n.67 (citing DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 15.07A, at 15-64 (2007)).

[25] *Id.* at 1104.

[26] *Id.* at 1104-05.

[27] Hamermesh, *supra* note 21, at 1108-09.

[28] *Id.* at 1109 & n.88.

[29] Donald E. Pease, *Delaware's Disclosure Rule: The "Complete Candor" Standard, its Application, and Why Sue in Delaware*, 14 DEL. J. CORP. L. 445, 448 (1989) (citing Empire S. Gas Co. v. Gray, 46 A.2d 741 (Del. Ch. 1946)).

[30] 46 A.2d 741 (Del. Ch. 1946).

[31] *Id.* at 746.

[32] *Id.*

[33] Hamermesh, *supra* note 21, at 1110.

[34] *Id.* at 1110-11.

[35] *See* Maclary v. Reznor, 3 Del. Ch. 445, 464 (Del. Ch. 1870).

Indeed, two early cases deal with fraud in connection with directors' communications with shareholders and impose a duty of "honesty." In *Hall v. John S. Isaacs & Sons Farms, Inc.*,[36] the plaintiffs alleged that the director-defendants issued false and fraudulent annual reports to shareholders that overstated inventory and accounts receivable.[37] The court explained that, although directors do not have a statutory duty to provide annual reports to shareholders, "corporate directors must honestly disclose all material facts when they undertake to give out written statements concerning the condition or business of their corporation."[38] Because the director-defendants' accounting system and disclosures met Bureau of Internal Revenue requirements, the court concluded that there was no proof that the director-defendants issued false or fraudulent annual reports.[39]

In *Kelly v. Bell*,[40] the shareholders alleged in a derivative action that the directors of United States Steel Corporation fraudulently reported to shareholders, and falsely represented for accounting purposes, that certain payments to the local county government were tax payments.[41] The court provided that "directors owe a duty to honestly disclose all material facts when they undertake to give out statements about the business to shareholders," but the directors in this case were not dishonest because they did not purposefully conceal the true nature of the payments from shareholders.[42] The court reasoned that the details of the payments were well publicized and therefore there was no intent to deceive shareholders.[43]

B. *Delaware Gradually Develops the Fiduciary Duty of Disclosure*

While the origins of the duty of candor are not certain, the Delaware courts have articulated an obligation of complete candor—also referred to as a duty of disclosure—in a piecemeal fashion. Early cases dealt with the duty in reference to self-dealing transactions or other corporate transactions, such as mergers, for which the board sought shareholder approval. Later, the rule

---

[36]146 A.2d 602 (Del. Ch. 1958).
[37]*Id.* at 609.
[38]*Id.* at 609-10 (citing DEL. CODE ANN. tit. 8, § 144 (1953)).
[39]*Id.* at 610.
[40]254 A.2d 62 (Del. Ch. 1969).
[41]*Id.* at 71.
[42]*Id.*
[43]*Id.* (explaining that "there is not a shred of evidence to show that this procedure was adopted for sinister reasons").

was expanded to cover all director communications with shareholders, regardless of whether or not the board was seeking shareholder action.

The term "candor" was first used in 1958 in the context of a shareholder ratification of a self-dealing transaction.[44] In *Gerlach v. Gillam*,[45] the Delaware Court of Chancery explained that a fully informed shareholder ratification validates a self-dealing transaction.[46] The ratification was ineffective, however, because the defendant did not satisfy his disclosure duty—that is, his "obligation to exhibit complete candor in dealings involving a conflict between his personal interests and those of [the corporation's] stockholders."[47]

Nearly twenty years later, the Supreme Court of Delaware imposed a duty of candor on majority shareholders purchasing stock from minority shareholders in *Lynch v. Vickers Energy Corp.*[48] In *Lynch*, the Supreme Court of Delaware held that the directors of Vickers Energy Corp. (Vickers) breached their fiduciary duty of candor when they failed to disclose material information to minority shareholders to whom they owed a duty and whose stock Vickers wanted to acquire.[49] After the minority shareholders of TransOcean tendered their shares to Vickers (the majority shareholder of TransOcean), they sued the boards of directors of Vickers and TransOcean for making "less than a full and frank disclosure in the tender offer of the value of TransOcean's net assets."[50] The Supreme Court of Delaware explained that Vickers, as the majority shareholder of TransOcean, owed the minority shareholders a fiduciary duty of "'complete candor' in disclosing fully 'all the facts and circumstances surrounding the' tender offer."[51] The defendants were required to disclose "all information in their possession germane to the transaction."[52] The Supreme Court of Delaware adopted a similar definition to the federal securities materiality standard, defining "germane" as "information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock."[53] The Supreme Court

---

[44]Hamermesh, *supra* note 21, at 1113-14 (citing Pease, *supra* note 29, at 449).

[45]139 A.2d 591 (Del. Ch. 1958).

[46]*Id.* at 595.

[47]*Id.* at 593.

[48]383 A.2d 278, 281 (Del. 1977); *see also* Hamermesh, *supra* note 21, at 1115 (explaining that *Lynch* is often considered the original case to define the board of directors' fiduciary duty of candor).

[49]*Lynch*, 383 A.2d at 281.

[50]*Id.* at 279.

[51]*Id.* (quoting Lynch v. Vickers Energy Corp., 351 A.2d 570, 573 (Del. Ch. 1976)).

[52]*Id.* at 281.

[53]*Lynch*, 383 A.2d at 281 (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

of Delaware defined the duty of candor as a duty owed by an agent to a principal when the agent possesses special knowledge[54] and explained that the objective of the duty "is to prevent insiders from using special knowledge which they may have to their own advantage and to the detriment of the stockholders."[55]

In 1985, the Supreme Court of Delaware imposed a duty of complete candor on directors seeking shareholder approval of a merger in *Smith v. Van Gorkom*.[56] After finding that the directors breached their duty of care in approving the merger because they failed to fully inform themselves of the circumstances surrounding the merger, the court considered whether the shareholders were fully informed in approving the arm's-length transaction.[57] The court permitted the recovery of money damages because the directors breached their duty to disclose all material facts that a reasonable investor would consider important when voting on the merger.[58]

In *Rosenblatt v. Getty Oil Co.*,[59] the Supreme Court of Delaware stopped using the term "germane," explaining that "'germane' means 'material' facts. The term 'germane' has no well accepted meaning in the disclosure context, while 'material' does."[60] Later, in *Stroud v. Grace*,[61] the Supreme Court of Delaware denounced the use of the word "candor" in similar fashion. The court stated in *Stroud* that the fiduciary duty was better articulated as one of disclosure.[62] The court noted that:

> [t]he term "duty of candor" has no well accepted meaning in the disclosure context. Its use is both confusing and imprecise given the well-established principles and duties of disclosure that otherwise exist. Thus, it is more appropriate for our courts to speak of a duty of disclosure based on a materiality standard

---

[54]*Id. See also* Z. Jill Barclift, *Senior Corporate Officers and the Duty of Candor: Do the CEO and CFO Have a Duty to Inform?*, 41 VAL. U. L. REV. 269, 283 (2006) (explaining that "the court defined the duty of candor as the duty an agent owes a principal when in possession of special knowledge").

[55]*Lynch*, 383 A.2d at 281.

[56]488 A.2d 858, 890 (Del. 1985).

[57]*Id.* at 890-93.

[58]*Id.* at 893.

[59]493 A.2d 929 (Del. 1985).

[60]*Id.* at 944 ("[I]t is clear from the Delaware cases that the materiality standard of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) applies.").

[61]606 A.2d 75 (Del. 1992).

[62]*Id.* at 84.

rather than the unhelpful terminology that has crept into Delaware court decisions as a "duty of candor."[63]

In *Marhart, Inc. v. CalMat Co.*,[64] the Delaware Court of Chancery significantly expanded the duty of disclosure by holding that directors owe a fiduciary duty to disclose all material information in any public disclosure, regardless of whether or not shareholder action is sought.[65] The Delaware Court of Chancery looked to section 144 of the 1953 DGCL.[66] The 1953 provision imposed joint and several liability on directors and officers for damages resulting from knowingly distributing or publishing materially false written statements about the condition of the corporation.[67] The Delaware Court of Chancery concluded that the legal rule of section 144 of the 1953 DGCL survived the statute's repeal.[68] The court explained that "[i]t is entirely consistent with this settled principle of law that fiduciaries who undertake the responsibility of informing stockholders about corporate affairs, be required to do so honestly."[69]

In *Williams v. Geier*,[70] the Supreme Court of Delaware held that directors owe shareholders a duty of full and fair disclosure when seeking shareholder approval to amend the corporation's certificate of incorporation.[71] The Supreme Court of Delaware explained that in circumstances where corporate action cannot take effect without the approval of both the board of directors and the shareholders, the approval of the shareholders must be fully informed.[72] The three main situations in which both director and shareholder approval are required are: amendments to the certificate of incorporation under section 242 of the DGCL; mergers under section 251; and sales of all or substantially all of a corporation's assets under section 271.[73]

---

[63] *Id.*

[64] No. 11,820, 1992 WL 82365 (Del. Ch. Apr. 22, 1992), *reprinted in* 18 DEL. J. CORP. L. 330 (1993).

[65] *Id.* at *3, *reprinted in* 18 DEL. J. CORP. L. at 336.

[66] *Id.*, *reprinted in* 18 DEL. J. CORP. L. at 335.

[67] *Id.*

[68] *Marhart*, 1992 WL 82365, at *3, *reprinted in* 18 DEL. J. CORP. L. at 335-36 (discussing Kelly v. Bell, 254 A.2d 62, 71 (Del. Ch. 1969); Hall v. John S. Isaacs & Sons Farms, Inc., 146 A.2d 602, 609-10 (Del. Ch. 1958)).

[69] *Id.*, *reprinted in* 18 DEL. J. CORP. L. at 336.

[70] 671 A.2d 1368 (Del. 1996).

[71] *Id.* at 1379.

[72] *Id.* at 1379-80.

[73] *Id.* at 1379.

In *Malone v. Brincat*,[74] the Supreme Court of Delaware sought to tie together the various applications of the fiduciary duty of disclosure. The court clarified that directors owe a duty of honesty to shareholders not only in communications seeking shareholder action—whether for approval or ratification[75]—but also "[w]henever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action."[76] The court held that "directors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances."[77]

Pfeffer v. Redstone[78] is the most recent decision to address the fiduciary duty of disclosure. The Delaware Court of Chancery decided *Redstone* after the options backdating cases that are discussed below in Part III. The Supreme Court of Delaware affirmed the Delaware Court of Chancery's opinion this year.[79] The supreme court clarified in *Redstone* that the duty of disclosure is not an independent duty but part of the duties of care and loyalty.[80] The court held that the Delaware Court of Chancery properly stated: "'Corporate fiduciaries can breach their duty of disclosure under Delaware law . . . by making a materially false statement, by omitting a material fact, or by making a partial disclosure that is materially misleading.'"[81] The Delaware Court of Chancery explained that a disclosure violation may implicate the duty of loyalty if there is reason to believe the board lacked good faith in approving the disclosure.[82] If the board was merely careless, was not interested in the transaction, and did not knowingly (and in bad faith) approve the disclosures, then the disclosure violation would only implicate the duty of care.[83]

The Delaware courts' designation of the duty of candor as part of the duty of loyalty, when there is a failure to act in good faith, is consistent with

---

[74]722 A.2d 5 (Del. 1998).

[75]For a discussion of the difference between shareholder approval and shareholder ratification, see *In re PNB Holding Co. S'holders Litig.*, No. 28-N, 2006 WL 2403999, at *14 n.70 (Del. Ch. Aug. 18, 2006), *reprinted in* 32 DEL. J. CORP. L. 654, 676 n.70 (2007).

[76]*Malone*, 722 A.2d at 10.

[77]*Id.* at 9.

[78]No. 2317-VCL, 2008 WL 308450 (Del. Ch. Feb. 1, 2008), *aff'd*, No. 115, 2008, 2009 WL 188887 (Del. Jan. 23, 2009).

[79]Pfeffer v. Redstone, No. 115, 2008, 2009 WL 188887 (Del. Jan. 23, 2009).

[80]*Id.* at *4.

[81]*Id.* (quoting *Redstone*, 2008 WL 308450, at *8).

[82]*Redstone*, 2008 WL 308450, at *7 n.34 (citing *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563, 597-98 (Del. Ch. 2007)).

[83]*Id.* at *7.

recent opinions of the Supreme Court of Delaware that expand the duty of loyalty beyond traditional conflicts of interest. The duty also includes acts not in good faith, even in the absence of a conflict of interest, under the premise that a director who fails to act in good faith does not act in the corporation's best interests and is therefore disloyal.[84] Earlier cases, such as *Sinclair Oil Corp. v. Levien*,[85] provided that the duty of loyalty is implicated only when there is a conflict between the personal interests of the fiduciary and the best interests of the corporation, such as when the corporate fiduciary engages in self-dealing.[86] The Supreme Court of Delaware held in *Sinclair* that, absent self-dealing, the business judgment rule protects a fiduciary's decision and the intrinsic fairness standard, which is applied for allegations of breach of the duty of loyalty, does not apply.[87] In *Stone v. Ritter*,[88] the Supreme Court of Delaware held that a director breaches his duty of loyalty when he fails to exercise his duty of oversight in good faith, such as when he utterly disregards his duty.[89] *Redstone* demonstrates the Delaware courts' willingness to extend the duty of loyalty beyond traditional self-dealing situations. Consequently, misconduct by corporate fiduciaries will not be protected by the business judgment rule simply because there was no conflict of interest.

In *Redstone*, to complete a spin-off transaction in which Viacom was to divest itself of its majority shareholdings in Blockbuster, Viacom made a voluntary exchange offer to its shareholders, giving them the opportunity to exchange their shares for Viacom's shares of Blockbuster.[90] The shareholders who accepted the exchange offer received a premium of 17.6% for Viacom class A stock and a premium of 19.2% for Viacom class B stock.[91] Before the exchange offer, Blockbuster paid a pro rata special cash dividend of $5 per share to its existing shareholders.[92] Viacom, as Blockbuster's majority shareholder, received $738 million of the $905 million that Blockbuster paid in the distribution, which Blockbuster financed by a new

[84] *See* Stone v. Ritter, 911 A.2d 362 (Del. 2006).
[85] 280 A.2d 717 (Del. 1971).
[86] *See id.* at 720.
[87] *Id.*
[88] 911 A.2d 362 (Del. 2006).
[89] *Id.* at 370.
[90] Pfeffer v. Redstone, No. 2317-VCL, 2008 WL 308450, at *2 (Del. Ch. Feb. 1, 2008), *aff'd*, No. 115, 2008, 2009 WL 188887 (Del. Jan. 23, 2009).
[91] *Id.* at *3.
[92] *Id.* at *2.

$1.45 billion debt issuance.[93] All of this information was disclosed in Viacom's prospectus.[94]

A shareholder who tendered her Viacom shares for Blockbuster stock in the exchange offer brought a class action on behalf of all former Viacom shareholders who had tendered their shares in the exchange and on behalf of all Blockbuster shareholders who held stock at the time that Blockbuster made its special distribution.[95] The plaintiff alleged that Viacom's directors "breached their duty of disclosure by making material misstatements, omissions, and representations in the Prospectus."[96] She also alleged that the directors breached their fiduciary duty of loyalty and good faith by permitting the disclosure of a false and misleading prospectus in connection with the exchange offer.[97] The Delaware Court of Chancery dismissed both allegations. The court explained that the plaintiff failed to show a breach of the duty of loyalty for approving the allegedly false and misleading prospectus.[98] The court reasoned that there was no showing that the directors authorized the exchange offer to further the interests of Viacom's controlling shareholder or that they knowingly, and in bad faith, approved the disclosures.[99] Despite the plaintiff's various allegations that the board must have known about the omitted information, the court refused to infer that the directors had knowledge. It explained that it can only infer that a director had knowledge if the information was "either known (or reasonably assumed) to have been disclosed to or discussed with the board as a whole or otherwise known publicly."[100] "By contrast, directors are not as a matter of general experience presumed to know business operational information that is not of a kind routinely disclosed to boards of directors."[101]

Because there were no disclosure violations in *Redstone*, the Delaware Court of Chancery explained that it would not apply the entire fairness analysis to the transactions.[102] When a majority shareholder makes a non-coercive tender offer to acquire the shares of minority shareholders and when a corporation makes a voluntary, noncoercive self-tender to acquire its own shares, the offeror has a duty to structure the terms noncoercively and to

[93] *Id.*
[94] *Redstone*, 2008 WL 308450, at *3.
[95] *Id.* at *1.
[96] *Id.* at *5.
[97] *Id.*
[98] *Redstone*, 2008 WL 308450, at *7 n.34.
[99] *Id.*
[100] *Id.* at *10.
[101] *Id.*
[102] *Redstone*, 2008 WL 308450, at *7.

disclose all material facts—but there is no duty of entire fairness.[103] The Delaware Court of Chancery explained that entire fairness applies when self-interest exists.[104] Because "there [was] nothing to suggest that the Viacom directors who approved the Exchange Offer structured the transaction to put their own interests above those of either Viacom or any identifiable group of Viacom stockholders," and because the complaint did not allege that the exchange offer was coercive, the Delaware Court of Chancery would only consider whether the transaction was accomplished with the use of materially false or misleading disclosures.[105] Because the court did not find any disclosure violations, the complaint was dismissed. The Supreme Court of Delaware held that the Delaware Court of Chancery properly dismissed the complaint and affirmed the Delaware Court of Chancery's opinion.[106]

In Delaware, under the duty of candor, directors owe a fiduciary duty to disclose all material information to shareholders when: (1) seeking shareholder approval of transactions that cannot proceed without a shareholder vote; (2) seeking shareholder ratification of otherwise invalid or suspect transactions, such as self-dealing transactions or executive compensation and stock option plans; and (3) voluntarily communicating to shareholders, or the market generally, about the business of the corporation, even if no shareholder action is sought. In addition, majority shareholders owe a duty to disclose all material information to minority shareholders when making a tender offer for their shares.

III. THE DUTY OF CANDOR AND OPTIONS BACKDATING

Despite the Delaware Supreme Court's denunciation in *Stroud*, Delaware courts still use the term "candor," as recently seen in the Delaware Court of Chancery opinions addressing the 2006 options backdating scandal.[107] As discussed below, the Delaware Court of Chancery explained that when directors intentionally backdate stock options and conceal that information from the shareholders, public markets, and regulatory authorities, the directors' failure to be completely candid constitutes an act of bad

---

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] Pfeffer v. Redstone, No. 115, 2008, 2009 WL 188887, at *9 (Del. Jan. 23, 2009).

[107] For more on options backdating at that time, see James Bandler & Kara Scannell, *In Options Probes, Private Law Firms Play Crucial Role*, WALL ST. J., Oct. 28, 2006, at A1; Charles Forelle & James Bandler, *The Perfect Payday—Some CEOs Reap Millions by Landing Stock Options When They are Most Valuable; Luck—or Something Else?*, WALL ST. J., Mar. 18, 2006, at A1; James Surowiecki et al., *The Dating Game*, NEW YORKER, Nov. 6, 2006, at 54.

faith and a breach of the duty of loyalty. Because the Delaware Court of Chancery only considered the culpability of directors, the shareholder derivative complaints were dismissed if the boards were not aware of the option grant manipulation and did not knowingly approve the resulting false disclosures. In those cases that were dismissed, a nondirector, usually an executive officer, orchestrated the option grant manipulation scheme and hid his actions from the board. The results are the same regardless of whether the officers or the directors engaged in the misconduct—the company violates its shareholder-approved stock option plan and the company's public disclosures are rendered false and misleading because of the failure to account for the manipulation. This subjects the company to federal securities and tax liability and causes the grant recipients to be unjustly enriched or excessively compensated. Yet the board lacks the requisite bad faith when the officers engage in the misconduct and conceal it from the board. At most, the directors were careless for failing to detect the misconduct.

The Delaware Court of Chancery's inability to impose liability when the plaintiffs cannot show that the board had knowledge of the misconduct reveals a gap in the duty of candor.[108] The Delaware courts could fill this gap by imposing the candor obligation on corporate officers to provide information to the directors, rather than only imposing the obligation on directors to provide information to the shareholders. While a director owes a fiduciary duty to provide information to the shareholders, an officer owes a fiduciary duty to provide information to the board, which acts on behalf of the corporation and its shareholders. Lack of candor by corporate officers can cause the corporation to issue false public disclosures, to violate its shareholder-approved stock option plan and to unfairly compensate the recipients of the manipulated stock options. If a shareholder could bring a derivative action on behalf of the corporation to recover from a corporate officer based on the officer's breach of the duty of candor, the corporation could be compensated for the harm the officer caused.

A. *The Practice of Backdating Options*

When a company grants a stock option, it gives the recipient the right (option) to buy stock for a set price some time in the future. When the recipient exercises the option, he has the right to purchase the stock at the

---

[108] Knowledge usually was inferred either by directors knowingly approving or receiving the backdated options with the intent to conceal their actions from the shareholders.

previously set price, usually the price at which the stock was trading on the date the option was granted. This is called an "at the money" option. The recipient will instantly earn a profit when he exercises the option if the stock price has increased. When the stock's current trading price exceeds the exercise price, the options are said to be "in the money." Stock options are intended to align the interests of the recipients (usually directors, executives and employees) with the interests of the stockholders. The options give the recipient an incentive to increase the stock price so that he may exercise the options and realize a gain. Manipulating the date of the option grant defeats the purpose of awarding the options, that is, to create an incentive for future good performance, because the recipient can exercise the options immediately as they are already "in the money."

The three main ways that companies engage in option grant date manipulation are backdating, spring-loading, and bullet-dodging. A company backdates options when it issues options on a particular date but falsely records that the options were issued on an earlier date, when the company's stock was trading at a lower price. The company then reports that the options were granted at an exercise price that equals the market price on the date of the grant, but, because the grant dates were falsified, the options were actually "in the money" when granted.[109] A company spring-loads options when it makes option grants at market value at a time when the company has not yet released positive information about the company that is likely to increase the stock price when disclosed.[110] Finally, a company engages in bullet-dodging when it grants options after releasing negative news that brings down the stock price so that the recipient may benefit from the lower exercise price.[111]

News of the options backdating scandal broke in 2006 when an article in *The Wall Street Journal* suggested that various companies were backdating options.[112] Soon after, Merrill Lynch released a report that implied that the officers of various public companies had received backdated options.[113] Because of the reports, federal securities regulators and prosecutors investigated more than 130 companies.[114] Companies began massive

---

[109]Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007).

[110]*Id.*

[111]*Id.* (citing *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563 (Del. Ch. 2007)).

[112]*See* Forelle & Bandler, *supra* note 107.

[113]*See* Ryan v. Gifford, 918 A.2d 341, 345-46 (Del. Ch. 2007) (explaining that Merrill Lynch issued its report shortly after the Forelle and Bandler article appeared in *The Wall Street Journal*).

[114]*See* Bandler & Scannell, *supra* note 107.

internal investigations as well. "More than 40 executives or directors . . . resigned or [were] pushed out in the wake of internal probes that found options backdating problems."[115] One study suggested that fourteen percent of stock option grants to top executives between 1996 and 2005 were backdated or manipulated in some other way.[116]

There are two common theories why the companies engaged in the grant date manipulation and concealed their actions.[117] The first is for public relations purposes. As mentioned earlier, stock options are justified as providing an incentive for future performance. The stock options are only valuable to the recipients if the recipients do their jobs well and cause the stock price to go up.[118] In fact, most stock options are granted pursuant to a shareholder-approved stock incentive plan, the terms to which the shareholders consented because of the company's asserted purpose of providing incentives to employees. When the recipient receives a stock option that is valuable immediately, the option grant fails to motivate the recipient and defeats the purpose of the stock incentive plan.[119] The second reason is to receive more favorable accounting treatment. At the time when much of the backdating occurred, the accounting regulations required "in the money" options—but not "at the money" options—to be recorded as an expense, which decreases the company's reported earnings.[120] By backdating the options, companies could secretly compensate the recipients with "in the money" options while receiving the favorable accounting treatment of "at the money" options.[121] The company also avoided reporting decreased earnings, which would have likely affected the company's stock price.[122]

B. *The Delaware Court of Chancery Addresses Options Backdating*

On February 6, 2007, the Delaware Court of Chancery released two opinions that dealt with allegations of breach of fiduciary duty based on options backdating and other option grant manipulation. *Ryan v. Gifford*[123] addressed the alleged backdating of stock option grants. *In re Tyson Foods,*

---

[115] *Id.*
[116] *See* Surowiecki et al., *supra* note 107.
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] Surowiecki et al., *supra* note 107.
[121] *Id.*
[122] *Id.*
[123] 918 A.2d 341, 345 (Del. Ch. 2007).

Inc. Consolidated Shareholder Litigation (*Tyson I*)[124] addressed the alleged spring-loading of stock options.[125] *Tyson I* also addressed the practice with the opposite effect, bullet-dodging, as did the later-released *Desimone* opinion.[126]

In *Ryan*, the Delaware Court of Chancery does not use the term "candor" expressly but speaks of a fiduciary's obligation to be honest to the shareholders and to act in good faith in order to be loyal to the corporation. The plaintiff in *Ryan* alleged that between 1998 and 2002, John F. Gifford, the founder, chairman, and CEO of Maxim Integrated Products, Inc. (Maxim), received nine allegedly backdated stock option grants.[127] The board's three-member compensation committee awarded the grants pursuant to a shareholder-approved stock option plan.[128] The plan authorized the board, or a committee designated by the board, to administer the terms of the plan and required the exercise price of all stock options granted to be no less than the fair market value of the company's stock on the date of the grant.[129] All nine grants were dated on an "unusually low (if not the lowest)" trading day that year or immediately before significant increases in the market price of the company, which gave the appearance that they were "too fortuitously timed to be explained as simple coincidence."[130]

The plaintiff, a Maxim shareholder since 2001, brought a derivative action against Gifford and the members of the board of directors and compensation committee.[131] The plaintiff alleged that the backdating caused Maxim to receive lower payments upon the exercise of the options than Maxim would have received otherwise.[132] The plaintiff also alleged that Maxim suffered adverse tax and accounting consequences because options priced below the stock's market value on the date of the grant gave Gifford an instant paper gain.[133] Because such compensation must be treated as a cost to the company and deducted from earnings, the backdating causes overstated profits, as reflected in the company's financial statements and tax

[124]919 A.2d 563 (Del. Ch. 2007).

[125]*Id.* at 576 & n.16, 593 (discussing both the practice of spring-loading and bullet-dodging manipulation).

[126]Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007).

[127]*Ryan*, 918 A.2d at 346.

[128]*Id.*

[129]*Id.* (noting that fair market value was to be measured by the publicly traded closing price on the date of the grant).

[130]*Id.*

[131]*Ryan*, 918 A.2d at 346.

[132]*Id.* at 348.

[133]*Id.*

reporting.[134] Finally, the plaintiff alleged that Gifford was unjustly enriched.[135]

The Delaware Court of Chancery explained that the knowing and purposeful violations of the stock option plans and the release of intentionally fraudulent public disclosures could constitute a breach of the fiduciary duty of loyalty.[136] In response to the director-defendants' argument that they did not know that backdating options violated the duty of loyalty, the court explained that "[d]irectors of Delaware corporations should not be surprised to find that lying to shareholders is inconsistent with loyalty, which necessarily requires good faith."[137] The court went on to explain that:

> [a] director who approves the backdating of options faces at the very *least* a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty.[138]

The Delaware Court of Chancery also suggested that backdating options may very well be one of those rare situations, under the *Aronson* standard for demand excusal, in which a transaction is "so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."[139] Therefore, the court attached director liability for knowingly backdating options to the Delaware Supreme Court's newly articulated concept of good faith as a component of the duty of loyalty.[140]

The Delaware Court of Chancery began its analysis in *Ryan* with the foundational principle, codified in section 141(a) of the DGCL, that "the business affairs of a corporation are to be managed by or under the direction of its board of directors."[141] To encourage the "full exercise of managerial powers," managers of Delaware corporations are protected by the business

---

[134]*Id.*

[135]*Ryan*, 918 A.2d at 348.

[136]*Id.* at 354, 356 n.38 (doubting that "the challenged transactions resulted from a valid exercise of business judgment").

[137]*Id.* at 355.

[138]*Id.*

[139]*Ryan*, 918 A.2d at 355-56 (quoting Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984)).

[140]*See* Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006) (explaining that good faith is a "subsidiary element" of the duty of loyalty).

[141]*Ryan*, 918 A.2d at 357 (citing DEL. CODE. ANN. tit. 8, § 141(a) (2001)).

judgment rule, which presumes that in making a decision the directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[142] Upon a showing that the directors breached the fiduciary duty of care or loyalty in connection with the challenged transaction, the presumption is rebutted. "[A] breach may be shown where the board acts intentionally, in bad faith, or for personal gain."[143] Just as the Delaware Supreme Court held in *Stone v. Ritter*, the Delaware Court of Chancery stated in *Ryan* that "acts taken in bad faith breach the duty of loyalty."[144]

Bad faith includes any action that "demonstrates a faithlessness or lack of true devotion to the interests of the corporation and its shareholders."[145] Dishonesty and lack of complete candor are inconsistent with a director's duty of loyalty regardless of whether or not the director received a personal financial benefit. The Delaware Court of Chancery concluded in *Ryan* that backdating options and then issuing false public disclosures about the option grants constitutes acts of bad faith.[146] It is disloyal to the corporation to intentionally violate a shareholder-approved stock option plan and knowingly make false public disclosures claiming compliance with that plan, even if the director does not benefit personally.

In *Tyson I*, the Delaware Court of Chancery again invoked the concept of "candor" to find that spring-loading options is disloyal to the corporation and an act of bad faith.[147] The Tyson Foods compensation committee had complete discretion to award options pursuant to the company's shareholder-approved stock incentive plan but was instructed to consult with and receive

---

[142] *Id.* (quoting *Aronson*, 473 A.2d at 812).

[143] *Id.* (citing Malpiede v. Townson, 780 A.2d 1075, 1093-97 (Del. 2001)).

[144] *Id.* (citing *Stone*, 911 A.2d at 370). In *Stone*, the Supreme Court of Delaware expanded the duty of loyalty to include not only the traditional conflict of interest situations, but also situations in which the director demonstrates lack of good faith by failing to act faithfully to the corporation. *Stone*, 911 A.2d at 369-70.

[145] *Ryan*, 918 A.2d at 357. The court also states:

> Bad faith . . . may be shown where "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

Id. (quoting *Stone*, 911 A.2d at 369).

[146] *Id.* at 358 (explaining that Chancellor Chandler was "unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith").

[147] *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563, 593 (Del. Ch. 2007).

recommendations from the chairman of the board and CEO, each of whom had received options under the plan.[148] The plan allegedly required the "price of the option to be no lower than the fair market value of the company's stock on the day of the grant."[149] The compensation committee allegedly engaged in spring-loading on four occasions by awarding options to key employees, including the CEO, CFO, COO and chairman of the board, days before Tyson issued press releases that were very likely to drive stock prices higher.[150] "Around 2.8 million shares of Tyson stock bounced from the corporate vaults to various defendants in this manner," the Delaware Court of Chancery noted in *Tyson I*.[151] Tyson's annual proxy statements, however, stated that the options were issued at "market rate" and did not disclose the spring-loading, which caused the options to become "in the money" shortly after they were granted.[152]

The Delaware Court of Chancery determined in *Tyson I* that the plaintiffs failed to adequately challenge whether the compensation committee was truly independent and disinterested.[153] The members of the committee were not beholden to any executives or members of the board and, even though they were required to take recommendations from the chairman and CEO with regard to the granting of options, were capable of exercising independent judgment to approve or modify whatever recommendations they received.[154] The members of the compensation committee did not receive the options and had no personal interest in approving the option grants. Perhaps because an independent compensation committee approved the grants and its members did not receive any spring-loaded options or receive any other financial benefit for approving the options, the Delaware Court of Chancery expanded on the idea that the duty of loyalty involves more than selfish acts. "Not all acts of disloyalty or bad faith will directly benefit the malefactor, and a director may be held personally liable for a breach of the duty of loyalty in the absence of a personal financial gain."[155] Therefore, to survive the defendants' motion to dismiss under

---

[148]*Id.* at 575.

[149]*Id.*

[150]*Id.* at 576.

[151]*Tyson I*, 919 A.2d at 576.

[152]*Id.* at 590-91.

[153]*Id.* at 595.

[154]*Id.* at 591.

[155]*Tyson I*, 919 A.2d at 591 n.72. On the other hand, the beneficiary of the disloyalty (the recipient of the spring-loaded grants) is not directly liable for the losses, because he did not approve the options grants, he only received them. Chancellor Chandler explained that while the beneficiary may not have breached a fiduciary duty, he "might still be found to retain 'money or property of another against the fundamental principles of justice or equity and good conscience,' and thus to be

Delaware Court of Chancery Rule 12(b)(6), the plaintiffs had to show that the spring-loaded option grants could not have been a valid exercise of business judgment by the members of the compensation committee, that is, that no person could possibly authorize such a transaction if he were attempting in good faith to comply with his fiduciary duties.[156] The issue, therefore, was whether a board of directors could, in good faith, approve the grant of spring-loaded options.

The court distinguished, as more subtle, the deception involved in spring-loading as compared to the deception in backdating.[157] Backdating options always involves a lie to shareholders because the directors conceal the date on which the grant was made and falsely represent that the grant was made on an earlier date.[158] In contrast, the deception in spring-loading is indirect. The court explained that a director breaches his duty of loyalty, which "includes the duty to deal fairly and honestly [i.e., candidly] with the shareholders for whom he is a fiduciary," by asking for shareholder approval of a stock option plan and then later distributing shares to managers "in such a way as to undermine the very objectives approved by shareholders," even if the board complies with the letter of the plan.[159] Accordingly, a director acts in bad faith by authorizing options with a market-value exercise price, as he is required to do by a shareholder-approved incentive plan, at a time when the director *knows* the shares are actually worth more than the exercise price. The Delaware Court of Chancery held in *Tyson I* that "[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."[160] Therefore, to support a claim that the director acted disloyally and in bad faith by issuing spring-loaded options, a plaintiff must show that: (1) "options were issued according to a shareholder-approved employee compensation plan," and (2) "the directors that approved spring-loaded . . . 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."[161]

---

unjustly enriched." *Id.* (quoting Schock v. Nash, 732 A.2d 217, 232-33 (Del. 1999)).

[156] *Id.* at 592 (citing Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052-53 (Del. Ch. 1996)).

[157] *Id.*

[158] *Id.*

[159] *Tyson I*, 919 A.2d at 592-93.

[160] *Id.* at 593.

[161] *Id.* (noting that the same showing is required for bullet-dodging options).

Later, *In re Tyson Foods, Inc. Consolidated Shareholder Litigation* (*Tyson II*)[162] clarified that the options were granted pursuant to a provision in the plan that gave the board (or compensation committee) discretion to set the exercise price of the options and did not require the price to be at least the fair market value on the date of the grant.[163] Regardless, the shareholders were deceived. When the compensation committee approved allegedly spring-loaded options and violated a shareholder-approved stock option plan that required the option price to be no less than the fair market value of the stock on the date of the grant, the committee members were disloyal to the shareholders who gave them permission to issue stock options. Because the directors knew the options were actually worth significantly more than their value on the date of the grant, they were deceiving shareholders. The members of the compensation committee had been deceptive because they knew of information that would increase the share price when reported to the public, granted stock options pursuant to a shareholder-approved plan prior to releasing the information so that the options would shortly be "in the money," and then represented to shareholders in public disclosures that the options were granted at market value.[164] The Delaware Court of Chancery explained in *Tyson II* that when "directors communicate with shareholders, they . . . must do so with *complete candor*."[165] The court characterized candor as one of the various obligations that comprises fiduciary duty:

> 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.[166]

Lack of candor as to the true nature of the option grants "intentionally and deceptively" facilitates channeling of corporate profits to executives.[167]

---

[162]*In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson II*), No. 1106-CC, 2007 WL 2351071 (Del. Ch. Aug. 15, 2007).

[163]*Id.* at *3.

[164]*Id.* (explaining that "a scheme that relies upon bare formalism concealed by a poverty of communication" is not a good faith exercise of business judgment).

[165]*Id.* at *3 (citing Malone v. Brincat, 722 A.2d 5, 11 (Del. 1998)).

[166]*Tyson II*, 2007 WL 2351071, at *4.

[167]*Id.*

"Sophism and guile" with respect to executive compensation "does not serve shareholder interests."[168] When a board conceals the true nature of a stock option grant, whether or not the grant violates express provisions of the option plan, the court may infer that the grant was not consistent with the fiduciary duty of loyalty.[169] Granting spring-loaded or bullet-dodging options and intentionally concealing that information from shareholders clearly demonstrates a lack of complete and utter candor.[170]

The Delaware Court of Chancery gave some guidance in *Tyson II* about how to fulfill the duty of complete candor. If the "board of directors candidly discloses why and when it awarded options, and accounted for them in a lawful manner consistent with the actual facts, the board has, absent unusual circumstances, insulated itself from fiduciary liability for misleading investors or regulatory authorities."[171] In contrast, acting in a deceptive manner with the intent to circumvent the purposes of the stockholder-approved stock option plan and concealing one's actions demonstrates a lack of candor.[172]

Between *Tyson I* and *Tyson II*, *Desimone v. Barrows*[173] addressed the alleged backdating, spring-loading and bullet-dodging of options at Sycamore. In *Desimone*, a plaintiff-shareholder brought a derivative action on behalf of the corporation against the recipients of the stock options and against the board alleging breach of fiduciary duty for allowing the stock option grants to occur.[174] The plaintiff alleged that options had been improperly granted to rank-and-file employees (Employee Grants) and to executive officers (Officer Grants).[175] In this case, the directors lacked the element of intent—or bad faith—that was a predicate to a finding of liability in *Ryan* and *Tyson*. Unlike the earlier cases, there was no evidence that the

---

[168] *Id.* at *4 n.18.

[169] *Id.* at *5.

[170] *Tyson II*, 2007 WL 2351071, at *4-5 & n.19 (citing *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563, 593 (Del. Ch. 2007)).

[171] *Id.* at *6 (noting that the directors might, however, be subject to a claim that the amount of compensation was "excessive because, for example, it involved self-dealing and was not fair to the corporation").

[172] *Id.*

[173] 924 A.2d 908 (Del. Ch. 2007).

[174] *Id.* at 912-13.

[175] *Id.* at 913. They also alleged that grants were improperly awarded to outside directors but because those grants were made pursuant to the stockholder-approved option plan, which provided that each outside director was to receive a predetermined amount of shares each year on a predetermined date, that claim was more easily disposed of and will not be addressed in this article. *See id.* at 917.

Sycamore board approved or received the improper Employee and Officer Grants.[176]

In public filings following investigations by the SEC and U.S. Department of Justice, Sycamore had admitted that the Employee Grants had been backdated and that the company's filings falsely represented that the options had been issued at fair market value on the date of the grants when they were really issued at a lower price.[177] Therefore, the Delaware Court of Chancery concluded that "the backdating was hidden."[178] The shareholder-plaintiff, however, failed to show that the directors knew of the backdating or that the directors intentionally concealed information from the shareholders.[179] The two directors who were also officers and employees had not received backdated grants.[180] Further, the plaintiff could not show who had actually approved the employee grants or whether any of the directors knew that the grants had been backdated.[181] The stockholder-approved option plan permitted the board to delegate the granting of options to nondirector executive officers.[182] Most of the backdating was orchestrated by an executive officer, CFO Frances Jewels, who ensured that the backdating was "actively concealed" from the board and the company's auditors.[183] The Delaware Court of Chancery noted that, at most, the board's failure to prevent the grants of backdated options to the rank-and-file employees implicated the duty of care, which, in light of the company's exculpatory charter provision, would not result in liability.[184]

The Officer Grants involved the undisclosed backdating of options, as well as spring-loaded and bullet-dodging options.[185] As to the alleged improperly backdated options, the Delaware Court of Chancery determined that the board (or compensation committee) was less likely to have delegated to an executive officer the discretion to grant these options because of the high amount of the awards and the nature of the recipients—high-ranking executive officers.[186] The plaintiff, however, was unable to show that the

---

[176] *Id.* at 914.

[177] *Desimone*, 924 A.2d at 914.

[178] *Id.*

[179] *Id.*

[180] *Id.*

[181] *Desimone*, 924 A.2d at 914.

[182] *Id.*

[183] *Id.* at 914, 922.

[184] *Id.* at 914 (explaining that presuit demand was not excused with regard to the Employee Grants because none of the directors appeared to face a substantial threat of liability as a result of the Employee Grants that would render them unable to objectively evaluate a demand).

[185] *Desimone*, 924 A.2d at 914.

[186] *Id.* at 914-15.

two directors who comprised the compensation committee or any of the other four directors knew that the options had been backdated. Therefore, presuit demand was not excused.[187] If the plaintiff could have shown that, as in *Ryan*, the directors had "knowingly approved backdated grants of options, realizing that the corporation would deceptively account for them to investors and regulatory authorities as having been made at fair market value on the date of the issuance," then demand would have been excused.[188]

One set of Officer Grants also allegedly involved both bullet-dodging and spring-loading. The plaintiff alleged that the Officer Grants made on April 9, 2001, were issued shortly after the release of bad news (that the company had missed its quarterly earnings estimate) that lowered the stock price and sixteen days before the release of good news that increased the stock price.[189] The plaintiff argued that the issuance of these grants was a breach of the duty of loyalty because the grants were hidden bonuses to the officer recipients and rewarded them for past accomplishments.[190] The options were purported to be issued at fair market value but were actually issued when the company knew of information that, when released, would increase the company's share price and make the options "immediately in the money."[191] This argument failed, however, because, again, the plaintiff could not show that the board *intended* the grants to be a hidden bonus that was concealed from regulators and stockholders.[192]

The court noted that the only possible argument that the plaintiff might have made with regard to the bullet-dodging grants is that they constituted a waste of corporate assets and that the recipients were unjustly enriched at the expense of the corporation (because the board or compensation committee lacked any personal financial interest in awarding the options), or that those who awarded the options engaged in unfair self-dealing at the expense of the corporation (because the board or compensation committee was controlled by the recipients).[193] Because there was no deception—to the stockholders, the market generally or regulators—there was no intentional wrongdoing on which to attach liability.[194]

The plaintiff in *Desimone* made a *Tyson*-type argument with regard to the fact that the options were issued sixteen days before the release of good

[187] *Id.* at 915.
[188] *Id.* (citing Ryan v. Gifford, 918 A.2d 341, 355 (Del. Ch. 2007)).
[189] *Desimone*, 924 A.2d at 915.
[190] *Id.*
[191] *Id.*
[192] *Id.* at 915-16.
[193] *Desimone*, 924 A.2d at 916.
[194] *Id.*

news, asserting that the grants constituted a bonus for past performance rather than an incentive for future performance.[195] Unlike *Tyson*, however, this was a single grant issuance and not a pattern of issuing options on optimal dates that made the grants seem too fortuitous to be coincidence.[196] As with the backdated Officer Grants, there was no showing that the board had acted in bad faith. The Delaware Court of Chancery could not infer that the board had any "illicit intent to enrich the recipients at the expense of the Sycamore stockholders or to subvert the purposes of Sycamore's stockholder-approved options plan through clever timing of these Grants."[197]

None of the Sycamore director defendants—Deshpande, Smith or the four outside directors—received the allegedly backdated options.[198] Five executive officers received backdated options and one executive officer in particular—Jewels—apparently oversaw the backdating of the options granted to the rank-and-file employees.[199] The options were granted under a stock incentive plan that was approved by the shareholders. The board had a limited role in awarding options under the plan because the plan permitted the board to delegate its authority to authorize shares to an executive officer.[200] The plan provided that it was to be administered by a committee appointed by the board that consisted of at least two directors.[201] But it also provided that the board could delegate to any of the executive officers the power to grant the options and exercise any other powers under the plan, as long as the board fixed the maximum number of shares that could be granted under the plan and the maximum number of shares that could be granted to any one recipient.[202] In addition, the plan did not require the price of the options to be no less than the fair market value of the stock on the date of the grant.[203] The administrators of the plan had discretion to set the exercise price. In order for the options to qualify as incentive stock options or as performance-based compensation under the Internal Revenue Code (for

---

[195] *Id.*

[196] *Id.*

[197] *Desimone*, 924 A.2d at 916.

[198] *Id.* at 919. The outside directors did receive options that were allegedly bullet-dodging options, but the court easily disposed of those claims because the options were granted pursuant to a shareholder-approved option plan that provided for a specific grant of options to the outside directors each a year on a predesignated date as their only form of compensation. *Id.*

[199] *Id.*

[200] *Id.* at 920.

[201] *Desimone*, 924 A.2d at 920.

[202] *Id.*

[203] *Id.*

purposes of receiving favorable income tax treatment), however, they had to be priced at the fair market value of the stock on the date of the grant.[204]

Whether stock options are granted at fair market value or below fair market value also has accounting implications. At the time of the alleged misconduct, generally accepted accounting principles required a company that granted options with a below-market exercise price to recognize a noncash expense in the amount of the difference between the exercise price and market price.[205] A company was not required to recognize any compensation expense when the exercise price of the options was equal to or more than the fair market value of the company's stock on the date of the grant.[206] As of December 2004, public companies were required to account for stock option grants under a "'fair value' standard," which requires companies to recognize a compensation expense for options granted regardless of whether or not the exercise price was the market value on the date of the grant.[207]

Sycamore's granting of options had come under scrutiny after the former Director of Human Resources, Stephen Landry, accused the company of backdating options.[208] Landry claimed that Jewels had orchestrated the back-dating scheme and repeatedly instructed Landry to alter and falsify human resources documents to corroborate the falsified option grant dates, often by forging personnel files so that an employee's start date would correspond with the date of the option grant.[209] If the allegations were true, Jewels had clearly and deliberately engaged in backdating.[210] While the nondirector CFO—Jewels—appeared to have engaged in deceptive behavior and to have caused the company to issue false disclosures (resulting from the accounting errors in the company's financial statements), the Delaware Court of Chancery determined that the board of directors had no knowledge of the CFO's misconduct.[211] Therefore, the board lacked intent to deceive—or bad faith—even if the company's public disclosures were false.

Another difference between *Desimone* and the earlier cases is that, while *Ryan* and *Tyson I* involved knowing violations of the shareholder-approved stock option plan, the *Desimone* option grants did not violate the options plans because the plans gave the administrators discretion to set the

---

[204] *Id.*

[205] *Desimone*, 924 A.2d at 921 n.24.

[206] *Id.*

[207] *Id.*

[208] *Id.* at 922.

[209] *Desimone*, 924 A.2d at 922.

[210] *Id.* Because the options were subject to a three-year vesting schedule, however, the recipients would not realize an immediate gain. *Id.*

[211] *Id.* at 939.

exercise price. Nonetheless, there was an element of deception because the company represented that the exercise price of the options was the fair market value of the stock on the date of the grant when the company was secretly manipulating the exercise price of the option.[212] The concealed backdating also caused tax and accounting fraud.[213]

Regardless of the officer's intentional misconduct and the company's resulting false disclosures, the plaintiff in *Desimone* could not show any bad faith on the part of the board of directors because the board was not aware of the backdating and did not intentionally make the false representations to the shareholders. Therefore, the court concluded that demand was not excused.[214] The court explained that "there are important nuances about *who* bears responsibility when the corporation violates the law, nuances that turn importantly on the state of mind of those accused of involvement."[215] When the directors lack knowledge of the option grant manipulation, they cannot be said to have acted in bad faith and were not disloyal to the company. At most, they may have been careless for failing to fully inform themselves of the circumstances surrounding the options grants. The directors can be liable for a breach of the duty of loyalty only when they consciously disregard their shareholder-granted authority by issuing options that violate the shareholder-approved stock option plan or they knowingly permit false disclosures that conceal the option grant manipulation and expose the corporation to securities and tax violations. *Desimone* emphasized that the element of deception is what elevates option grant manipulation to a breach of the duty of loyalty. The directors' lack of candor about the motive for their actions is the conduct that gives rise to liability and such conduct was missing in this case.[216] The Delaware Court of Chancery explained that it could not hold the directors liable for the CFO's misconduct because the directors were not aware of the misconduct.[217] It seems, however, that the court could have imposed liability for the directors' failure to exercise oversight of Jewels because the board had delegated to her the authority to administer the stock option grants pursuant to the option plan and had a duty to oversee her compliance with the plan.

---

[212]*Id.* at 930-31.

[213]*Desimone*, 924 A.2d at 931.

[214]*See id.* (explaining that the board was not subject to liability for the alleged misconduct and could therefore exercise independent judgment in evaluating demand).

[215]*Id.*

[216]*Id.* at 937.

[217]*Desimone*, 924 A.2d at 939.

Although the Delaware Court of Chancery's next options backdating case, *Brandin v. Deason*,[218] focused substantively on standing and jurisdiction, its facts are notable. In *Brandin*, a former CEO/director, a former CEO/president/director and a former CFO allegedly engaged in backdating.[219] An internal investigation concluded that after the officers received authorization to prepare paperwork for various option grants, and before the formal grant documentation was submitted to the compensation committee for approval, the CEO and/or CFO would select favorable grant dates that did not reflect the actual date that the options were granted.[220] There was also a question in *Brandin* of whether the board, or at least a majority of the board, was unaware of the backdating and thus could not be subject to liability for demand excusal purposes.

Two more recent cases addressing stock option manipulation and the pleading requirements for demand futility are *Weiss v. Swanson*[221] and *London v. Tyrrell.*[222] In *Weiss*, the plaintiff-shareholder alleged that the board of directors of Linear Technology Corporation (Linear) routinely engaged in the spring-loading and bullet-dodging of stock options.[223] The options were granted pursuant to a shareholder-approved option plan that permitted the directors to grant "in the money" options that had an exercise price lower than the fair market value of the corporation's stock on the grant date.[224] To receive favorable tax treatment, however, the options had to be given as an incentive for future performance and were required to have an exercise price equal to the closing price of the corporation's stock on the grant date.[225] The directors allegedly engaged in spring-loading by granting options just before releasing quarterly earnings reports that contained positive information expected to increase the price of the company's stock.[226] They also allegedly engaged in bullet-dodging by delaying the granting of options until after the release of quarterly earnings reports that contained negative information expected to decrease the price of the company's stock.[227] The plaintiff alleged that the spring-loading and bullet-dodging of options was "inconsistent with the expectations of the stockholders who

---

[218]941 A.2d 1020 (Del. Ch. 2007).

[219]*Id.* at 1021-22.

[220]*Id.* at 1022 n.1.

[221]948 A.2d 433 (Del. Ch. 2008).

[222]No. 3321-CC, 2008 WL 2505435 (Del. Ch. June 24, 2008), *reprinted in* 33 DEL. J. CORP. L. 929 (2008).

[223]*Weiss*, 948 A.2d at 439.

[224]*Id.* at 438-39.

[225]*Id.* at 439 n.7.

[226]*Id.* at 439.

[227]*Weiss*, 948 A.2d at 439.

approved the plans" and that the board failed to disclose in various proxy statements that the options had been spring-loaded and bullet-dodged.[228]

The Delaware Court of Chancery concluded in *Weiss* that demand was excused because there was a reason to doubt whether a majority of the directors was disinterested. A majority of the directors considering the demand had approved the challenged options grants and had also received options granted in violation of the option plan.[229] In addition, demand was excused because the plaintiff's allegations created a reasonable doubt that the options grants were the result of a valid exercise of business judgment.[230] Directors' compensation decisions to grant options pursuant to a shareholder-approved plan are protected by the business judgment rule only when the directors abide by the terms of the option plan.[231] The court determined that, under *Tyson I*, a claim of spring-loading or bullet-dodging may rebut the business judgment rule when the plaintiff establishes: "the challenged grants were given pursuant to an options plan"; and "the directors who approved the grants (a) possessed material nonpublic information soon to be released that would affect the company's share price, and (b) issued options with an intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options."[232]

Based on the board's failure to disclose that the grants were spring-loaded or bullet-dodged, the Delaware Court of Chancery can infer that the directors intended to grant options in violation of the plan and, accordingly, that the directors did not make the grants in good faith.[233] Because the Linear directors granted the options pursuant to a shareholder-approved option plan, had access to the quarterly earnings statements before they became public and knew that the releases would materially affect Linear's share price, the plaintiff's allegation supported an inference that the directors granted spring-loaded and bullet-dodged options.[234] The Delaware Court of Chancery noted that its decision in *Tyson II* was limited in that it only held that the spring-loading of options is material information that must be disclosed to shareholders.[235] The Delaware Court of Chancery concluded in

---

[228]*Id.* at 440.
[229]*Id.* at 448.
[230]*Id.* at 447-48.
[231]*Weiss*, 948 A.2d at 441.
[232]*Id.* at 441 n.21 (citing *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563, 592 n.75, 593 (Del. Ch. 2007)).
[233]*Id.* at 442 (citing *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson II*), No. 1106-CC, 2007 WL 2351071, at *4-5 (Del. Ch. Aug. 15, 2007)).
[234]*Id.* at 442-43.
[235]*Weiss*, 948 A.2d at 443.

Weiss that the bullet-dodging of options is also material information that must be disclosed to shareholders because it is reasonable to infer that shareholders would consider the practice of timing options after the release of negative information that is expected to decrease the company's share price important when deciding whether to approve the option plans and whether to reelect the directors.[236] The court also concluded that the fact that the options were spring-loaded and bullet-dodged was material information and the board's failure to disclose that information in the options plans, subsequent proxy statements, or SEC filings describing the options grants "give[s] rise to an inference that the Director Defendants, in violation of their fiduciary duties, intended to circumvent the restrictions found in the plans."[237]

The Linear disclosures differed from the Tyson disclosures because the Linear disclosures were ambiguous as to the exercise price of the options. The Tyson disclosures affirmatively misrepresented that all options were granted with an exercise price equal to the fair market value of the stock on the date of the grant.[238] Despite what the court characterized as a "weaker" inference of impropriety, the court concluded that the plaintiffs had alleged sufficient facts to create a reasonable doubt that the options were granted pursuant to a valid exercise of business judgment.[239] In *Weiss*, the Delaware Court of Chancery effectively lowered the pleading requirements for demand excusal by permitting the plaintiff to show that the board made intentional, affirmative misrepresentations to the shareholders with respect to the options grants or that the board engaged in deceptive conduct by failing to fully disclose to the shareholders all material information regarding the options grants. The court explained that the board's obligation to disclose its policy of spring-loading and bullet-dodging options arises from "'a moral intuition . . . that directors should be candid with shareholders' and [the Delaware Court of Chancery's] well-established definition of materiality."[240] The court further explained that the plaintiff adequately stated a claim for breach of fiduciary duty against the directors, based on the board's improper disclosures, because (1) the directors failed to disclose in proxy statements seeking approval of the option plan and later amendments to the plan that they would grant spring-loaded and bullet-dodging options and (2) the directors made statements in the proxy statements seeking reelection of

[236] *Id.*
[237] *Id.*
[238] *Id.* at 443-44.
[239] *Weiss*, 948 A.2d at 444.
[240] *Id.* at 446-47 (quoting Lewis v. Vogelstein, 699 A.2d 327, 332 (Del. Ch. 1997)).

directors that suggested that the option plan had been implemented according to its shareholder-approved terms when in fact the board was engaging in spring-loading and bullet-dodging practices that were not authorized by the plan.[241] The plaintiff also adequately stated a claim for breach of fiduciary duty by the corporate officers who had received the challenged grants because they knew, or should have known, that the grants were spring-loaded or bullet-dodged and knew that the granting of spring-loaded or bullet-dodging options violated the shareholder-approved option plan.[242] While the court in *Desimone* refused to infer bad faith where there was no showing that the spring-loaded grants to officers were made with the intent to unjustly enrich the recipients or to violate the purpose of the options plan, the court in *Weiss* inferred lack of good faith and bad intent from the board's approval of the misleading disclosures regarding the options grants while in possession of knowledge that the options were granted prior to the release of good news or immediately after the release of bad news.

In *London v. Tyrrell*,[243] demand was also excused and the Delaware Court of Chancery denied the defendants' motion to dismiss because the plaintiffs adequately pleaded that the defendants intentionally inflated stock option prices for personal financial gain. The plaintiffs, who were shareholders and directors of the government contracting firm iGov, alleged that in 2006 the defendants—two directors and the CFO of iGov, all shareholders—"secretly decided to implement an options plan at an unfair price to benefit themselves at the expense of the other stockholders."[244] The defendants allegedly obtained a valuation of the company as of July 31, 2006, and then used that valuation to set the price of stock options granted to themselves and others in February or May 2007 pursuant to a plan that required the exercise price of the options to be equal to at least 100% of the fair market value of iGov's stock as of the date of the grant.[245] The plaintiffs claimed that the defendants engaged in wrongdoing that harmed the corporation when: (1) CFO Michael Tyrrell provided misleading and incomplete information for the valuation; and (2) the options granted violated the stock option plan because they were based on the value of the company as of July 2006 rather than on the value of the company when the options were granted in February or May 2007.[246]

[241] *Id.* at 449.

[242] *Id.*

[243] No. 3321-CC, 2008 WL 2505435 (Del. Ch. June 24, 2008), *reprinted in* 33 DEL. J. CORP. L. 929 (2008).

[244] *Id.* at *1, *reprinted in* 33 DEL. J. CORP. L. at 930.

[245] *Id.*, *reprinted in* 33 DEL. J. CORP. L. at 930-31.

[246] *Id.* at *2, *reprinted in* 33 DEL. J. CORP. L. at 931.

The information Tyrrell supplied to the financial firm for the July 2006 valuation suppressed the value of the company and directly contradicted information he provided to a potential lender that boasted the company's good performance.[247] After one of the plaintiffs objected to the July 2006 valuation as stale and the other plaintiff offered to purchase the other directors' interests in iGov, which the defendants summarily rejected, the defendants caused the plaintiffs to be removed from the board through a written consent.[248] Then, the defendants elected CFO Tyrrell to the board by written consent.[249] As of January 19, 2007, the three "defendants comprised the entire board of iGov."[250] On January 30, 2007, the defendants voted unanimously to adopt a stock option plan that required the exercise price of an option to be not less than 100% of the fair market value of the common stock on the date the option is granted.[251] The defendants also voted unanimously to adopt $4.92 per share, the price provided by the July 2006 valuation, as the fair market value of the company's stock.[252] Next, they approved the grant of 300,000 options to themselves and other company employees.[253]

In March 2007, iGov won a large contract with the Department of Homeland Security and, in April 2007, iGov obtained positive second quarter results for fiscal year 2007.[254] It was clear that iGov would outperform its own projections for 2007.[255] Yet, in May 2007, the defendants, by unanimous written consent, granted 25,000 options to an employee at the price of $4.92 per share based on the July 2006 valuation.[256] The defendants claimed that share price was the proper exercise price because "there ha[d] been no material changes affecting [iGov's] financial operations or prospects" since February 2007 that would change the valuation.[257]

The Delaware Court of Chancery held that the plaintiffs adequately pled that their failure to make a demand on the board was justified because demand would have been futile.[258] The complaint created "'a reasonable doubt . . . that: (1) the directors [were] disinterested and independent; [*and*]

---

[247]*Tyrrell*, 2008 WL 2505435, at *2-3, *reprinted in* 33 DEL. J. CORP. L. at 932.
[248]*Id.* at *3, *reprinted in* 33 DEL. J. CORP. L. at 932.
[249]*Id.*
[250]*Id.*
[251]*Tyrrell*, 2008 WL 2505435, at *3, *reprinted in* 33 DEL. J. CORP. L. at 933.
[252]*Id.*
[253]*Id.*
[254]*Id.* at *4, *reprinted in* 33 DEL. J. CORP. L. at 933.
[255]*Tyrrell*, 2008 WL 2505435, at *4, *reprinted in* 33 DEL. J. CORP. L. at 933.
[256]*Id.*
[257]*Id.*, *reprinted in* 33 DEL. J. CORP. L. at 933-34.
[258]*Id.*, *reprinted in* 33 DEL. J. CORP. L. at 935.

(2) the challenged transactions [i.e., the options grants] were otherwise the product of a valid exercise of business judgment.'"[259] A majority of the board was interested in the challenged transactions because the defendants, who constituted the entire board at the time the options were granted, stood on both sides of the challenged transactions. "[T]he defendants both granted and received the stock options."[260] Further, consistent with the Delaware Court of Chancery's prior statement in *Weiss*, "[a]lthough . . . compensation decisions are typically protected by the business judgment rule, the rule applies to the directors' grant of options pursuant to a stockholder-approved plan only when the terms of the plan are adhered to."[261] The plaintiffs' allegations in the complaint rebutted the business judgment rule because they "'support[ed] an inference that the [defendants] intended to violate the terms of [the] stockholder-approved option plans.'"[262] The complaint alleged particularized facts that created a reasonable inference that the defendants intentionally granted options in violation of the option plan requirement that the exercise price should be 100% of the fair market value of the stock on the date of the grant.[263] First, the complaint alleged that "the defendants intentionally gamed the . . . valuation by withholding positive information about the Company while freely supplying the negative."[264] Second, the complaint alleged that the "directors intentionally violated the [stock option plan] by pricing the options . . . granted in February and May of 2007 at the price . . . said [to be] fair as of July 2006."[265] The complaint further alleged that the defendants knew the July 2006 valuation did not consider later material positive developments and therefore knew that the valuation "could not possibly represent the fair market value of the Company as of February and May 2007."[266] The complaint successfully created an inference that the directors knowingly violated the stock option plan and the Delaware Court of Chancery denied the defendants' motion to dismiss for failure to plead demand futility.[267]

---

[259]*Tyrrell*, 2008 WL 2505435, at *4, *reprinted in* 33 DEL. J. CORP. L. at 935 (quoting Aronson v. Lewis, 473 A.2d 805, 814-15 (Del. 1984)).

[260]*Id.* at *5, *reprinted in* 33 DEL. J. CORP. L. at 936.

[261]*Id.* at *6, *reprinted in* 33 DEL. J. CORP. L. at 936-37 (quoting Weiss v. Swanson, 948 A.2d 433, 441 (Del. Ch. 2008)).

[262]*Id.*, *reprinted in* 33 DEL. J. CORP. L. at 937 (quoting *Weiss*, 948 A.2d at 441).

[263]*Tyrrell*, 2008 WL 2505435, at *6, *reprinted in* 33 DEL. J. CORP. L. at 937.

[264]*Id.*

[265]*Id.*

[266]*Id.*

[267]*Tyrrell*, 2008 WL 2505435, at *6, *reprinted in* 33 DEL. J. CORP. L. at 937.

IV. THE INTERNAL DUTY OF CANDOR AS A MEANS OF IMPOSING OFFICER LIABILITY

The Delaware Court of Chancery has held that "directors have a responsibility to communicate with complete candor in all shareholder communications."[268] Articulating the duty of candor as a duty owed by directors to shareholders leaves the court unable to impose liability when nondirector executives or other employees act in ways that cause harm to the corporation and then intentionally conceal their actions from the directors. Because officers also have fiduciary duties and because those duties are usually owed to the corporation and its shareholders—not just the shareholders—it has been suggested that there is a gap in corporate fiduciary duty law with regard to the duty of candor inside the corporation and the flow of information to the board.[269] If the Delaware courts were to recognize an internal duty of disclosure owed by officers to the corporation, which acts through its board of directors, then the court would have a broader basis on which to hold executive officers liable for engaging in deceptive behavior and on which to hold the board of directors liable for failing to exercise adequate oversight of the officers. In the options backdating cases, an internal duty of candor would have provided a way for shareholders to bring derivative suits on behalf of the corporation against the officers who knowingly engaged in the deceptive behavior. An internal duty of candor is particularly important because CEOs and other corporate officers often control the flow of information to the board. If the board is not fully informed of all material information, it cannot fulfill its fiduciary duties when making decisions, exercising oversight and communicating with shareholders.

A. *A Broader Duty of Candor*

Section 141(a) of the DGCL provides that the business and affairs of the corporation are to be "managed by or under the direction of the board of directors."[270] This fundamental tenet of Delaware corporation law is based on the notion of separation of ownership from legal control. Because the directors have broad legal authority to run the company, their informational needs are different than those of the shareholders, whose rights with regard

---

[268] *In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 1001 (Del. Ch. 2007).

[269] Barclift, *supra* note 54, at 272; Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1189 (2003).

[270] DEL. CODE ANN. tit. 8, § 141(a) (2001).

to corporate actions are significantly limited.[271] Shareholders need sufficient information to determine whether or not to purchase or sell their stock. They also need sufficient information to cast an informed vote on matters for which their approval is needed or ratification is sought. Directors require a steady flow of information to both monitor and advise management. Therefore, directors require more information and a more consistent flow of information than do the shareholders in order for directors to make informed decisions and fulfill their fiduciary duties to the corporation and its shareholders.

Section 141(a) also gives the board authority to delegate management of the corporation's day-to-day business to the corporate officers.[272] Directors therefore have the obligation to exercise oversight of these corporate officers.[273] According to section 141, directors who reasonably rely in good faith on the reports of corporate officers are protected from liability for breach of fiduciary duty.[274] Without an obligation to be candid with directors, officers can intentionally withhold information from the board and the board will escape liability because it lacked knowledge, creating in officers a "what they don't know can't hurt them" mindset.[275] For the board to exercise its oversight obligations and decision-making functions properly, the senior officers must be candid with the board.[276] So far, the Delaware courts' application of the duty of disclosure has ignored the idea that the fiduciary responsibility is owed to the corporation and has only recognized that the duty is owed to shareholders. In a way, the options backdating cases tied together the concepts of director candor and loyalty to the company by explaining that a director who intentionally deceives shareholders acts disloyally to the company. The disloyalty to the company is indirect, however, because it occurs by deceiving shareholders.

Fiduciary obligations run, first and foremost, to the corporation, and then to the shareholders. The business judgment rule recognizes this principle.

> The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under [DGCL] Section 141(a). It is a presumption that in making a business

---

[271] *See* Langevoort, *supra* note 269, at 1190.
[272] DEL. CODE ANN. tit. 8, § 141(a) (2001); Barclift, *supra* note 54, at 276.
[273] Barclift, *supra* note 54, at 276.
[274] DEL. CODE ANN. tit. 8, § 141(e) (2001); Barclift, *supra* note 54, at 271.
[275] *See* Barclift, *supra* note 54, at 271-72.
[276] *See id.* at 282.

> decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.[277]

Because the board of directors manages the company, the board needs sufficient information to make informed decisions. Naturally, a fiduciary owes a duty of candor to the corporation and to the board, as the group that embodies the corporate entity, and not just to shareholders.

While *Malone v. Brincat*[278] spoke specifically about the directors' duty to shareholders, its language leaves room to recognize a broader fiduciary duty to the corporation. Beginning with the premise that section 141(a) gives the board of directors "the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners,"[279] the Supreme Court of Delaware recognized that "[t]he directors of Delaware corporations stand in a fiduciary relationship not only to the stockholders but also to the corporations upon whose boards they serve."[280]

Further, directors are not the only corporate representatives charged with fiduciary duties. Officers also owe duties of care and loyalty to the corporation and its shareholders.[281] In *Guth v. Loft*,[282] the Supreme Court of Delaware held that "[c]orporate officers and directors . . . stand in a fiduciary relation to the corporation and it stockholders."[283] The Supreme Court of Delaware recently held that officers' fiduciary duties to the corporation are identical to those owed by directors.[284] Those holdings leave room for the idea that corporate officers could be held liable for failing to fully inform the board of all material information in the officers' possession.[285] In *In re Walt Disney Co. Derivative Litigation*,[286] the Delaware Court of Chancery criticized CEO and Chairman Michael Eisner as the most culpable director

---

[277] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253 & n.13 (Del. 2000).

[278] 722 A.2d 5 (Del. 1998).

[279] *Id.* at 9.

[280] *Id.* at 10 (citing Guth v. Loft, 5 A.2d 503, 510 (Del. 1939)).

[281] Gantler v. Stephens, No. 132, 2008, 2009 WL 188828, at *9 (Del. Jan. 27, 2009) (holding as a matter of first impression "that corporate officers owe fiduciary duties that are identical to those owed by corporate directors"); *see also* Gantler v. Stephens, No. 2392-VCP, 2008 WL 401124, at *7 (Del. Ch. Feb. 14, 2008), *reprinted in* 33 DEL. J. CORP. L. 528, 538 (2008).

[282] 5 A.2d 503 (Del. 1939).

[283] *Id.* at 510. *See also Gantler*, 2008 WL 401124, at *7, *reprinted in* 33 DEL. J. CORP. L. at 538 (quoting *Guth*, 5 A.2d at 510).

[284] *Gantler*, 2009 WL 188828, at *9.

[285] *See* Barclift, *supra* note 54, at 274.

[286] 907 A.2d 693 (Del. Ch. 2005).

because he failed to keep the board informed with regard to the hiring and termination of President Michael Ovitz.[287] Because the parties had treated the officers and directors as having similar fiduciary duties, however, the court declined to address the liability of an officer as distinct from the liability of the board.[288] In *Smith v. Van Gorkom*,[289] the Supreme Court of Delaware held CEO and Chairman Van Gorkom liable with the rest of the board of directors for breach of the duty of care and for failure to disclose material information to shareholders, but the court criticized Van Gorkom specifically for failing to provide information to the board and for causing the board to fail to fully inform the shareholders as a result.[290] Commentators have noted that the Supreme Court of Delaware seemed to suggest that if the parties had separated Van Gorkom from the other members of the board, he would have been the only director held liable for breach of fiduciary duty.[291] In addition to the supreme court holding that officers can be held liable for breach of fiduciary duty, Delaware's personal jurisdiction statute permits the Delaware courts to extend personal jurisdiction over corporate officers.[292] The statute's definition of officers includes "the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, or chief accounting officer," as well as anyone identified in public filings as one of the company's most compensated executive officers or anyone who has consented in writing to be identified as an officer.[293]

Given that a corporate fiduciary owes duties of care and loyalty to the corporation as a whole, and not just to the shareholders, and given that officers, in addition to directors, stand in a fiduciary relationship with the company, it follows that officers owe fiduciary duties to the corporation. Because the corporation can only act through its board of directors, officers owe a duty of complete candor to the board so that the board can make informed decisions in managing the business of the corporation. The duty of complete candor should not be confined to an external duty that the directors owe to shareholders. It seems more consistent with fiduciary duty law to

---

[287] *Id.* at 760.

[288] *See* Barclift, *supra* note 54, at 274 (citing *Disney*, 907 A.2d at 777-78 & n.588).

[289] 488 A.2d 858 (Del. 1985).

[290] *See* Barclift, *supra* note 54, at 280-81 (citing *Van Gorkom*, 488 A.2d at 864).

[291] *Id.*

[292] DEL. CODE ANN. tit. 10, § 3114(b) (2004); *see also* Barclift, *supra* note 54, at 273 (explaining the extension of personal jurisdiction to include corporate officers and executives).

[293] DEL. CODE ANN. tit. 10, § 3114(b) (2004); *see also* Gantler v. Stephens, No. 2392-VCP, 2008 WL 401124, at *7 (Del. Ch. Feb. 14, 2008), *reprinted in* 33 DEL. J. CORP. L. 528, 537-38 (2008) (explaining that an employee is not an officer for the purposes of DEL. CODE ANN. tit. 10, § 3114(b)).

apply the duty of complete candor with respect to the flow of information internally from officers to directors.

For demand excusal purposes, however, the Delaware Court of Chancery assesses whether the board of directors can objectively evaluate the breach of fiduciary duty claim and considers whether the board approved the challenged transactions or whether the challenged actions could not have been a valid exercise of business judgment. In order for a plaintiff to overcome the demand excusal standard, the plaintiff has to show misconduct or knowledge by the board. If the board is not aware of the officer's misconduct or the officer intentionally concealed information from the board, then the board lacks the requisite knowledge and demand is excused, despite the fact that the corporation may have suffered an injury as a result of the officer's misconduct. One way to circumvent the demand excusal standard could be to show that the board also breached its fiduciary duty of oversight in failing to ensure that the officers were providing the board with all relevant information. The board might also breach its duty of disclosure to shareholders as a result of the officer's breach of his duty of disclosure to the board if the board unreasonably relied on the officer's report or the officer failed to report information. Another way around the demand excusal standard could be to show that the directors lacked independence from the CEO or another corporate officer who intentionally withheld information from the board. The board cannot escape liability by delegating authority to a nondirector officer, as Sycamore did in *Desimone*. The board has a duty of oversight that includes ensuring that the corporate officers are properly managing the day-to-day affairs of the corporation pursuant to the authority granted to them by the board of directors.

B. *Application of the Internal Duty of Candor to Options Backdating*

Had an internal duty of candor applied in the options backdating cases, the Delaware Court of Chancery could have held the corporate officers responsible for their wrongdoing and could have ordered recovery from the officers for the harm their misconduct caused the corporation.[294] The officers who knowingly approved or received backdated options and intentionally lied to the board, causing the corporation to violate its

[294]Of course, unless and until the Delaware General Assembly amends section 102(b)(7) of the DGCL, corporate officers cannot be exculpated "for monetary liability for an adjudicated breach of their duty of care." Gantler v. Stephens, No. 132, 2008, 2009 WL 188828, at *9 n.37 (Del. Jan. 27, 2009).

shareholder-approved stock options plan and issued false public disclosures, could have faced liability for their failure to be completely candid with the board, a clear act of bad faith and disloyalty to the corporation.

In *In re infoUSA, Inc. Shareholders Litigation*,[295] the directors allegedly approved statements in the company's Form 10-K that concealed certain related-party transactions.[296] Because the directors had received a report describing the improper nature of the related-party transactions prior to approving the 10-K, the Delaware Court of Chancery concluded that it was reasonable to infer that the directors had acted in bad faith by concealing the true nature of the transactions.[297] The court explained that a director who had knowledge of the improper transactions and then approved public disclosures concealing those transactions cannot act in good faith because he intentionally concealed information.[298] Similarly, an officer who knows that options have been improperly backdated or otherwise manipulated and conceals that impropriety from the board cannot act in good faith. The directors in *infoUSA* and the officers in the options backdating cases seem equally culpable.[299]

The imposition of an internal duty of candor on corporate officers who engaged in options backdating would have protected the corporation's purpose for granting the options, that is, to align the interests of the recipient with the interests of the corporation and its shareholders. A recipient who receives an option to buy stock at a certain price has an incentive to perform well at his job in the hope that his performance will increase the corporation's stock price. When options are backdated, whether the officer receives the back-dated options himself or grants them to other employees, the incentive function is lost. Furthermore, the officer's interests are no longer aligned with the corporation's. His intentions may be altruistic if he aims to compensate the option recipient—and retain a valuable employee—in a way that does not cause the company to lose earnings. But ultimately, he will cause the company to violate its shareholder-approved stock option plan and issue false public disclosures, thereby exposing the company to

[295]953 A.2d 963 (Del. Ch. 2007).

[296]*Id.* at 980.

[297]*Id.* at 1000.

[298]*Id.*

[299]*See* Langevoort, *supra* note 269, at 1210-13 (suggesting that agency law might impose a duty of candor upon lower-level employees, a whistleblower-type obligation in the corporate law context to inform the board of employee and officer misconduct might be unwise without further qualifications). The Delaware courts seem less likely to extend a fiduciary duty to all employees in a company, but this would have provided a way for the director of human resources in *Desimone* to inform the board of the CFO's improper and secret backdating of options to rank-and-file employees.

liability under state and federal law. Accordingly, an officer who intentionally backdates options (or knowingly receives backdated options) and conceals his actions from the board of directors breaches his duty of candor to the board of directors and to the corporation.

In *Desimone*, the Delaware Court of Chancery noted that a director may believe his actions are in the best interests of the corporation when they are actually disloyal because they cause the corporation to act unlawfully.[300] "The knowing use of illegal means to pursue profit for the corporation is director misconduct."[301] The Delaware Court of Chancery explained in *Desimone* that "it is utterly inconsistent with one's duty of fidelity to the corporation to consciously cause the corporation to act unlawfully."[302] The analysis in *Desimone* could easily apply to an officer's misconduct. A fiduciary who intentionally withholds or otherwise manipulates the information he is required to provide to the relevant decision makers lacks candor and loyalty.[303] The court in *Desimone*, however, would not infer that the board had knowledge of the option grants manipulation or intended to enrich the grant recipients and violate the purpose of the option plan.[304] *Desimone* seems inconsistent with *Weiss* and *infoUSA*, in which the Delaware Court of Chancery did infer bad intent from the circumstances of the board's knowledge of material nonpublic information and its approval of public disclosures that failed to reveal the truth about that material information.[305]

As with director liability, an officer's duty of candor need not be an independent duty but can be a component of his duties of care and loyalty.[306] In the options backdating cases, the Delaware Court of Chancery used the concept of bad faith to find that the board's lack of candor was an act of

---

300 Desimone v. Barrows, 924 A.2d 908, 934-35 (Del. Ch. 2007).

301 *Id.*

302 *Id.* at 934 & n.89 (quoting *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006)) ("A failure to act in good faith may be shown . . . where [a] fiduciary acts with intent to violate applicable positive law.").

303 *See* Lewis v. Vogelstein, 699 A.2d 327, 334 (Del. Ch. 1997) (explaining that shareholder ratification derives from concepts of agency law that contemplate the principal subsequently confirming the legal authority of the agent to act in circumstances in which he had no authority to act and noting that such ratification is not effective unless the agent fully discloses all relevant circumstances surrounding the action prior to the ratification). Chancellor Allen also noted: "Beyond that, since the relationship between a principal and agent is fiduciary in character, the agent in seeking ratification must act not only with candor, but with loyalty. Thus an attempt to coerce the principal's consent improperly will invalidate the effectiveness of the ratification." *Id.* (citing RESTATEMENT (SECOND) OF AGENCY § 100 (1958)).

304 *Desimone*, 924 A.2d at 946.

305 *See* Weiss v. Swanson, 948 A.2d 433, 448-49 (Del. Ch. 2008); *In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 990-91 (Del. Ch. 2007).

306 *See* Gantler v. Stephens, No. 132, 2008, 2009 WL 188828, at *9 (Del. Jan. 27, 2009).

disloyalty. The opinions emphasized that knowledge and intentional concealment (failing to be candid) indicated lack of good faith and implicated the duty of loyalty. A fiduciary is disloyal if he is not honest to the corporation. Because an officer is a fiduciary, his acts of dishonesty and disloyalty should also be actionable. In *Tyson I*, when the Delaware Court of Chancery addressed the misleading disclosures related to the Tyson CEO's compensation, it explained that the existence or lack of good faith determines whether a disclosure violation implicates the duty of care or the duty of loyalty.[307] A misstatement or omission made as a result of a director's erroneous judgment with regard to the proper scope and content of the disclosure, but nonetheless made in good faith, implicates only the duty of care and a finding of liability for breach of the duty of care would be exculpated under the corporation's section 102(b)(7) provision.[308] If there is reason to believe the board lacked good faith in approving the disclosure, however, the duty of loyalty is implicated.[309] Bad faith requires knowledge of the falsity of the disclosures or personal interest in the transaction (self-dealing),[310] which was the case with the directors in *London v. Tyrrell*.[311] An officer who was aware of the practice of backdating options within the company and knew that the backdating violated the shareholder-approved option plan or that it caused the corporation to issue false financial statements and other disclosures would lack good faith if he failed to inform the board of this misconduct and resulting violations. An officer who orchestrated a backdating scheme and who granted backdated options to himself or to others to whom he was beholden would be engaging in self-dealing and, as a result, would lack the requisite good faith.

Holding officers liable for failure to disclose material information to the board is also consistent with *Weiss*, in which the court explained that the board's obligation to disclose their policy of spring-loading and bullet-dodging options arises from "'a moral intuition . . . that directors should be

---

[307] *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563, 597-98 (Del. Ch. 2007).

[308] DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

[309] *Tyson I*, 919 A.2d at 597 (citing Orman v. Cullman, 794 A.2d 5, 40-41 (Del. Ch. 2002)); *see also* La. Mun. Police Employees' Ret. Sys. v. Crawford, 918 A.2d 1172, 1180 n.8, 1185-86 (Del. Ch. 2007) (explaining that directors are bound by a duty of disclosure as part of their fiduciary duties of care and loyalty, so that a disclosure violation cannot give rise to liability unless it implicates the duty of loyalty—as violations implicating only the duty of care would likely be exculpated under the corporation's section 102(b)(7) provision).

[310] *See* Pfeffer v. Redstone, No. 2317-VCL, 2008 WL 308450, at *7 n.34 (Del. Ch. Feb. 1, 2008), *aff'd*, No. 115, 2008, 2009 WL 188887 (Del. Jan. 23, 2009).

[311] *See* London v. Tyrrell, No. 3321-CC, 2008 WL 2505435 (Del. Ch. June 24, 2008), *reprinted in* 33 DEL. J. CORP. L. 929 (2008).

candid with shareholders' and . . . [the Delaware Court of Chancery's] well-established definition of materiality."[312] Similarly, corporate officers have an obligation to provide material information to the board that arises from the moral intuition that officers—who usually control the flow of information about the corporation's day-to-day affairs—must be candid with directors in order for directors to fulfill their fiduciary obligations to the corporation and its shareholders. The standard for determining what information officers must provide to directors derives, therefore, from the materiality standard or all relevant information the board would consider important in making decisions, exercising oversight, and communicating with shareholders.

In addition, an internal duty of candor that requires corporate officers to provide information to the board of directors would bolster the board's monitoring and supervisory duties.[313] In *Desimone*, the Delaware Court of Chancery noted that there were situations in which directors could be held liable for options backdating at the company even though the directors did not know that the options were granted in violation of the stock option plan or that the options were accounted for improperly. If the directors' "failure to obtain that information resulted from their knowing abdication of their directorial duties," then the directors would have possessed the bad faith required for a finding of breach of the duty of loyalty.[314] In *Stone v. Ritter*,[315] the Supreme Court of Delaware adopted the Delaware Court of Chancery's decision in *In re Caremark International Inc. Derivative Litigation*[316] and held that directors may be held liable for a failure to monitor (exercise oversight), even if they did not intend to harm the corporation and were not aware of the employee misconduct that caused the corporation to violate the law, if they acted in bad faith.[317]

> [W]here a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt

[312]Weiss v. Swanson, 948 A.2d 433, 446-47 (Del. Ch. 2008) (quoting Lewis v. Vogelstein, 699 A.2d 327, 332 (Del. Ch. 1997)).

[313]*See* Langevoort, *supra* note 269, at 1200-01.

[314]Desimone v. Barrows, 924 A.2d 908, 933 (Del. Ch. 2007) (citing Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)).

[315]911 A.2d 362 (Del. 2006).

[316]698 A.2d 959 (Del. Ch. 1996).

[317]*Stone*, 911 A.2d at 369-70. *See also Desimone*, 924 A.2d at 935 (explaining that the directors must have "acted with a state of mind consistent with a conscious decision to breach their duty of care").

> to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.[318]

The Delaware Court of Chancery recognized in *Desimone* that a plaintiff could use *Stone* to seek to hold a director accountable for failing to prevent backdating by corporate officers:

> *Caremark* . . . plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director—bad faith—because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance.[319]

If officers had a duty to provide information to the board, then the board would have the responsibility of ensuring that a system was in place in which the officers could fulfill that duty and prevent a violation of law. Imposing a fiduciary duty of candor directly on the officers therefore increases the board's duties under *Stone* to ensure that an information and reporting system between the officers and directors exists. *Redstone* also lays a foundation for imposing a duty of candor on officers to provide information to the board and for exposing the board to liability for failing to ensure an information and reporting system is in place. The Delaware Court of Chancery explained in *Redstone* that the court can infer a director's knowledge of information if the information was "either known (or reasonably assumed) to have been disclosed to or discussed with the board as a whole,"[320] but the board is not presumed to know business operational information that is not routinely disclosed to it.[321] If officers have a fiduciary duty to routinely disclose material information to the board, then the court might infer that the board had knowledge of misconduct by officers and employees that an officer who was properly exercising his fiduciary duties would have brought to the board's attention. An internal duty of candor

---

[318] *Stone*, 911 A.2d at 369 (quoting *Caremark*, 698 A.2d at 971).

[319] *Desimone*, 924 A.2d at 935 (citing *Caremark*, 698 A.2d at 968-70).

[320] *See* Pfeffer v. Redstone, No. 2317-VCL, 2008 WL 308450, at *10 (Del. Ch. Feb. 1, 2008), *aff'd*, No. 115, 2008, 2009 WL 188887 (Del. Jan. 23, 2009).

[321] *Id.*

would therefore provide a way for the court to hold the board accountable for misconduct that the board was not aware of but that causes harm to the corporation.

A fiduciary obligation that corporate officers provide material information to the board seems consistent with early Delaware cases that dealt with false representations. Arguably, cases such as *Hall* and *Kelly* did not provide the foundation for a director's fiduciary duty of disclosure to shareholders because those cases suggest that the duty to be honest is broader than that. Those cases permit the duty to be extended beyond communications with shareholders to include other external communications. Those cases could easily be applied to internal communications as well because they suggest that there exists a broader duty that is owed generally by someone in a fiduciary relationship.[322]

C. *Implications of the Internal Duty of Candor*

A broader duty of candor that includes officer communications with directors would have implications for the type of action brought, remedies sought, and pleading standards. A derivative suit is brought on behalf of a corporation by a shareholder-plaintiff seeking redress for harm caused to the corporation.[323] A direct suit, such as a class action, is brought on behalf of a class of shareholders seeking redress for harm to the shareholders independent of any harm caused to the corporation. When a plaintiff alleges that the board breached its duty of candor to the shareholders, that claim may be direct if the plaintiff demonstrates that the breach caused a separate harm to the shareholders that is distinct from the harm to the corporation. A claim in which the plaintiff alleges that a corporate officer breached his duty of candor would be derivative because the officer breached his duty to the corporation by failing to be candid with the board. By creating an internal duty of disclosure, the Delaware courts could permit a plaintiff to seek redress for a disclosure violation that caused harm to the corporation. A plaintiff could then bring a derivative action on behalf of the corporation, rather than a direct action, in situations in which the disclosure violation caused harm to the corporation and did not cause an independent harm to the shareholders.

---

[322] *See* Maclary v. Reznor, 3 Del. Ch. 445, 464-65 (Del. Ch. 1870).

[323] *In re* The Topps Co. S'holders Litig., 924 A.2d 951, 957 (Del. Ch. 2007) (citing Ryan v. Gifford, 918 A.2d 341, 349 (Del. Ch. 2007)) (explaining that a shareholder plaintiff who brings a derivative suit does not sue for his direct benefit but instead alleges an injury to and seeks redress on behalf of the corporation; any shareholder with standing may represent the injured party).

In *In re J.P. Morgan Chase & Co. Shareholder Litigation*,[324] shareholders of J.P. Morgan brought a class action against the J.P. Morgan directors, challenging J.P. Morgan's acquisition of Bank One Corporation and alleging, among other things, that shareholder approval of the merger was sought with materially inaccurate or incomplete disclosures.[325] The shareholders sought money damages.[326] The Supreme Court of Delaware affirmed the Delaware Court of Chancery's holding that the complaint failed to state a claim for a breach of the duty of disclosure that caused money damages because the complaint did not allege any compensable harm to the shareholder class.[327] The damages that allegedly flowed from the disclosure violation were exactly the same as those suffered by J.P. Morgan and so the injury was one to the corporation and not to the class.[328] Because such a claim for actual damages belongs to the corporation, the claim could "only be pursued by the corporation, directly or derivatively."[329]

The proxy materials seeking approval of the merger did not disclose an alleged offer by the CEO of Bank One to sell Bank One to J.P. Morgan at no premium if J.P. Morgan would let the Bank One CEO assume the position of CEO at J.P. Morgan immediately.[330] J.P. Morgan declined the offer, retained its current CEO and acquired Bank One at a fourteen percent premium.[331] The shareholder class argued that they were entitled to recover compensatory damages of $7 billion, the amount of the premium paid for Bank One.[332] The Supreme Court of Delaware explained that "[t]o the extent the plaintiffs' claim is that the compensatory damages worth $7 billion flow from the disclosure violation, that damages claim is derivative, not direct."[333] Even if there was a breach of the duty of disclosure to the shareholders because the misleading proxy disclosures induced the J.P. Morgan shareholders to approve the merger, the harm resulting from the overpayment was to the corporation and, accordingly, any damages would go to the corporation and not to the shareholder class.[334]

---

[324]906 A.2d 766 (Del. 2006).

[325]*Id.* at 769.

[326]*Id.*

[327]*Id.* at 770 (citing *In re* J.P. Morgan Chase & Co. S'holder Litig. (*In re J.P. Morgan I*), 906 A.2d 808, 825-26 (Del. Ch. 2005)).

[328]*In re J.P. Morgan*, 906 A.2d at 770.

[329]*Id.* (quoting *In re J.P. Morgan I*, 906 A.2d at 826).

[330]*Id.* at 769.

[331]*Id.*

[332]*In re J.P. Morgan*, 906 A.2d at 769.

[333]*Id.* at 772.

[334]*Id.*

The Supreme Court of Delaware further clarified that a claim that the directors' violated the duty of disclosure and impaired the shareholders' right to a fully informed vote is a direct claim and not a derivative one.[335] "[A] duty of disclosure violation may entitle the injured party to compensatory damages in appropriate circumstances."[336] In order for shareholders (through their class action) to recover directly, however, they must have suffered some harm separate from the injury to the corporation as a result of the breach. The shareholders are not "automatically . . . entitled to recover the identical damages on their disclosure claim, that the corporation would be entitled to recover on its underlying (derivative) claim."[337] Compensatory "damages must be logically and reasonably related to the harm or injury for which compensation is being awarded."[338] While $7 billion is the logical and reasonable consequence of the harm to J.P. Morgan for being caused to overpay for Bank One by $7 billion, for which J.P. Morgan has an underlying derivative claim for waste, that amount "has no logical or reasonable relationship to the harm caused to the shareholders *individually* for being deprived of their right to cast an informed vote."[339]

The Supreme Court of Delaware further construed *Tri-Star Pictures* narrowly as standing for the proposition that when directors breach "their disclosure duties in a corporate transaction that has in turn caused impairment to the economic or voting rights of stockholders, there must at least be an award of *nominal* damages."[340] Damages for directors' breaches of the fiduciary duty of disclosure are only available, the court explained, "in circumstances where disclosure violations are concomitant with deprivation to stockholders' economic interests or impairment of their voting rights."[341] Where the only economic injury asserted is J.P. Morgan's loss of the opportunity to acquire Bank One at a lower price, that injury is to the corporation, not to the shareholders.[342]

The Delaware Court of Chancery in *Tyson I* summarized the remedies available for disclosure violations as follows:

---

[335] *Id.* (citing *In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 330 n.12, 332 (Del. 1993)).

[336] *In re J.P. Morgan*, 906 A.2d at 772.

[337] *Id.* at 772-73.

[338] *Id.* at 773 (citing Jardel Co. v. Hughes, 523 A.2d 518, 528 (Del. 1987)).

[339] *Id.*

[340] *In re J.P. Morgan*, 906 A.2d at 773 (quoting *In re* J.P. Morgan Chase & Co. S'holder Litig. (*In re J.P. Morgan I*), 906 A.2d 808, 826 (Del. Ch. 2005)).

[341] *Id.* at 774 (quoting Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 147 (Del. 1997)).

[342] *Id.*

> In a direct suit based upon a disclosure claim, [a class action on behalf of shareholders,] . . . damages to plaintiff shareholders are limited only to those that arise logically and directly from the lack of disclosure, and nominal damages are appropriate only where the shareholder's economic or voting rights have been injured.[343]

When the lack of disclosure caused harm to the corporation, the shareholders have no direct right to share in any of the benefits the directors might have received as a result.[344]

In *infoUSA*, the Delaware Court of Chancery clarified that a claim for breach of fiduciary duty for the board's alleged failure to disclose material information when seeking shareholder action presents a direct claim for relief on the part of the shareholders.[345] The infoUSA board had allegedly failed to disclose material information about the CEO's beneficial stockholdings prior to an annual meeting at which the company asked shareholders to approve an amendment to the company's stock option plan that would increase the number of shares available to management.[346] The court explained that:

> [w]here a disclosure claim states that a shareholder was denied the opportunity to exercise a fully-informed vote, the claim is direct, and where a significant shareholder's interest is increased at the sole expense of the minority, such a claim is individual in nature and entitles plaintiffs to at least nominal damages.[347]

In the past, the Delaware courts were inconsistent about whether the duty of candor is an independent wrong that gives rise to a remedy or whether it simply implicates one of the two fiduciary duties of care and loyalty. The classification is important for purposes of fashioning a remedy for an officer's failure to be candid with the board. The opinions of the Delaware Court of Chancery addressing options backdating concluded that, while lack of candor can result in a finding of breach of the duty of loyalty,

---

[343] *In re* Tyson Foods, Inc. Consol. S'holder Litig. (*Tyson I*), 919 A.2d 563, 602 (Del. Ch. 2007) (citing *In re J.P. Morgan*, 906 A.2d at 773-74).

[344] *Id.*

[345] *In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 1001 n.82 (Del. Ch. 2007).

[346] *Id.* at 1000-01.

[347] *Id.* at 1001 n.82.

the act of failing to be fully candid can result in independent remedies. In *Tyson I*, the Delaware Court of Chancery explained that a disclosure claim must "demonstrate damages that flow from the failure to adequately *disclose* information, not that the information disclosed concerned matters for which damages are appropriate."[348] There must be some connection between the lack of disclosure and an actual harm, but "exposure to risk of investigation" is not sufficient.[349] In a shareholder derivative suit alleging an officer's breach of the duty of candor to the board in violation of his duty of loyalty to the company, the plaintiff would be seeking redress to the corporation. Perhaps the shareholders could seek an independent remedy if they could show that they suffered some distinct harm from the harm suffered by the corporation. The main concern, however, is the harm to the corporation that the officer causes by his lack of candor with the board. For example, in *Desimone* and *Brandin*, where the board was unaware that an officer was granting backdated options and the board, in good faith, approved the false and misleading public filings, a shareholder could bring a derivative action on behalf of the corporation. Those actions sought redress for the harm to the corporation caused by the issuance of the backdated options, the resulting violations of the shareholder-approved option plan and the securities and tax regulations (which subjected the corporation to liability).

If plaintiffs can bring a derivative action for an officer's breach of the duty of candor, then plaintiffs can seek redress for harm to the corporation that the board might not otherwise pursue. In a later memorandum opinion addressing other issues in the *Ryan* litigation (*Ryan II*),[350] the Delaware Court of Chancery focused on the culpability of two corporate officers.[351] Although the board was not aware of the backdating, Maxim's CEO and CFO knew of, and had participated in, the backdating of options that were granted to certain employees.[352] Maxim had established a special committee (comprised of one director) to investigate the company's option grant practices after Merrill Lynch published its report that certain companies, including Maxim, had almost certainly backdated options.[353] As a result of the special committee's investigation, Maxim terminated the employment of the CEO and CFO.[354] The company took no action, however, to recover the

[348]*Tyson I*, 919 A.2d at 597 (citing Brown v. Perrette, No. 13,531, 1999 WL 342340, at *6 (Del. Ch. May 14, 1999)).

[349]*Id.* (citing Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 147 (Del. 1997)).

[350]Ryan v. Gifford (*Ryan II*), No. 2213-CC, 2008 WL 43699 (Del. Ch. Jan. 2, 2008).

[351]*See id.* at *3.

[352]*Id.*

[353]*Id.* at *1.

[354]*Ryan II*, 2008 WL 43699, at *3.

damages Maxim suffered as a result of the backdating and the unjust enrichment of the grant recipients.[355] Similarly, in *Conrad v. Blank*,[356] the Delaware Court of Chancery found it "troubling" that the board had determined that the company's stock options were erroneously issued with "incorrect measurement dates" but "did nothing to remedy those past 'errors.'"[357] And in *Brandin*, the corporation did not take action against the compensation committee where the committee approved the backdated options that caused the corporation to issue false and misleading proxy disclosures.[358] Even though the interests of the party that engaged in the wrongdoing and the interests of the corporation diverged, the board of directors was unwilling to recover from the wrongdoers for the harm to the corporation.[359] If shareholders have the ability to bring a derivative claim on behalf of the corporation for harm to the corporation caused by an officer's lack of complete candor with the board, then the company receives redress for harm that would otherwise go uncollected.

To overcome the Delaware Court of Chancery's high pleading standard, a shareholder plaintiff bringing a derivative suit has to show that presuit demand would have been futile and is therefore excused in order for the claim to survive a motion to dismiss under Delaware Court of Chancery Rule 23.1.[360]

> When a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that shareholder to first make demand on that corporation's board of directors, giving the board the opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interest of the corporation.[361]

In some circumstances, the court recognizes that demand would be futile and is therefore excused, and permits the claim to proceed. The court first considers whether the directors considering the presuit demand—those members of the board at the time the derivative claim is brought—are the persons who committed the actions challenged in the shareholder's

[355] *Id.*
[356] 940 A.2d 28 (Del. Ch. 2007).
[357] *Id.* at 37.
[358] Brandin v. Deason, 941 A.2d 1020, 1022 & n.1 (Del. Ch. 2007).
[359] *See id.*
[360] *See* DEL. CT. CH. R. 23.1.
[361] Ryan v. Gifford, 918 A.2d 341, 352 (Del. Ch. 2007).

complaint.[362] If the board members evaluating the demand are the same members who engaged in the wrongdoing for which the shareholder is seeking redress, then the board cannot objectively evaluate whether to pursue a claim against itself on the corporation's behalf.[363] In those cases, under the *Aronson* test for demand excusal, demand is excused "if a plaintiff can raise a reason to doubt that: (1) a majority of the board is disinterested or independent or (2) the challenged acts were the product of the board's valid exercise of business judgment."[364]

If the challenged acts were not a decision of the board in place when the complaint is filed, then a different test applies. Under *Rales v. Blasband*,[365] where the board of directors made "no conscious decision . . . to act or refrain from acting," the business judgment rule did not apply to the challenged decision.[366] In those situations, in order to show that demand is excused, the plaintiff must create a reason to doubt that the board could have "exercised its independent and disinterested business judgment in responding to a demand."[367] The directors therefore have a disabling interest for presuit demand purposes if they face a substantial likelihood of liability.[368]

This last part of *Rales* is probably the best way to show demand excusal in shareholder derivative actions seeking redress against corporate officers for their failure to provide information to the board. In the context of options backdating, when an officer orchestrates the backdating or is aware that the backdating is occurring but conceals it from the board, the board could face liability for its failure to detect the backdating, even if the board was not aware of, and did not approve, the backdating. An officer's duty of candor to the board is an ongoing duty to provide material information to the board that enables the board to perform its ongoing duty to exercise oversight.[369] The board relies on a continuous flow of information from the senior corporate officers—the CEO and CFO particularly—in order to properly exercise its oversight functions. If the CEO fails to provide information to the board, the board may face a substantial likelihood of liability for its failure to exercise oversight, especially if it should have

[362] *Id.*

[363] *Id.*

[364] *Id.* (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[365] 634 A.2d 927 (Del. 1993).

[366] *Id.* at 933.

[367] *Ryan*, 918 A.2d at 353 (quoting *Rales*, 634 A.2d at 933-34).

[368] *Id.* at 355 (citing *In re* Baxter Int'l, Inc. S'holders Litig., 654 A.2d 1268, 1269 (Del. Ch. 1995)).

[369] *See* Barclift, *supra* note 54, at 290 (suggesting that "senior officers owe an unremitting affirmative duty to disclose material information," and that boards depend on the CEO and CFO for a constant and accurate flow of information and cannot perform their oversight duties without it).

ensured that it was receiving a constant and accurate flow of information and failed to do so. The board might also face a substantial likelihood of liability in situations such as *Desimone*, where the directors delegated to the CFO the authority to grant options pursuant to the option plan. Although the CFO engaged in the backdating and concealed that conduct from the board, perhaps the board should have exercised better oversight of the CFO to whom it had delegated authority. Once the board delegates authority to a senior officer, it has an obligation to oversee that the senior officer properly exercises that authority. The board's lack of knowledge of the misconduct would not shield it from liability if it should have supervised the CFO better. It cannot turn a blind eye to the backdating by delegating the authority to the CFO to administer the stock options and then fail to ensure that the CFO is administering the options properly. As with *Van Gorkom*, where the board failed to fully inform itself of the circumstances surrounding the proposed merger, the board has failed to fully inform itself of the circumstances surrounding the CFO's exercise of authority. The board is not the only actor liable. The fiduciary obligations run both ways. The CFO has an obligation to provide information to the board and the board has an obligation to ensure that it is receiving information from the CFO in order to fulfill its fiduciary duties in managing the affairs of the corporation. Although the court in *Desimone* refused to infer bad intent on the part of the board because of the board's lack of knowledge, it seems that the board was able to escape liability by delegating authority to the CFO and then keep itself in the dark about the CFO's conduct.

There are other ways to show that demand is futile. A director who materially benefited from a backdated option would not be disinterested.[370] In addition, in *Tyrrell*, the Delaware Court of Chancery held that a majority of the board was interested in the challenged option grants because the directors stood on both sides of the transaction.[371] They both granted and received the stock options.[372] Similarly, if an officer orchestrated a backdating scheme and granted options to the directors, the directors would not be disinterested in the challenged option grants. Even if the director recipients were unaware that the options were backdated—and it is difficult to imagine how they could have been unaware of the backdating—they would not want to pursue a claim against the officer because it might mean that the directors would lose their option grants or that they would be

---

[370]Melzer v. CNET Networks, Inc., 934 A.2d 912, 914 (Del. Ch. 2007).

[371]*See* London v. Tyrrell, No. 3321-CC, 2008 WL 2505435, at *5 (Del. Ch. June 24, 2008), *reprinted in* 33 DEL. J. CORP. L. 929, 936 (2008).

[372]*Id.*

implicated in the wrongdoing. A director also might have a disabling interest if he did not want to address the misconduct publicly. To avoid the negative publicity that would result from exposing the corporate officer's misconduct, the company might prefer to terminate the officer quietly. A board that fears liability for failing to detect the officer's misconduct, or that simply fears that exposure of the misconduct will lower the company's stock price and cause more harm to the corporation, would be interested for demand purposes.

Further, if directors lacked independence from—or were beholden to—the officer who engaged in the backdating, demand would be excused. If the board is controlled by the officer who has engaged in the backdating, the board cannot evaluate the demand objectively. This is particularly plausible because the CEO and CFO tend to control the flow of information to the board about the day-to-day affairs of the corporation. Finally, as the court suggested in *Ryan*, backdating options may very well be one of those rare situations, under the *Aronson* standard for demand excusal, that is "so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."[373] Under this premise, no matter the identity of the corporate actor engaged in the backdating, the conduct is so egregious that the board cannot escape liability whether it was aware of the conduct or not.

If a plaintiff brings a derivative action alleging that a corporate officer breached his duty of candor to the board by intentionally backdating options (or by having knowledge that options were intentionally backdated in violation of an option plan) and then concealing the backdating from the board, demand might be excused even though the board was unaware of the backdating. If the board feared liability for its failure to monitor because it had not ensured that an information and reporting system existed between the board and the officers, it would be interested and demand would be excused. Even if the board did not fear liability but did not want public exposure or feared that the corporation's share price would drop if it sought to recover for the wrongdoing, then the board would also be interested and demand would be excused. Finally, the board might lack sufficient independence from the officers to objectively evaluate the demand. The board might not have known of the misconduct, but might have received backdated options. Or, once the board found out about the misconduct, it might not want to seek redress from the breaching officer because the

[373] *Ryan*, 918 A.2d at 355-56 (quoting Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984)).

breaching officer is valuable to the company. In any of these situations, demand would be excused and the plaintiff could proceed with its claim.

Cases such as *Ryan II*, where the CEO and CFO engaged in the backdating and concealed their conduct from the board, and *Desimone*, in which the CFO did the same, would not have to be dismissed for failure to make presuit demand if the Delaware courts extended the duty of candor to include an ongoing duty of corporate officers to provide information to the board. Creating a means of recovery against corporate officers for their breach of the duty of candor would deter corporate officers from engaging in misconduct out of fear of incurring personal liability. It would also provide the corporation with compensation for the corporate officers' misconduct and bolster directors' fiduciary duties to manage the business and affairs of the corporation.

V. CONCLUSION

State corporation law has implications for future corporate scandals, which are likely to involve intentional misconduct by corporate officers and concealment of that misconduct from the board of directors. Extending the duty of candor beyond its current application, as a duty that directors owe to disclose material information to the shareholders, would provide a way to seek redress for harm to the corporation that the board may not seek otherwise. If officers owe a duty of candor to the board of directors as part of the officers' fiduciary duty of loyalty to the corporation, then boards will be forced to establish an internal system to ensure that important information known by corporate officers reaches the board. In addition, corporate officers will be deterred from engaging in misconduct and concealing that misconduct from the board because the officers could face personal financial liability for doing so.

Had an internal duty of candor existed when the Delaware courts addressed the cases arising from the options backdating scandal of 2006, there would have been a basis upon which to hold the wrongdoers accountable and some of the cases would not have been dismissed for failure to make a demand. If the duty of candor is extended to officers as well as to directors, then officers might be further deterred from engaging in misconduct. Simply hiding their actions from the board will be insufficient to escape liability. Officers' lack of candor and intentional concealment will give rise to liability. Therefore, officers will have to be more honest, a desirable result for all of the corporation's constituencies.