



## message from partner in charge

It is my pleasure to welcome you to the second edition of the *Wilmington Update*. In this issue, you'll find articles about stock option backdating and spring-loading, as well as restrictions to loans for military personnel. These are just a few of the topics Pepper attorneys have on their minds, so be sure to visit [www.pepperlaw.com](http://www.pepperlaw.com) for a variety of articles and podcasts on topics of interest.

I'm also pleased to inform you that I, along with my colleague and friend Robert S. Hertzberg who resides in our Detroit office, have been named co-chairs of Pepper's Corporate Restructuring and Bankruptcy Practice. Bob and I succeed long-time chairman I. William Cohen, who helped the group diversify to include all types of clients in the bankruptcy field and adopt many best practices that became models for other practice groups here at Pepper.

Bob and I would like to thank Bill for his leadership, and let our clients know that we look forward to building on the excellent platform he developed while expanding our presence in the mid-market debtor and committee cases.

As always, if you have any questions about any legal issue you or your company are experiencing, or would like further information about the topics discussed in this newsletter, give us a call. We're here to listen.

David B. Stratton  
302.777.6566  
[strattond@pepperlaw.com](mailto:strattond@pepperlaw.com)

## DE Court of Chancery Weighs In on Stock Option Backdating and Spring-Loading

On February 6, 2007, Chancellor William B. Chandler III released two opinions in which the Delaware Court of Chancery held that the practice of backdating or spring-loading stock options may result in breaches of fiduciary duty under Delaware law. The Court's opinions follow a recent wave of publicity and a surge of litigation concerning improper directorial action in granting stock options at a number of large public companies.

The practice of stock-option backdating gained national recognition after a March 18, 2006, *Wall Street Journal* article that reported a widespread pattern of low stock prices just before option grant dates and then an immediate rise in stock prices after the grant dates – a practice that strongly suggested that the timing of such stock option grants had been manipulated by corporate insiders. The practice of backdating or spring-loading stock options has resulted in SEC and IRS investigations, has caused companies under investigation to restate financial statements, and has compelled the resignation or firing of many company executives. The two opinions authored by Chancellor Chandler represent the first time that the Court of Chancery has addressed the propriety of backdating or spring-loading stock options.

In *Ryan v. Gifford*, 2007 WL 416162 (Del. Ch. Feb. 7, 2007), the Chancellor denied in part a motion to dismiss the complaint, which alleged that directors of Maxim Integrated Products, Inc., a manufacturer of microprocessor components, backdated stock options grants in violation of a company stock option plan. Stock option backdating involves the granting of stock options on a certain date while modifying the option documentation to make it appear that the options actually had been granted on an earlier date that corresponds with a recent low in the company's stock price. The practice allows a board to effectively grant "in-the-money" options in order to attract and retain

executives while gaining favorable tax treatment and avoiding shareholder approval requirements. Backdating stock options can, however, (1) violate SEC regulations regarding company representations in SEC filings; (2) violate GAAP and Financial Accounting Standards for the failure to report the difference between the exercise and market price of the company's stock on the grant date as an expense in the company's financial statements, which could result in a reduction of earnings; and (3) affect tax liabilities of the option grantee and the company.

The Court held that it was "convinced that the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitutes conduct that is disloyal to the corporation and is therefore an act in bad faith." This holding was based upon allegations that "Maxim's directors affirmatively represented to Maxim's shareholders that the exercise price of any option grant would be no less than 100 percent of the fair value of shares, measured by the market price of the shares on the date the option is granted" coupled with empirical data demonstrating that every challenged option grant occurred during "the lowest market price of the month or year in which [the option] was granted."

In the second opinion, *In Re Tyson Foods, Inc. Consolidated Shareholder Litigation*, 2007 WL 416132 (Del. Ch. Feb. 7, 2007), a group of shareholders challenged an assortment of transactions between directors and controlling shareholders of Tyson Foods, including the grant of stock options to current and former management and directors. The Court denied in part the defendants' motion to dismiss on various grounds set forth in the 77-page opinion.

The plaintiffs challenged transactions related to the stock option grants because on multiple occasions the grants were made shortly before the company issued favorable press releases. This practice is colloquially referred to as spring-loading because the public announcement of positive information, known only to insiders at the time the options are granted on an earlier date, is likely to drive the company's stock price upwards.

Referencing its holding from *Ryan v. Gifford*, the Court explained that "all backdated options involve a fundamental, incontrovertible lie" and that "allegations of spring-loading implicate a much more subtle deception.... A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding

shareholder-imposed requirements cannot, in [the Court's] opinion, be said to be acting loyally and in good faith as a fiduciary."

The Court held that in order to state a claim related to stock-option spring-loading, "a plaintiff must [first] allege that options were issued according to a shareholder-approved employee compensation plan.... Second, a plaintiff must allege that the directors that approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issue those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options." The Court ruled that the plaintiffs in Tyson had plead sufficient allegations to satisfy this legal test at the pleading stage.

In both cases, the Court addressed Delaware fiduciary principles, including the recently evolved duty of good faith, with "novel" sets of facts in mind. The holdings, however, should come as no great surprise since backdating and spring-loading involve "deception" by a board, conduct that is by no means consistent with a director's unyielding fiduciary duty to the company and its shareholders under Delaware law.

Although these two opinions were the first opportunity for the Court of Chancery to address these important issues, the decisions represent the well-reasoned, even-handed treatment that the Court of Chancery has and will continue to bring to backdating or spring-loading stock option issues. Since these two decisions, at least four other stock option backdating cases have been filed in the Court of Chancery: *Sherwood v. Valeant Pharmaceuticals International et. al*; *Weiss v. Linear Technology Corp. et. al.*; *Teitelbaum v. L-3 Communications Holdings, Inc. et. al.*, and *Denver Employees Retirement Plan v. Electronic for Imaging, Inc. et al.*

Author:

Albert H. Manwaring IV  
302.777.6514  
manwaringa@pepperlaw.com

## Congress Federalizes and Restricts High Cost Loans to Military Personnel

Despite tremendous opposition from supporters of the payday lending industry, the House and Senate have approved, and the President on October 16 signed into law an amendment to the Miscellaneous Prohibitions and Penalties chapter of the General Military Law [10 USC 49] (the Act) which prohibits creditors from entering into payday loan and title loan agreements with active duty servicemembers, including active National Guard and Reserve servicemembers, and their dependents (covered members).<sup>1</sup> The Act caps the annual percentage rate of interest on loans to covered members at 36 percent; prohibits rollovers, renewals or refinances of loans to covered members; and prohibits holding checks, ACH authorizations or vehicle titles as security for a loan to a covered member. The Act was backed by the Department of Defense, legislators and consumer advocate groups. In addition to those limitations and prohibitions, the Act would:

- Apply to **all forms of consumer credit** (including those made through the Internet) to covered members, except residential mortgage loans or purchase money loans for purchasing a car or personal property and secured by that car or personal property.
  - Apply to **all creditors**, including banks, finance company, licensed lenders and their assignees.
  - Require disclosures be given **orally and in writing** before making the loan including all disclosures required by the Truth in Lending Act and Regulation Z, with a clear description of the payment obligations of the covered member.
  - Prohibit creditors from requiring a covered member to establish an allotment to repay a loan.
  - Prohibit creditors from charging a prepayment penalty or from prohibiting a covered member from prepaying a loan.
  - Preempts any provisions of state and federal laws, rules and regulations, including any state usury laws, that are less protective than the Act.
- The Act raises a host of issues and is very troublesome for the entire consumer credit industry.*
- Prohibit states from authorizing creditors to charge covered members rates of interest higher than the legal limit for residents of the state or allowing waivers or violations of state consumer protection laws based upon the non-resident or military status of a covered member, regardless of their permanent home state of record.
  - Define interest to **include all cost elements of credit** including service charges, renewal charges, fees, credit insurance premiums, the cost of any ancillary product sold with the loan and any other charge or premium with respect to the extension of consumer credit.
  - Require the **annual percentage rate to be calculated using all of the interest charges**, including those not considered finance charges under Regulation Z.
  - Prohibit a creditor from requiring any waiver by the borrower of their legal rights to recourse under any state or federal law.
  - Prohibit a creditor from requiring a borrower to submit to arbitration or from imposing onerous legal notice provisions in the case of a dispute.
  - **voids any agreements to arbitrate disputes.**
  - **voids any contract made in violation of the Act.**
  - Imposes penalties for violations, including fines or imprisonment or both.

- Provides for payment of awards for consequential and punitive damages.

The Act is effective on October 1, 2007 or an earlier date if prescribed by the Secretary of Defense. The Secretary of Defense is responsible for issuing regulations to implement the Act. The regulations will establish the required disclosures, the maximum fees, the method for calculating the annual percentage rate in compliance with the Act and any other criteria or limitations as determined appropriate by the Secretary of Defense. The Secretary of Defense will consult with the Federal Trade Commission, the federal banking agencies, the National Credit Union Association and the Treasury Department in prescribing the regulations.

The Act raises a host of issues and is very troublesome for the entire consumer credit industry. The cap on interest will very likely apply to many loans that are not classified as “payday” loans, since the cap will include many fees currently excluded from the definition of a finance charge under Regulation Z. In addition, the very broad coverage of this Act - active duty servicemembers, active National Guard and Reserve servicemembers, and their dependents - will present many compliance challenges for lenders. Finally, giving responsibility to the Secretary of Defense for drafting regulations to implement the Act’s provisions, even with the required consultations with the bank regulatory agencies and the FTC, may present troublesome issues for the consumer credit industry.

Should you have questions about this Act, please contact Richard P. Eckman, Albert Manwaring, a partner and

lieutenant colonel in the Judge Advocate General Corps of the U.S. Army Reserves, or Darcy Malcolm.

*Authors:*

*Richard P. Eckman*  
302.777.6560  
[eckmanr@pepperlaw.com](mailto:eckmanr@pepperlaw.com)

*Albert H. Manwaring IV*  
302.777.6514  
[manwaringa@pepperlaw.com](mailto:manwaringa@pepperlaw.com)

*Darcy L. Malcolm*  
Paralegal  
302.777.6551  
[malcolmd@pepperlaw.com](mailto:malcolmd@pepperlaw.com)

#### Endnotes

- <sup>1</sup> The term “covered member” is defined in the Act as a member of the armed forces who is (1) on active duty under a call or order that does not specify a period of 30 days or less or (2) on active Guard and Reserve Duty. The term “dependent” is defined as a covered member’s spouse, child or individual for whom the covered member provided more than one-half of the individual’s support for 180 days immediately preceding an extension of consumer credit covered by the Act.

## RSS on [www.pepperlaw.com](http://www.pepperlaw.com)

Subscribe to the latest Pepper articles via RSS feeds. Visit [www.pepperlaw.com](http://www.pepperlaw.com) today and click on the RSS button to subscribe to our latest articles in your news reader.

## Pepper Hamilton LLP

Attorneys at Law

The material in this publication is based on laws, court decisions, administrative rulings and congressional materials, and should not be construed as legal advice or legal opinions on specific facts.

[www.pepperlaw.com](http://www.pepperlaw.com)

Berwyn | Boston | Detroit | Harrisburg | New York | Orange County  
Philadelphia | Pittsburgh | Princeton | Washington, D.C. | Wilmington

© 2007 Pepper Hamilton LLP. All Rights Reserved.

This publication may contain attorney advertising.