A Guide to Challenging Option Repricing

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I. INTRODUCTION

For many years, companies have used stock option plans to attract and keep quality employees and to align employees' interests with those of shareholders.¹ Stock options give company employees² the right to buy a certain number of shares of stock from the company at a predetermined exercise price for a limited period of time.³ The exercise price is usually at or above the market price of the company's stock at the time the option is issued.⁴

Stock options theoretically provide employees with incentives to work hard⁵ in the hopes that their efforts will ultimately result in a higher market price for the company's stock.⁶ If the market price does rise, then the employees will usually exercise their stock options and purchase the stock from the company at the exercise price.⁷ Absent

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² In most cases, employees are not required to pay for the stock options themselves. Instead, at the time the option is exercised, the employee buys stock from the company at the predetermined exercise price. See JOHN DOWNE & JORDAN ELLIOT GOODMAN, BARRON'S FINANCE & INVESTMENT HANDBOOK 300 (4th ed. 1995) [hereinafter BARRON'S]. But see Haft v. Dart Group Corp., No. CIV.A.13736, 1994 WL 643185, at ¶1 (Del. Ch. Nov. 14, 1994) (describing an incoming president who paid company for options at time of issuance).
³ See BARRON'S, supra note 2, at 611. The exercise price is also sometimes referred to as the strike price. See id. at 300, 614.
⁴ See Susan J. Stabile, Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?, 2 U. PA. J. LAB. & EMPLOYMENT L. 227, 235 n.28 (1999) ("While options need not be granted with an exercise price equal to fair market value at the date of grant, doing so is common and reasonable.").
⁵ See generally Stabile, supra note 4. While it is unclear whether equity-based compensation causes positive performance, there appears to be a positive linear correlation between a company's performance and the equity-based portion of its CEO's compensation. See Hamid Mehran, Executive Compensation Structure, Ownership, and Firm Performance, 38 J. FIN. ECON. 163, 164, 169, 176-78 (1995).
⁶ See generally Statutory Stock Options, NCEO Library (visited Sept. 29, 2000) <http://www.nceo.org/library/equityl.html> (stating that "[s]tock options are the most popular form of long-term compensation incentives for [U.S.] executives," but that they need to be properly structured to accomplish their intended results) [hereinafter Statutory Stock Options].
⁷ Some commentators have stated that equity interests such as stock option repricing provide "incentives to key employees by giving them a stake in the business, preserve[] capital by enabling companies, such as start-ups, to pay lower cash
restrictions imposed by the securities laws, employees are free to sell their stock in the open market at the current price and capture what is hopefully a significant profit. For example, a company issues stock options that give employees the option to purchase one share of stock at an exercise price of $10.00 per share. The exercise price is a higher price than the current market price of the company’s stock. One year later, however, the company’s stock rises to $15.00 per share. An employee may then decide to exercise his option and purchase stock from the company at $10.00 per share. The employee will then immediately turn around and sell it in the open market for $15.00 per share. Hence, the employee makes a $5.00 profit per share.

When employees profit from the exercise of their options, the employees receive a nice fringe benefit. However, the company has also gained; the company enjoys a higher stock price and has compensated its employee without a cash outlay. Additionally, upon the exercise of compensation; and permit[...] smaller companies to compete for talent with larger companies with greater resources by holding out the prospect of significant appreciation in value.” Stanley Keller, *Overview of Employee Equity Compensation, ALI-ABA Course of Study: Tax, Business, and Succession Planning for the Growing Company*, Mar. 6, 1997, at 281, 283, available in Westlaw, SB71 ALI-ABA 281.

8. This would include such things as the prohibition against buying or selling stock based upon material inside information. See, e.g., United States v. Smith, 155 F.3d 1051, 1063-64 (9th Cir. 1998) (stating that insider trading liability arises where insider makes actual use of material non-public information in consummating securities transaction).

9. For example, an employee is granted an option to buy one share of the company’s stock at $10.00, which is the price at which the company’s stock is publicly trading at the time of the grant of the option. The terms of the stock option plan provide that she may exercise this option at any time over the next five years, but she will probably not exercise the option immediately because it would not be profitable. She would simply be engaging in a wash by paying the company the same price ($10.00) as she would if she were to purchase the stock in the open market ($10.00).

10. Even when the exercise of the option would not produce an instant profit to the employee, a well-intentioned employee, seeking to acquire his company’s stock, might still exercise his option at a wash (i.e., notwithstanding the fact that the stock’s market price is equal to the exercise price) if he wants to provide the company with capital (as opposed to acquiring stock in the open market and paying some unknown third party, instead of the company, for his stock).

11. When a company’s stock price is higher, it, as a form of currency, goes further. Thus, a company with a higher stock price may be more willing to use its own stock (instead of cash) in connection with acquisitions, as the company can part with fewer of its shares when it makes an acquisition. Cf. e.g., Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 451 (7th Cir. 1982) (finding that company’s misleading picture of financial health inflated its stock price and allowed it to make lucrative acquisitions of other companies and borrow money at lower rates).

12. See Herbert S. Wander, *Current Issues in Corporate Governance and...*
the option, the company receives an infusion of capital through the employee’s payment to the company of the option’s exercise price.\textsuperscript{13}

However, as all investors know, stock prices do not always go up.\textsuperscript{14} When they do not, the value of a company’s stock option plan to its employees is diminished. When the market price for a company’s stock falls below the exercise price of the stock option, the options are often referred to as being “underwater.”\textsuperscript{15} In such a case, the plan becomes less valuable to employees, who must now see an even greater increase in stock price before they can hope to profit from the exercise of their options.\textsuperscript{16}

If the stock option plan is a significant part of an employee’s compensation package, the employee with underwater options may feel that, in the absence of repricing, such options are worthless and that she has lost a significant fringe benefit. Hence, the employee may entertain the prospects of other employment, offering more attractive compensation packages. Additionally, potential employees may not consider the company as offering competitive compensation. Consistent with this, some companies have expressed a fear that without repricing underwater options, they cannot attract and retain high quality employees or management.\textsuperscript{17} This statement might be characterized as

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\textit{Executive Compensation,} ALI-ABA Course of Study: Postgraduate Course in Federal Securities Law, July 24, 1997, at 545, 604, available in Westlaw, SC09 ALI-ABA 545 (“[U]sing stock options makes better use of the Company’s limited resources while offering the promise of higher reward for higher team accomplishment.”).

13. At that point, the company’s stock is actually issued to the employee.


16. For example, assume that one year after the grant of an option with a $10.00 exercise price, the company’s stock is trading at $5.00 per share. Exercising the option by paying the company $10.00 for one share of stock would make no sense for the employee because he would be purchasing stock for twice the price that he could buy it in the open market and accordingly twice the price that he could resell it in the open market. For a recent article on the pervasive decline of options value in the dot-com industry, see \textit{Shawn Tully, The Party’s Over,} \textit{Fortune}, June 26, 2000, at 156, 157 (“Glenn Davis of Next Step Recruiting targets new-economy sales managers whose options have tanked: ‘The first question I ask is, ‘What are your options worth?’ If the answer is nothing, candidates you couldn’t budge six months ago are often anxious to move.’”).

17. \textit{See, e.g.,} General Datacomm Indus., Inc. v. Wisconsin Inv. Bd., 731 A.2d 818, 819 (Del. Ch. 1999) (discussing company claim that, in response to institutional investor’s proposed option repricing bylaw, requiring it to “submit option repricing to stockholders at the next annual meeting or at a special meeting is both cumbersome and untimely and would effectively eliminate the ability to reprice options for employees...
management’s repricing mantra.\textsuperscript{18}

To preserve the value of the stock option plan, companies faced with this “underwater” situation may “reprice” their employees’ stock options or, in other words, lower the exercise price of the options to the stock’s current market price or some price close to it.\textsuperscript{19} Instead of repricing employee stock options, companies may also issue “exchange” or replacement options, whereby the employee trades the company her existing options for options with lower exercise prices. Companies might also cancel or terminate the old options or simply let them expire and issue new ones with lower exercise prices in their place. Companies may choose between these alternatives, in part, because they may be constrained by the terms of the employee stock option plan.\textsuperscript{20}

In any event, the economic problem remains the same, and its resolution has the economic effect of restoring value to underwater employee stock options.\textsuperscript{21} The effect of such an action is to make it once again attractive for an employee to hold stock options.\textsuperscript{22} With lower priced options in hand, the employee has a much greater chance of making money from the exercise of her stock options (assuming the company’s stock price rises above the now reduced exercise price).\textsuperscript{23}

Because a company’s board of directors is authorized to manage the

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\textsuperscript{18} Not all companies agree with this mantra. See Wander, supra note 12, at 604 (discussing stock option plan at Campbell’s prohibits repricing).

\textsuperscript{19} Although private companies may also provide stock option plans, the phenomenon of repricing discussed in this article is principally associated with public companies whose stock trades on exchanges and, therefore, for which there is a fluctuating market price.

\textsuperscript{20} See, e.g., Stemerman v. Ackerman, 184 A.2d 28 (Del. Ch. 1962) (discussing derivative action alleging that stock options granted to certain employees and officers violated terms of company’s stock option plan).

\textsuperscript{21} Unless noted to the contrary, this Article will use the umbrella term “repricing” to refer to any or all of these alternative structures.

\textsuperscript{22} One commentator has expressed the critical view that “[o]ptions are a free ride for management—no cost, no risk on the down side, only wins—and in those cases where the market goes the wrong way, repricing and a new start.” Robert A.G. Monks, \textit{Executive and Director Compensation: 1984 Redux}, ALI-ABA COURSE OF STUDY: CURRENT AND EMERGING ISSUES, Dec. 11, 1997, at 317, 323, available in Westlaw, SC53 ALI-ABA 317.

company's affairs, any repricing decision would generally be made by the board. At first blush, one might assess a board's repricing decision as a reasonable business judgment. Without a cash outlay, the board has salvaged the company's stock option plan and restored the employees' coveted perk. At the same time, a potential exodus of employees has been prevented. Moreover, as the lower exercise price makes it more likely that the option will ultimately be exercised, the company is more likely to receive a capital infusion.

However, as discussed herein, it is not quite that simple. Shareholders do not always share the view that repricing is necessary, or even positive, for a company. This is especially true if those who stand to benefit from the option repricing include directors whom the shareholders perceive to be responsible for the depressed stock price.

This Article analyzes if and when shareholders can attack option repricing, giving special attention to the case of option repricing that benefits directors. In Part II, this Article will discuss shareholders' objections, in general, to option repricing. Part III will discuss the fiduciary duties of directors implicated in the repricing decision. Part IV will then examine the effect of the business judgment rule in insulating directors from liability associated with repricing decisions and other obstacles to those challenging option repricing through litigation. Part V explores whether there is an effective alternative to litigation to deal with the repricing problem, namely, monitoring and lobbying by institutional shareholders.

26. For example, if a stock's current market price is $5.00 per share and the original exercise price is $25.00 per share, it is far more likely that the employee's options will be exercised if the strike price is reduced to $5.00 per share. This is because the chances are greater that the market price will exceed $5.00 than $25.00.
27. See Michelson v. Duncan, 407 A.2d 211, 223 (1979) (accusing board of waste as a result of option repricing). See also Randall S. Thomas & Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans, 35 Wake Forest L. Rev. 31 (2000) (finding shareholders particularly sensitive to effects of dilution with stock option plans and that repricing provisions are significant sources of opposition to such plans).
28. The law of Delaware is primarily examined herein because of the large number of companies that have incorporated under Delaware law and because Delaware is the state with the most developed body of corporate law. See Julie L.Y. Huan, The Director's Duty of Care: A Comparative Analysis of Delaware and Singapore Laws, 12 Colum. J. Asian L. 279, 280 (1998) ("Delaware's prominence as the domicile of large corporations has resulted in its having one of the most developed and litigated corporation laws in the United States."); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1925-26 (1998) (commenting that Delaware is the leader in corporate chartering).
Finally, Part VI concludes that challenges to option repricing raise many of the same issues long associated with all types of executive compensation cases. However, option repricing, especially under the circumstances where directors stand to benefit from it, presents a unique problem. In such a case, the directors may have responsibilities to critically assess both a stock option plan's value and the impact of their own performance on the plan's value—responsibilities that may be at odds with their interests as option-holding shareholders. When directors fail to faithfully discharge these responsibilities, shareholders should be able to reliably resort to derivative litigation for redress.

II. SHAREHOLDER OBJECTIONS TO OPTION REPRICING

While management often claims that option repricing is beneficial to companies, non-employee shareholders frequently complain about repricing. Not considered in the discussion above, the perspective of the long-suffering shareholder may be different from those of directors and employees.

A. The Risk of Ownership

The purpose of stock option plans is often cited as giving employees an ownership interest in the company that they work for in order to more closely align their interests with those of the shareholders. Disgruntled shareholders will assure anyone willing to listen that ownership is not exclusively a bowl of cherries. Non-employee shareholders did not receive the luxury of a "free" option, but instead bought the company's

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30. See, e.g., *In re Cendant Corp. Derivative Action Litig.*, 189 F.R.D. 117, 126 (D.N.J. 1999) (discussing, in a shareholder derivative action alleging breach of fiduciary duty, plaintiff's allegation that option "repricing provided the[] defendants with a benefit in excess of $100 million and caused [the company] to be severely criticized by Wall Street"); Bergmann v. Lee Data Corp., 467 N.W.2d 636, 637 (Minn. Ct. App. 1991) (finding that plaintiff, suing for wrongful termination, also presented a stockholder proposal alleging a breach of fiduciary duty by chairman in recommending option repricing without regard to performance).

stock at the then prevailing market price in the hopes of an upturn. These shareholders have fully beared the risk of a downturn. They may have stuck by a company through positive and negative business cycles, and, at the point of the board’s decision to reprice, may be holding a depressed stock for which the immediate prospects may not be very good. These non-employee shareholders face the tough decision of selling their stock at a certain loss or facing the uncertainty of continuing to hold the stock in the hopes of a recovery.

In contrast, option grantees, some of whom may already be very well, if not excessively, compensated by other means, are spared the dilemma of whether or not to sell their stock. The repricing instantaneously and risklessly resolves the problem of a depressed stock price for them. Ownership traditionally promises the potential for reward, but only in return for the risk of loss. Repricing, however, makes the risk/reward picture asymmetrical in favor of the option grantees, who is certainly along for the ride on the stock’s ascent, but has the benefit of the repricing safety net on the way down. Thus, non-employee shareholders may believe that stock option repricing makes a mockery of true ownership. Such is not, however, the shareholder’s only basis for objecting to option repricing.

32. Moreover, these shareholders, unlike the option holders, do not have the “repricing fairy” to assist them with this problem; their only hope of salvaging this investment is for the market price of the stock to rebound.

33. Neither alternative for the shareholder is attractive. Nevertheless, this is the risk that the shareholder voluntarily assumed at the outset.


   The issue for me is pulling the trigger too soon. Many people have gotten used to very big gains in their options driven by a bull market, and when the market goes down, they think a right of theirs has been taken away. The knee-jerk reaction is, “Let’s fix that right now.”

   Id. See also infra notes 22-23 and accompanying text.

36. As one scholar noted, repricing “allows directors to remove effectively the downside risk of performance pay while maintaining some semblance of a competitive compensation.” Joshua A. Kreinberg, Note, Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive, 45 DUKE L.J. 138, 151 (1995). See also infra notes 22-23 and accompanying text.

B. Shareholder Dilution

Another economic effect on shareholders is that of dilution. Dilution is any situation that reduces a shareholder’s ownership interest (expressed as a percentage of the whole) in a company. Dilution often occurs when an employee exercises a stock option. Upon the option’s exercise, the company issues a share of its stock to the employee and the holdings of all pre-existing shareholders are to some degree diluted. Hence, most employee stock option plans present the threat of dilution.

Option repricing makes the threat of dilution more real. As the market price of the company’s stock is more likely to exceed the exercise price, employees will be more likely to exercise their options. The more likely it is that employees will exercise their options, the more likely it is that shareholders will be harmed by dilution.

C. The Impact on Capitalization

Yet another objectionable aspect of repricing is that it potentially deprives the company of useful capitalization. Every penny by which the exercise price is reduced is one that the company will not receive when the repriced options are exercised. Repricing, therefore, may deprive the company of capital, which could have enhanced the


39. As an illustration, assume a shareholder owns 100 shares of a company that has 1000 shares outstanding. At that point, the shareholder owns 10% of the company. However, if options are exercised causing the corporation to issue another 1000 shares, then the shareholder’s interest has been diluted to 5% (because the shareholder still owns only 100 out of the now increased total of 2000 shares outstanding). If the company thereafter is sold for $1,000,000.00, the shareholder (now owning only 5% of the company) will receive only $50,000, as opposed to the $100,000.00 that he would have received had he continued to own 10% of the corporation.

40. The threat of dilution would not be present if the company were to buy back a corresponding number of shares when options are exercised. Under these circumstances, the dilution resulting from the exercise of the stock options (and the accompanying issuance of stock) would be negated by the buyback. In other words, the total number of outstanding shares in the company would remain constant, as would the shareholder’s relative ownership interest. See also infra note 27 and accompanying text.

41. See Charles M. Yablon, Bonus Questions—Executive Compensation in the Era of Pay for Performance, 75 NOTRE DAME L. REV. 271, 295 (1999) (stating that stockholders are hurt when their shares are diluted by large option grants to CEOs).

42. For instance, if an exercise price is lowered from $10.00 to $7.00, the company will receive $3.00 less per share upon the exercise of the option.
company’s financial condition.\textsuperscript{43} Option repricing may also be interpreted by investors as an insider vote of “no confidence” in the ability of the company’s stock price to recover.\textsuperscript{44} Attitudes such as this may impair a company’s ability to raise capital or borrow funds from outside sources.\textsuperscript{45}

D. Management’s Performance

There are still other reasons why shareholders may resent option repricing. Many of these relate to their perceptions of management’s performance. Shareholders may object to repricing, noting that repricing of stock options “undermine[s] the performance-based nature of stock option awards”\textsuperscript{46} and essentially rewards management for “poor performance of the company’s stock.”\textsuperscript{47} Although the stock price may not precisely measure management’s performance,\textsuperscript{48} shareholders, and accordingly management, often use the company’s stock price as a

\textsuperscript{43} The deprivation is not certain, though, as the market price of the stock must still exceed the new exercise price before the option will be exercised. Nevertheless, assuming that the repriced option is ultimately exercised, the company will receive less money than it would have received under the former, higher exercise price.


Opponents argue that option repricing rewards poor performance, particularly when senior management participates in the repricing. Furthermore, repricings sever the alignment of shareholder and employee interests, as shareholders do not reap the same repricing benefits for their stock. Finally, repricing options, which is disclosed in a company’s financial statements, may signal to the markets that the company lacks confidence its stock price will recover lost value.

\textit{Id.}

\textsuperscript{45} It may be that option repricing is more of a threat to companies with small capitalizations than large established publicly held companies. First, “small caps” are often already undercapitalized and in need of additional funds; hence, the impact of the potential capital forgone by the company due to the repricing may be relatively greater. Also, if these companies have small amounts of stock outstanding, the effects of dilution (upon the exercise of the repriced options) may be more pronounced. Finally, smaller companies usually lack institutional investors and analyst coverage, which otherwise might serve as deterrents to option repricing due to the watchdog function large investors often serve. \textit{See discussion infra notes 221-41 and accompanying text.}


\textsuperscript{47} \textit{Id.}

\textsuperscript{48} See Statutory Stock Options, supra note 6 (“Empirical research shows that over one-half of the variance in a company’s stock price is due to industry factors, stock market trends, and macroeconomic conditions. These conditions cannot be influenced by executive performances.”). \textit{See also Executive “Stock Unit” Retirement Plan Invalid as Bearing No Reasonable Relation to Value of Services Performed, 72 HARV. L. REV. 375, 375-76 (1958-1959) (discussing case invalidating stock plan where court found that factors other than management’s ability influenced company’s stock price).
measure of executive performance. It is not unusual to see a company's officers and directors claim credit for outstanding stock price performance. It is much less common to see such executives assume responsibility for poor stock price performance.

In any event, whatever its short-comings as a performance index may be, market price does measure shareholders’ principal concern about the profitability of their investment. Consequently, shareholders may perceive that the fallen stock price and the attendant “need” for repricing are circumstances created by poor management, not the vagaries of the market. In addition, it is not lost on shareholders that typically the “employees” who benefit the most from repricing are the company’s officers and directors, the same people that shareholders perceive as creating the “need” for repricing.

Shareholders may also take issue with management’s contention that repricing is necessary to attract and retain high quality employees. Where management is already under contract to remain with the company for a fixed term into the future, shareholders may question what the company gains through option repricing. This argument that

49. See Marleen A. O’Connor, Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b), 58 FORDHAM L. REV. 309, 344 n.204 (1989) (“Management’s attention is usually focused on short-term returns that are quickly reflected in the company’s stock prices.”).

50. See, e.g., Zupnick v. Goizueta, 698 A.2d 384, 385 (Del. Ch. 1997) (allowing corporation’s chief executive officer award of 1,000,000 options due to company’s performance under his tenure and dramatic increase in its market value during that time).

51. See, e.g., Marx v. Akers, 666 N.E.2d 1034, 1042-43 (N.Y. 1996) (finding that directors had almost tripled their compensation during a five-year period when company’s performance, measured by earnings and stock price, had been poor). See also Garber v. Lego, 11 F.3d 1197, 1204 (3d Cir. 1993) (discussing large compensation awards granted by directors notwithstanding huge loss suffered by company); In re General Homes Corp., 199 B.R. 148, 152 (S.D. Tex. 1996) (finding that directors of insolvent company sought compensation on par with what solvent companies paid their directors); Biggins v. Garvey, 630 N.E.2d 44, 52 (Ohio Ct. App. 1993) (finding that CEO of company received salary increases while company was in a “dismal” state).

52. While it is often said that one of the primary goals of a public company should be to maximize shareholders’ wealth, not all commentators agree with this view. See, e.g., Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 249 (1999) (“[W]e take issue with both the prevailing principal-agent model of the public corporation and the shareholder wealth maximization goal that underlies it.”).

53. Therefore, these shareholders reject management’s contention that repricing is necessary because management has been “harmed unfairly by adverse market conditions.” Kreinberg, supra note 36, at 151.

54. An analogous argument was unsuccessfully made in Zupnick, 698 A.2d at 386, where a shareholder complained of a large grant of options to company’s chief executive
the company gains nothing from repricing, however, would probably not apply to non-management level employees, most of whom are employees at will. Shareholders may also contend that the company's employees, particularly its executives, remain bound by their fiduciary obligations in the absence of repricing. Thus, the financial benefit of option repricing is not necessary (and hence a wasteful method) to ensure that the employees do what they are already legally obligated to do.

Moreover, shareholders challenging the mantra might question why it would be in the corporation's best interest to make any effort to retain the very executives who appear to be responsible for the current woes of the company and its stock price. In fact, if a refusal to reprice were to trigger management's departure, the sentiment of shareholders might be "good riddance."

To summarize, when a company's stock has sharply declined, shareholders will be cognizant of who benefits from the decision to reprice and who makes the decision to reprice. The very management that shareholders are displeased with often includes employees that will be the direct beneficiaries of the option repricing. Furthermore, it is these same individuals, or those closely associated with them, who frequently make the repricing decision. As one critic of option repricing said, "It is like the captain of the Titanic hitting the iceberg, commandeering a life boat for himself and then giving himself a bonus for having courageously overcome such dire circumstances."

55. One would expect these shareholders to have little sympathy for those claiming that their underwater options are of "no positive motivational use." Kreinberg, supra note 36, at 152-53.

56. Such an argument has had mixed success. See Ash v. Brunswick Corp., 405 F. Supp. 234, 241 (D. Del. 1975) (holding that even absent agreement by employee to remain in employ of company, consideration for option grant may be found where option plan prevents employee from exercising option unless he first renders substantial services to company). But see Frankel v. Donovan, 120 A.2d 311 (Del. Ch. 1956) (finding where no consideration for issuance of options existed at time of grant, subsequent execution of employment contracts by employees came too late to constitute consideration).


58. This quote is attributed to Mark J. Heise, an amateur investor and attorney practicing commercial litigation in Miami, Florida with the law firm of Heise Markarian & Foreman, P.A.
Shareholders may see no exaggeration in this statement.\(^9\)

From this perspective, repricing is nothing more than a windfall to an undeserving and self-dealing employee. If a company’s officers and directors have played a significant role in the drop in the stock price\(^9\) and participated in the decision to reprice and benefited from the repricing scheme, the shareholders’ lament becomes not only a sympathetic one, but one that may be successfully translated into lawsuits alleging breaches of fiduciary duty or waste in connection with the option repricing.\(^6\) Nevertheless, as discussed above, repricing may have legitimate uses and may represent the exercise of reasonable business judgment. Drawing a distinction between these two scenarios requires an understanding of what the law of fiduciary obligation demands of directors making repricing decisions.

### III. FIDUCIARY DUTIES IN THE CONTEXT OF OPTION REPRICING

As with all business decisions made on behalf of a corporation by its directors, decisions regarding option repricing must be evaluated in light of the duties owed to shareholders.

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\(^9\) An expert commenting on the practice of repricing noted this shareholder perspective as the principal "danger" of repricing:

If stock option repricing is not done very carefully and with the full approval of major shareholders, the company’s actions can backfire through shareholder discontent. Shareholders in the company may grow angry that they are forced to take the brunt of the falling stock price, while certain option holders lose little value and are relatively untouched by a sliding stock price. If the company is publicly traded, it may find out quicker than expected that shareholders without options don’t approve of the repricing scheme. Repricing options is often viewed as counterproductive to the intended purpose of equity compensation—using the option grants to tie employees [sic] interest to corporate performance. In addition, if a company reprices options too regularly, it may be perceived by employees who own stock options that they do not need to care much about the overall stock price, because their vested value in options will be relatively safe either way. When option repricing becomes common, employees win when the stock goes up, and when the stock price falls. The purpose of an option should be a motivation in good times and a motivation to improve in bad times.


\(^6\) Such things as mismanagement or intentional wrongdoing contribute to declining stock prices.

\(^6\) One might argue that by buying stock in a company, shareholders assume the risk of both mismanagement and option repricing. While that may be so, it cannot be said that the corporation assumes the risk of conflicted or grossly negligent decision-making by a company’s board of directors and, therefore, should not be able to recover for breaches of fiduciary duty.
of these agents’ fiduciary responsibilities to the corporation. In a general sense, corporate fiduciary duties break down into two general categories: the duty of care and the duty of loyalty.

The duty of care essentially requires a company’s directors to exercise the same level of care as ordinarily prudent persons in like positions would exercise under similar circumstances. The issue of whether directors have met their duty of care generally turns on whether they acted in an informed manner, without gross negligence and without committing a waste of corporate assets. In a similar fashion, the duty of loyalty requires directors to act with an undivided, unselfish loyalty to the corporation. The issue of whether directors have met their duty of loyalty generally focuses on whether such agents, in carrying out their responsibilities, refrained from self-dealing and placed the interests of

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62. This discussion assumes that the plaintiff bringing a claim to challenge option repricing does not face any ethical quandaries regarding frivolous claims or assertions. In other words, the assumption is that the facts support the allegations discussed. While the following discussion speaks of two potential claims (i.e., breach of fiduciary duty of care and breach of fiduciary duty of loyalty), it may be that in any given scenario none, one, both, or perhaps more might legitimately be asserted.

Any legal analysis of directors’ breach of fiduciary duty regarding a business decision in which they participated requires that consideration be given to the business judgment rule. This section of the Article will address the former, and the following section the latter.

63. See Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984). Common law also provides that a director has a fiduciary duty of disclosure to shareholders. See Arnold v. Society for Sav. Bancorp, Inc., 678 A.2d 533, 537 (Del. 1996). When the board of directors seeks shareholders’ approval or other action, this duty of disclosure requires directors to fully and fairly disclose “all material information within the board’s control.” Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992). See also infra notes 71, 166-70 and accompanying text.

64. See MODEL BUS. CORP. ACT § 8.30(a)(2) (1985) (“A director shall discharge his duties as a director . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances . . . .”); MODEL BUS. CORP. ACT § 8.30(b) (1998) (stating that a director “shall discharge [his] duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.”). See also Orlett v. Cincinnati Microwave, Inc., 953 F.2d 224, 229 (6th Cir. 1990); Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1982).


66. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that, prior to making business decisions, directors must inform themselves of “all material information reasonably available to them”), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).


68. See Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (“[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.”).

the corporation ahead of their own.\textsuperscript{70}

Both the duty of care and the duty of loyalty make demands on directors in the context of option repricing. Before one can establish whether directors should be entitled to protection for the decisions that they make in repricing options, it is necessary to understand these demands in the relevant context.\textsuperscript{71}

In considering the following discussions of the duty of care and duty of loyalty in the repricing context, it is important to remember that a plaintiff may demonstrate a breach of the duty of care (procedural or substantive), irrespective of whether the directors who made the repricing decision benefited from it. To demonstrate a breach of the duty of loyalty, however, the plaintiff will have to demonstrate that the directors who made the decision to reprice either benefited from it, or were dominated or controlled by (or not independent of) those who did benefit.\textsuperscript{72}

\textbf{A. The Procedural Duty of Care}

In the famous (or infamous) case of \textit{Smith v. Van Gorkom},\textsuperscript{73} the Delaware Supreme Court expounded on the directors' fiduciary duty, commonly referred to as the procedural duty of care.\textsuperscript{74} While the

\begin{itemize}
\item \textsuperscript{70} See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
\item \textsuperscript{71} In addition to the directors' fiduciary obligations under common law, directors must also concern themselves with the disclosure obligations imposed by the federal securities laws. See generally Patrick J. Straka, Comment, Executive Compensation Disclosure: The SEC's Attempt to Facilitate Market Forces, 72 Neb. L. Rev. 803 (1993).
\item \textsuperscript{72} See, e.g., Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997) (stating that use of independent directors to evaluate sale proposal of part interest in corporation controlled by individual shareholder to second corporation controlled by same shareholder did not shift burden of proof on fairness issue from defendants to plaintiff because board was not diligent and its most active member had ties to the controlling shareholder); Rales v. Blasband, 634 A.2d 927, 936-37 (Del. 1993) (discussing, in context of alleging demand futility, complaint alleged that director dominated and controlled other board members and company's officers); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
\item \textsuperscript{73} 488 A.2d 858 (Del. 1985).
\item \textsuperscript{74} Commentators have discussed the \textit{Van Gorkom} case extensively. See generally, e.g., Leo Herzel & Leo Katz, \textit{Smith v. Van Gorkom: The Business of Judging Business Judgment}, 41 Bus. Law. 1187 (1985); Bayless Manning, \textit{Reflections and Practical Tips on Life in the Boardroom After Van Gorkom}, 41 Bus. Law. 1 (1985) (suggesting, among other things, that directors take their time and fully inform themselves of all material details prior to making corporate decisions); Stephen A.
backdrop for this case was merger negotiations, its lessons nonetheless inform all director decision-making, including those in the context of option repricing. The basic lesson of Van Gorkom is that directors face liability for breach of the procedural duty of care if they are grossly negligent in failing to adequately inform themselves regarding a decision before them. In Van Gorkom, this meant, among other things, that the directors were required to investigate and question valuations of the company. For the present purpose, the question is what the meaning of Van Gorkom is in the context of option repricing decisions.

Experts suggest a laundry list of items that directors should consider in making repricing decisions. For instance, one consultant suggests that companies should not necessarily have the same policy for executives as for other employees. In the case of the latter, the need for repricing may be more pressing because the options represent a significant component of their basic pay. In the executives’ case, however, options “are explicitly awarded as incentives to help grow shareholder wealth.” Therefore, directors may appropriately exclude executives’ options from repricing.

Additionally, this expert suggests that directors must contemplate the effects of the repricing. Here, he is critical of the repricing mantra, stating that it would be useful to have outside experts assess whether, without repricing, valued employees will really leave. Directors should
also consider what impact the repricing may have (if any) upon the company’s financial statements or tax position.\textsuperscript{84} Thus, “any decision to reprice... should be discussed with tax... and audit advisors.”\textsuperscript{85}

Moreover, directors should take into account what consideration, services, or other value the corporation is getting or will get in return for the act of repricing. “For instance, option holders might be asked to give back some of the shares they currently hold, restart vesting, face blackout periods when they cannot exercise the new options, or some combination of all three.”\textsuperscript{86}

Furthermore, directors should also be aware of what the stock option plan provides with respect to option repricing. Legal counsel should be called upon to answer such questions as whether the plan permits repricing and, if so, whether the directors are authorized to undertake such action without the approval of the shareholders. In connection with repricing, it is not uncommon for derivative plaintiffs\textsuperscript{87} to contest the directors’ authority to act as they did, or to assert that the directors acted in contravention of the stock option plan.\textsuperscript{88} Related to this, directors must consider the structure of the repricing. It might be in a myriad of forms, from simply resetting the option price to the current market value,

\begin{footnotesize}

\textsuperscript{85} Hewitt Newsstand, supra note 15.

\textsuperscript{86} Rosen, supra note 78. Vesting is a “right an employee gradually acquires by length of service at a company to receive employer-contributed benefits.” See BARRON’S, supra note 2, at 675-76.

\textsuperscript{87} Derivative actions permit a company’s shareholder to sue wrongdoers on behalf of the company where the company has failed to, or to assert that the directors acted in contravention of the stock option plan.\textsuperscript{88} Related to this, directors must consider the structure of the repricing. It might be in a myriad of forms, from simply resetting the option price to the current market value,

\begin{footnotesize}
\textsuperscript{88} See, e.g., Cohen v. Ayers, 596 F.2d 733, 741 (7th Cir. 1979) (finding that plaintiff failed to create any issue of material fact concerning board’s authority to terminate certain options and issue others at a lower price and concerning disclosure of this transaction in proxy statement, placing burden on plaintiff to show waste, and holding that plaintiff could not carry that burden); Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979) (claiming that board lacked authority to permit options to be exchanged for those with lower exercise price).
\end{footnotesize}
to extending the exercise period, or to issuing new lower priced options.\textsuperscript{89}

Finally, another expert recommends that a long-term perspective is the correct one in repricing decisions.\textsuperscript{90} In other words, directors should not rush to reprice options at the first sign that the company's stock price is in trouble. Repricing should not be undertaken to address something as transitory as a temporary market decline.\textsuperscript{91}

While the law of fiduciary duty has typically resisted requiring, as a matter of law, any particular course of conduct,\textsuperscript{92} the above provides a guide to directors seeking to comply with their procedural duty of care. To successfully challenge whether this duty has been met, a plaintiff must establish that the directors departed in a grossly negligent manner from the road map described above.\textsuperscript{93} Thus, the plaintiff would have to demonstrate that, prior to making the option repricing decision, the directors failed to adequately inform themselves as to all material issues raised by the repricing decision, including such things as the effect of the repricing, or available alternatives to repricing.\textsuperscript{94}

Such a plaintiff must also brace for the directors' defense. The directors are likely to respond that both the amount of attention to be given to a matter and what information to consider in connection therewith are, in and of themselves, matters of business judgment and

\textsuperscript{89} While all of these may not technically be considered repricing, they have the same economic effect. See supra notes 19-20.

\textsuperscript{90} See Despite Ongoing Market Volatility, Most Companies are Resisting Stock Option Repricing, Towers Perrin Study Finds (visited December 14, 1998) <http://www.towers.com/towers/news/pr981214.html>. In the same release making these recommendations, it is reported that, following the market downturn in the Fall of 1998, 85\% of the respondents to a survey of 148 mid-sized to large companies, nearly all with underwater options, nonetheless stated that they were not considering any repricing. See id. Paula Todd, a principal and a senior consultant on executive compensation who believes that repricing should be the exception rather than the rule, stated:

The fact that so many companies are holding their ground in this volatile environment suggests a real commitment to preserving the intent of stock option programs, especially in terms of building both risk and reward into the equation... This also shows clearly in the main reason that respondents gave for avoiding repricing [namely, that it undermines the purpose of long-term incentives].

\textit{Id.}

\textsuperscript{91} Additionally, "[r]repricings are more appropriate for lower-level managers and employees than for top executives, who generally have more direct influence on stock price movement and should be held accountable for bad decisions by losing the opportunity for option gains." Id. Towers Perrin recommends that the recipients of repriced options be required to make some sacrifice. See id.

\textsuperscript{92} See Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985) (holding that an independent valuation study or fairness opinion is not always required as a matter of law).

\textsuperscript{93} See supra notes 73-91 and accompanying text.

\textsuperscript{94} See Van Gorkom, 488 A.2d at 876.
that the consideration they received was "adequate." Another related argument taken from the dissent in Van Gorkom would be that the business acumen and experience possessed by the directors inherently supplemented whatever other consideration was given to the matter.

In trying to prove a breach of the procedural duty of care, a plaintiff in an option repricing case may take comfort in Van Gorkom. Nevertheless, the plaintiff must be cognizant of the fact that Van Gorkom is one of the few cases in which plaintiffs have established such a breach. Additionally, it may be difficult to establish such a breach because the basic lesson of Van Gorkom probably has not been lost on most directors.

B. The Substantive Duty of Due Care

A director’s fiduciary duty of care has another component, sometimes referred to as the duty of substantive due care. This responsibility is said by some to be related to, or one in the same as, the responsibility of directors to refrain from committing waste of the corporation's assets.

The doctrines of waste, gift, and ultra vires are closely related to the doctrine of substantive due care. They rest on a judgment that a substantive decision could not have been the product of prudent and good faith decision-making. Which set of doctrines is used will depend on whether an action seeks damages against the directors for approving a conflicting interest transaction, or instead seeks to rescind the transaction itself.

Id. See also John F. Olson et al., The Board Compensation Committee Report on
Here, the analysis focuses on whether the corporation has received adequate consideration in any given transaction. The various formulations of this responsibility are quite deferential to directors.*

Generally speaking, waste will be found only where the consideration received by the company is "so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid." One might also describe waste as arising when the directors have put the corporation in a "no-win" situation. However, risky decisions, or even those obviously improvident with the benefit of hindsight, rarely rise to the level of waste.

In the context of option repricing, a plaintiff trying to demonstrate the directors' breach of their substantive duty of due care, for authorizing the repricing, would have to prove that the company essentially received no, or grossly inadequate, consideration in exchange for the repricing. However, Delaware courts, the most influential in the area of corporate law, have little difficulty finding adequate consideration flowing back to the corporation in connection with an options transaction.

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**Executive Compensation: The Effect on the State Law, Fiduciary Duties of Directors, in PRACTICING LAW INSTITUTE, EXECUTIVE COMPENSATION REPORTING 1993: LIVING WITH THE NEW RULES 305-18 (1993).**

100. See, e.g., Steiner v. Meyerson, No. CIV.A.13139, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995). In Steiner, the court stated that, to prove waste, plaintiffs must show that defendants:

approved a transaction exchanging something of value for consideration so inadequate that "no person of ordinary, sound business judgment would deem it worth what the corporation has paid." If under the circumstances any reasonable person might conclude that the deal made sense, then the judicial inquiry ends. This is obviously an extreme test, very rarely satisfied by a shareholder plaintiff.

101. See, e.g., Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962). Some cases and commentators draw a distinction between the doctrines of gift and waste. See, e.g., Aronoff v. Albanese, 446 N.Y.S.2d 368, 370 (N.Y. App. Div. 1982) ("The essence of a claim of gift is lack of consideration and the essence of waste is the diversion of corporate assets for improper or unnecessary purposes."). Often, in litigation, however, the distinction is not carefully drawn. This is probably because the distinction is rarely, if ever, outcome determinative. The doctrines are closely related and the legal analysis of such claims is similar, if not the same. This Article often uses the term "waste" and in doing so intends that term to encompass both doctrines where appropriate.


104. See supra note 28.

105. See, e.g., Beard v. Elster, 160 A.2d 731, 736, 738-39 (Del. 1960) (holding that, in a case alleging that stock option plan constituted invalid gifts of corporate assets, "there must be some reasonable assurance in the plan, or the circumstances of the particular case, which can reasonably be expected to make the corporation receive the
agreeing with the notion that companies must reasonably expect to receive a benefit from the issuance of stock options$^{106}$ and that there must be a reasonable relationship between the value of the options and the benefit to the corporation, the Supreme Court of Delaware has stated that the benefits to a corporation in connection with the issuance of stock options may be "ephemeral and not susceptible of identification and valuation in dollar terms."$^{107}$ As a result, stock options may properly be issued to induce key personnel to continue employment, or to expend greater effort on behalf of the corporation.$^{108}$ Such judicial deference suggests that successful waste cases in the repricing context will be rare.

Likewise, pure duty of care cases (i.e., those lacking allegations of conflict of interest), whether they be substantive or procedural, are few and those imposing liability are even fewer.$^{109}$ Hence, a plaintiff with nothing other than an alleged breach of the duty of care is unlikely to prevail. Allegations that directors breached their duty of loyalty may offer more hope for plaintiffs.

C. The Duty of Loyalty

The duty of loyalty generally provides that when a director makes decisions on behalf of the corporation, "the best interest of the contemplated benefit," but that where reasonable, informed, and disinterested businessmen might differ on such point, the court should not substitute its judgment). $^{106}$ See Stein v. Orloff, No. 7276, 1985 WL 11561, at *4-5 (Del. Ch. May 30, 1985) (holding that, although other allegations were insufficient to excuse demand, complaint created a reasonable doubt that certain stock option repricing was done without consideration and, hence, constituted a waste of corporate assets); Frankel v. Donovan, 120 A.2d 311, 316 (Del. Ch. 1956) (finding that where no consideration for issuance of options existed at time of grant, subsequent execution of employment contracts by employees came too late to constitute consideration).

$^{107}$ Pogostin v. Rice, 480 A.2d 619, 625-26 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244, 253-54 (Del. 2000).

$^{108}$ See id.

$^{109}$ See Deborah A. DeMott, Directors' Duties in Management Buyouts and Leveraged Recapitalizations, 49 OHIO ST. L.J. 517, 544 (1988) (noting Van Gorkom is one of few cases holding directors liable for breaching duty of care); Dale A. Oesterle, The Effect of Statutes Limiting Directors' Due Care Liability on Hostile Takeover Defenses, 24 WAKE FOREST L. REV. 31, 40 (1989) ("Until the early eighties, one could find very few cases in which directors were held liable in damages for a breach of a duty of care uncomplicated by self-dealing.").
corporation and its shareholders takes precedence over any interest possessed by a director." In other words, directors must act without the hindrance of conflict or divided loyalties so that they are free to objectively assess what is in the best interests of the corporation.

The duty of loyalty naturally applies to directors in connection with the repricing of stock options. Generally, this duty presents little difficulty in cases where the repricing does not concern options held by the board members, senior executives, or others close to them. In these instances, no conflict of interest or opportunity for self-dealing is usually present, leaving the plaintiff with whatever case he can make alleging a breach of the duty of care. When repricing does concern directors’ options, however, breaches of the duty of loyalty are a realistic possibility, as they are in many cases involving executive compensation.

The specter of conflict is in the backdrop of all decisions regarding executive compensation. In the simplest case, it is easy to see the conflict issue where, for example, all members of the board are “inside” directors and executive employees of the corporation. In any decision by the board to set their own pay, the directors are conflicted because they stand on both sides of the transactions. On one hand, they are duty bound to subordinate their self-interests to further those of the corporation, which would like to obtain the executives’ services at the lowest cost. On the other hand, consistent with their self-interests, these directors would like to receive the highest pay possible for their services. The interests of the directors and the corporation are, hence, drawn into direct conflict.

112. An obvious example of a board of directors’ breach of their duty of loyalty would be if they decided to reprice options not because the repricing was in the best interests of the corporation, but because the value of their own stock options had fallen.
113. In the course of this discussion, this Article may refer only to directors in this regard. This does not mean that the analysis herein cannot or should not be extended to the options of other officers, senior executives, or employees where the relationships and circumstances among the decision makers and the beneficiaries in the repricing suggest conflict of interest, lack of independence, or self-dealing.
115. Executive compensation is generally set by a company’s board of directors, who are authorized to manage the company’s business affairs. See Del. Code Ann. tit. 8, § 141(a) (1991). See also supra notes 24-25 and accompanying text.
116. This would not occur in a company traded on the New York Stock Exchange, as any such company must have at least two “outside” directors (i.e., directors that are not employees of the company). See New York Stock Exch., New York Stock Exchange Listed Company Manual ¶ 303.00-303.01 (Supp. 13, 1999).
Consistent with the above, a plaintiff complaining of management's option repricing would attempt to characterize what transpired as an act of self-dealing on the part of the directors who made the repricing decision. The plaintiff would have to, at a minimum, establish that the decision makers (the board or a committee appointed by the board) were either suffering from a disabling conflict of interest, or were otherwise not independent.

For example, assume a board consists of three members, all of whom, in addition to being directors, are key employees of the corporation. Moreover, all have received stock options pursuant to an employee stock option plan. Assume further that the company's stock price has collapsed and the board has elected to reprice all of the employee stock options, including their own. These facts provide the basis for allegations concerning conflict of interest but, despite this, the directors may still be able to establish that the repricing was fair to the corporation.

Plaintiff's case would undoubtedly be stronger if management's blunders brought about the drop in the company's stock price. If

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117. Of course, this argument would not be available if the executives did not have their own options repriced. See Peter C. Clapman, Current Major Initiatives of TIAA-CREF's Corporate Governance Program, ALI-ABA COURSE OF STUDY: CORPORATE GOVERNANCE: CURRENT AND EMERGING ISSUES, Nov. 12, 1998, at 79, 97-98, 103, available in Westlaw, SD39 ALI-ABA 79.

118. See, e.g., Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988) (holding that plaintiffs failed to establish directors' lack of independence where plaintiffs did not allege that the company's "directors were dominated or otherwise controlled by an individual or entity interested in the transaction"). See also supra note 72 and accompanying text.

119. It is not uncommon for members of the corporation's board of directors to have received stock options. This is especially true of "inside" directors who, in addition to being members of the board of directors, are also key officers or employees of the corporation.

120. In nearly every conceivable case, a board would probably reprice all the employee stock options in a plan or given class of grantees, as opposed to choosing to reprice only the board members' own stock options. To do the latter would seem to be an obvious example of self-dealing because the board of directors would be granting to themselves a benefit in the form of the repricing that is not afforded to others similarly situated in the corporation. Indeed, if a legitimate reason for the repricing existed, it would presumably extend to other participants in the plan.

121. See, e.g., Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58 (Del. 1952) ("[W]here the board members vote themselves stock options and do not obtain stockholder ratification, they themselves have assumed the burden of clearly proving their utmost good faith and the most scrupulous inherent fairness of the bargain.").

122. This fact may also bolster the argument of plaintiffs who claim there was no consideration provided to the corporation in exchange for the repricing. See infra notes...
management is responsible for the drop in stock price, then repricing gives directors a benefit that is disproportionate to that received by other non-director employees. The other employees presumably performed their jobs competently and, despite their efforts, still suffered the loss in the value of their options. Thus, arguably the repricing equitably restores these employees to their previous position.

The mismanaging directors, however, receive not only this benefit of restoration, but also the implicit pardon of their failures to competently perform. The directors in such a situation have bestowed on themselves greater benefit than that received by other grantees. This self-granted “financial pardon,” therefore, is an element of self-dealing. Here, proving fairness may be difficult for the directors, who may not have a satisfactory explanation as to why they did not reprice only the others’ options and refrain from repricing their own. If it is found to be unfair, the transaction may be voidable in accordance with the common law.

Directors must make option repricing, like any other decision, mindful of their fiduciary responsibilities. However, the business judgment rule and other formidable obstacles will still stand in the way of any prospective derivative plaintiff’s attempt to establish director liability. These issues are discussed in the following section.

IV. OBSTACLES TO THE PLAINTIFF’S CASE

A. The Business Judgment Rule

The business judgment rule, the standard of review that a court employs in assessing director conduct, is a rebuttable presumption that

183-201 and accompanying text.
123. See Lewis v. Austen, No. C.A.12937, 1999 WL 378125, at *3, *6-8 (Del. Ch. June 2, 1999) (noting that complaint did not allege that certain features of an option plan conferred a benefit on directors that was not shared equally by other option holders).
124. This is so because they have put their own interests ahead of the corporation and other shareholders generally by rewarding their mismanagement with a gift of repriced options.
125. See infra notes 159-61 and accompanying text.
126. These scenarios implicitly assume that the directors, by virtue of their grossly negligent or conflicted conduct, have been stripped of the protections of the business judgment rule. In Part IV, this Article focuses on why such scenarios may or may not leave a board of directors without business judgment rule protection; it will do so from the perspective of a plaintiff seeking to maintain a stockholder derivative action.
127. Some commentators have expressed the view that derivative actions provide little, if any, benefit to companies. See Roberta Romano, The Shareholder Suit: Litigation without Foundation?, 7 J.L. ECON. & ORG. 55, 84 (1991) (arguing that settlements in derivative actions generally provide minimal compensation and that primary beneficiaries appear to be lawyers).
corporate business decisions are made in good faith by disinterested and independent directors who honestly believe that their decision is in the best interests of the corporation they serve. The business judgment rule is perhaps the most formidable obstacle facing any derivative plaintiff.

One treatise on the subject offers five rationales for such a rule: (1) to encourage competent managers to serve as directors; (2) to encourage directors to take business risks; (3) to recognize that directors are better equipped to make business decisions than courts; (4) to reinforce the structure that directors, not shareholders, manage the corporation; and (5) to acknowledge that shareholders' disappointment in management should be principally addressed by replacing management. Whatever the rationale, the practical effect of the business judgment rule is a considerable amount of judicial deference to the decisions of boards of directors.

The burden falls upon the plaintiff to rebut the business judgment rule's presumption by alleging facts or introducing evidence of such things as director fraud, self-interest, self-dealing, lack of good faith, or failure to exercise due care. This is no small feat. In Delaware, for example, a derivative plaintiff hoping to survive a motion to dismiss

129. See id. at 4-5; see also Kahn v. Sullivan, 594 A.2d 48, 59 (Del. 1991); Polk v. Good, 507 A.2d 531, 536 (Del. 1986); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). “The business judgment rule may apply to a deliberate decision not to act, but it has no bearing on a claim that directors' inaction was the result of ignorance.” Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 972 (Del. Ch. 1986).

130. See id. at 12-18.

131. See id. at 21-22.


134. The Second Circuit Court of Appeals has held that a plaintiff seeking to overcome the presumption afforded by the business judgment rule has a “heavy burden” of pleading and proving facts to overcome the presumption. See Lewis v. S.L. & E., Inc., 629 F.2d 764, 768-69 (2d Cir. 1980). See also Robert C. Sheehan et al., Mergers and Acquisitions of Thrifts, PRACTISING LAW INSTITUTE COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES: THE THRIFT INDUSTRY IN 1985, Nov. 1, 1985, at 638, available in Westlaw 370 PLI/COMM. 593 (“The business judgment rule presumes that directors have acted in good faith absent a showing of fraud, self-dealing or bad faith, and a heavy burden of proof must be met to overcome the presumption.”).

135. A detailed discussion of the procedural standards and hurdles involved in derivative actions is beyond the scope of this article. For such discussion, see Ferrell, supra note 98. See also BLOCK ET AL., supra note 128, Chapter IV.
must allege particularized facts that raise a reasonable doubt that a majority of the directors are disinterested and independent, or that the challenged decision was otherwise protected by the business judgment rule. If the derivative plaintiff follows the general rule and does not go the “demand futility” route, then he must make demand on the board of directors to take corrective action. The demand requirement “exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits.” If the board makes a decision not to his liking (i.e., not to pursue the complaint), the plaintiff is left in the position of bringing a wrongful refusal suit, wherein he must allege facts that overcome the business judgment rule, not with respect to circumstances about which he originally complained, but with respect to the decision to decline to pursue the matter further. This “procedure” under Delaware law makes it difficult for a derivative plaintiff who cannot successfully allege facts supporting a finding of demand futility to obtain judicial review of the substance of his complaint.

The case law presents the problem of option repricing as a subset of cases concerning executive compensation, which have been analyzed under the traditional business judgment rule paradigm. Perhaps

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137. See Aronson v. Lewis, 473 A.2d 805, 814-15 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). This discussion presumes that a plaintiff is alleging demand futility, which is certainly no easy task. In Delaware, a plaintiff is required to make demand on a corporation's board of directors to redress his complaint before he resorts to litigation. See Del. Ch. Rule 23.1 (2000). The exception to this is when the plaintiff can establish that demand is excused or futile because the board would not fairly consider it. See id.; see also Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1169 (Del. 1995) (“To be disqualifying, the nature of the director interest must be substantial.”); Noerr v. Greenwood, No. CIV.A.14320, 1997 WL 419633, at *1, *9-10 (Del. Ch. July 15, 1997) (holding that, in the context of a motion to dismiss, plaintiff successfully alleged demand futility with respect to defendants' alleged breach of their duty of loyalty with respect to two integrated option pricing transactions); Byrne v. Lord, No. CIV.A.14040, 1995 WL 684868, at *4, *10 (Del. Ch. Nov. 9, 1995) (holding that plaintiff successfully alleged demand futility by alleging that every board member had a financial interest in option plan that was invalid as a matter of law).


option-repricing cases trigger slightly more judicial scrutiny than other compensation cases, but it certainly cannot be said that directors making repricing decisions do not enjoy the presumption of the business judgment rule.\footnote{41}

While cases concerning director decision making, breach of fiduciary duty and the business judgment rule are abundant, there are only a few cases framing these issues in the context of option repricing.\footnote{42} The relative paucity of reported decisions may be some indication of the difficulty of maintaining such an action. One good example, however, is \textit{Michelson v. Duncan}.\footnote{43} In this case, a stockholder brought a derivative action challenging the grant of stock options by the defendant officers and directors to certain key employees, including themselves.\footnote{44} Specifically, the plaintiff complained about actions taken by the defendants to modify an existing stock option plan.\footnote{45} One of these actions was the cancellation of existing options and the issuance of replacement or exchange options, the exercise price of which was substantially below

\begin{quote}
\begin{itemize}
\item To qualify for the protection of the business judgment rule, Delaware courts require a stock option plan or grant for existing employees to satisfy the following three-part test in addition to the duties of care and loyalty required under a traditional business judgment rule analysis:
\begin{itemize}
\item an identifiable (but not necessarily tangible) benefit must flow to the corporation;
\item the value of the options must be reasonably related to the anticipated benefit to the corporation; and
\item the terms or circumstances of the option grant must be such that the corporation can reasonably expect to receive the intended benefit.
\end{itemize}
\end{itemize}
\end{quote}

\textit{Id. See also MODEL BUS. CORP. ACT § 8.31 (1998) (distinguishing between standards of conduct for directors in § 8.30 and standards of liability for directors in § 8.31).}

\footnote{141. See O’KELLEY & THOMPSON, supra note 99, at 450 (“Judicial interference with corporate compensation is relatively rare. Cash compensation that is not deferred or contingent presents the easiest case. Courts look a bit more carefully at percentage compensation plans and stock options, but the hurdle to obtain judicial intervention is fairly high.”). See also Haber v. Bell, 465 A.2d 353, 359 (Del. Ch. 1983) (“[G]enerally directors have the sole authority to determine compensation levels and this determination is protected by the presumption of the business judgment rule in the absence of a showing that the business judgment rule does not apply because of a disabling factor.”).}

\footnote{142. See, e.g., Cohen v. Ayers, 596 F.2d 733 (7th Cir. 1979) (upholding option repricing approved by interested directors where shareholders ratified repricing and plaintiff failed to carry burden of proving waste); Halpern v. Armstrong, 491 F. Supp. 365 (S.D.N.Y. 1980) (repricing disallowed in dispute over whether shareholder approval of amendment to option plan was properly obtained); Goldsholl v. Shapiro, 417 F. Supp. 1291 (S.D.N.Y. 1976) (repricing disallowed where repricing approved by interested directors without shareholder ratification).}

\footnote{143. 407 A.2d 211 (Del. 1979).}

\footnote{144. See id. at 214-15.}

\footnote{145. See id. at 214.}
that of the old options. The ostensible purpose of this modification was predictably to “restore [the] incentive to exercise the options” that was lost “following a dramatic decline in the market price” of the company’s stock.

The plaintiff attacked the issuance of the exchange options, claiming that the board lacked authority to issue the exchange options and that the exchange options constituted a waste or gift of corporate assets. Plaintiff’s waste allegations accused the board of lowering the options’ exercise prices, accelerating their exercise rates, and granting new options “with no parity of services rendered to [the] value of [the] options granted.” The court considered these arguments in the context of cross-motions for summary judgment.

With respect to the first argument of lack of authority, the court found that a non-unanimous shareholder ratification of the amended plan had occurred that cured any problem of lack of board authority. However, plaintiff’s other argument fared better. The Michelson court concluded that the plaintiff had sufficiently alleged a claim that the exchange options constituted a waste or gift of corporate assets and that there was sufficient evidence in the record to raise a triable issue of fact with respect to that claim.

If nothing else, this case demonstrates that option repricing may fit rather neatly within the conventional lexicon concerning challenges to director action. Not all those opposed to option repricing, however, have had such success.

With respect to the second point, a significant portion of the court’s opinion is devoted to concluding that the plaintiff did allege a gift or waste of corporate assets, did not waive such claim, and created a material issue of fact with respect to it. Having lost on the authority point, without a claim of gift or waste, the plaintiff would not have been able to successfully defend defendants’ motion for summary judgment.

Moreover, in general, a substantial number of the

146. See id. at 215.
147. Id.
148. See id. With respect to the second point, a significant portion of the court’s opinion is devoted to concluding that the plaintiff did allege a gift or waste of corporate assets, did not waive such claim, and created a material issue of fact with respect to it. Having lost on the authority point, without a claim of gift or waste, the plaintiff would not have been able to successfully defend defendants’ motion for summary judgment. See id. at 216-23.
149. Id. at 223. The acceleration of exercise rates referred to the fact that the original plan provided that options could be exercised at a maximum rate of 10% per year and the amended plan increased this limit to 33.3%. See id. at 215.
150. See id. at 215-16.
151. See id. at 219-20. Presumably, this shareholder ratification also “cleansed” the transaction of any taint of conflict of interest. See infra notes 158-74 and accompanying text. However, only unanimous shareholder approval can sanitize a waste transaction. See O’KELLEY & THOMPSON, supra note 99, at 439.
152. See Michelson, 407 A.2d at 223.
153. See, e.g., Criden v. Steinberg, No. 17082, 2000 WL 354390, at *1 (Del. Ch. Mar. 23, 2000) (granting motion to dismiss where defendants failed to allege waste or breach of fiduciary duty in context of option repricing); Hoffman v. Dann, 205 A.2d 343 (Del. 1964). In Hoffman, a court was approving the settlement of a stockholder derivative action and an objecting stockholder believed that a claim of improper option repricing was meritorious and had the probability of substantial recovery. See id. at 349.
cases concerning stock options have been terminated in favor of the defendants at early stages in the litigation. Indeed, assuming that the ultimate decision-makers are independent and the decision is made by them with the requisite care in accordance with the plan, and also assuming that the corporation receives adequate consideration for the option repricing, then the decision is virtually unassailable because of the business judgment rule.

The business judgment rule is not, however, the only thing that stands in a plaintiff's way. In fact, certain statutory provisions also reinforce the protections of the business judgment rule. For example, as discussed above, a plaintiff may attempt to rebut the business judgment rule by alleging that the directors were conflicted in their decision-making. Upon first consideration, one might think this provides a plaintiff with considerable opportunity to rebut the business judgment rule in the context of option repricing that benefits directors. This is not the case, however, primarily due to the effect of statutes like Delaware

In concluding that this cause of action had no merit, the court opined:

The argument of [the objector] seems to be that a corporation should not permit the cancellation of old options and the issuance of new stock options at lower prices since that, in effect, excuses poor performance by management. Certain magazine and Law Review articles are cited to this effect and, indeed, we may assume that, as an ordinary business practice, such action is undesirable. This does not alter the fact, however, that under the law of this State a Stock Option Plan may not be successfully attacked when the options are granted by a disinterested committee with the approval of the directors and stockholders, and where the optionee is required to remain in the employ of the corporation. The new Option Plan meets these tests.

Id. (citation omitted).


155. See supra notes 101-08 and accompanying text.

156. The same can be said for all conflicting interest transactions, including those involving executive compensation, where the conflict is cleansed. See infra notes 158-74 and accompanying text.

B. Delaware's Section 144

At common law, the participation, or even presence, of conflicted directors provided a basis for voiding a transaction. In a modern corporate environment, however, the common law rule threatened to disrupt an unacceptably high number of corporate decisions. As a result, many jurisdictions have enacted statutes reversing the common law rule under certain circumstances. These statutes provide a mechanism for cleansing these transactions by a vote of disinterested directors or shareholders. These statutes also permit the board of

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159. See Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) (observing that under common law, stockholders had the “power to nullify an interested [director] transaction”). See also R. Franklin Balotti & James J. Hanks, Jr., Giving at the Office: A Reappraisal of Charitable Contributions by Corporations, 54 Bus. Law. 965, 983 (1999) (“At common law, transactions between a corporation and a director (or between a corporation and another entity in which the director had a significant personal interest) were originally void per se and, later, voidable.”); Melvin Aron Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham L. Rev. 437, 454 (1993) (at common law, “self-interested transactions [were] voidable without regard to fairness”).
160. See O’KEELLY & THOMPSON, supra note 99, at 403 (“As the complexity and interconnection of American business increased, conflicting interest transactions became an accepted business reality. Judicial views evolved accordingly.”).
161. See Daniel S. Evans, Use of Special Committees in Extraordinary Transactions, PRACTISING LAW INSTITUTE CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES: HANDLING Mergers & Acquisitions IN HIGH-TECH AND EMERGING GROWTH ENVIRONMENTS, Apr.-June 1998, at 889, 893, available in Westlaw, 1044 PLI/CORP. 889 (“[M]ost (if not all) corporation statutes provide that a transaction in which one or more directors are interested will not be void or voidable solely for the self-interest if it is approved by a majority of disinterested directors (even if not a quorum), if it is approved by the stockholders, or if it is fair to the corporation.”). Cf. Model Bus. Corp. Act §§ 8.60-8.63 (1998).

Earlier statutes left entirely to judicial interpretation—and to the guess of corporate counsel—the central question as to what does and what does not constitute a conflicting interest of a director. Great uncertainty has arisen as to the scope of that concept. Subchapter F takes the new step of spelling out a practical working definition of “conflicting interest” and declares that definition to be exclusive. Circumstances that fall outside the statutory definition of conflicting interest cannot constitute the basis for an attack on a transaction on grounds of a director’s interest conflict, although they may, of course, afford basis for legal attack on some other ground. Finally, to a greater degree than its predecessors, the subchapter specifies when judicial intervention is appropriate and when it is not.

Id. at 8-98 (Introductory Comment to Subchapter F). Cf. Principles of Corp. Gov. § 5.02 (ALI 1992). “For clarity of analysis, Part V avoids the use of the term ‘duty of loyalty,’ when dealing with the obligations of a person who acts with a pecuniary interest in a matter, and instead uses the term ‘duty of fair dealing.’” Id. (Introductory Note to Part V).
directors to defend an "uncleansed" conflict of interest transaction by proving that the transaction was fair to the corporation.\textsuperscript{163} Delaware's reversal of the common law rule is codified in Delaware General Corporation Law section 144.\textsuperscript{164} In pertinent part, Section 144 provides:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

1. The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

2. The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

3. The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.\textsuperscript{165}

In order for the cleansing provided for in Section 144 to be effective, the directors must disclose to the disinterested directors or shareholders "[t]he material facts as to his relationship or interest and as to the contract or transaction."\textsuperscript{166} If the approval of shareholders is being

\textsuperscript{163} See \textit{id.} In this context, the notion of what is "fair" to the corporation encompasses a showing both of "fair dealing" with the corporation and that the transaction was consummated at a "fair price." See Weinberger v. UOP, Inc., 457 A.2d, 701, 711 (Del. 1983). In this regard, "fair dealing" involves "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." \textit{id.} The fair price inquiry "relates to the economic and financial considerations of the proposed merger." \textit{id.}

\textsuperscript{164} DEL. CODE ANN. tit. 8, § 144 (1991).


\textsuperscript{166} DEL. CODE ANN. tit. 8, § 144. "A director is considered interested where he or
sought, the directors of a public company would typically make such disclosure via a proxy statement. The proxy rules promulgated by the Securities and Exchange Commission require fairly extensive disclosure of repricing transactions. Hence, a failure to make adequate disclosure with respect to a repricing transaction not only may deprive directors of the benefit of section 144, but also may be an independent breach of fiduciary duty as well as a violation of the federal securities laws. In any event, the failure to make adequate disclosure provides a shareholder with another basis for attacking the repricing.

she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders.” Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993).

167. The Delaware Supreme Court has held that a shareholder vote to validate an interested director transaction requires that the approval must come from a majority of disinterested shareholders. See Fliegler v. Lawrence, 361 A.2d 218, 221-22 (Del. 1976).

168. See 17 C.F.R. § 229.402(i) (1999). The Securities Exchange Commission’s proxy disclosure rules require, among other things, disclosure of the option repricing of all of the company’s officers and directors for a 10-year period, including an explanation of the basis for each repricing that has occurred. See also supra notes 71, 166-67 and accompanying text.

169. See, e.g., Galef v. Alexander, 615 F.2d 51, 63-64 (2d Cir. 1980). In Galef, the shareholder of an Ohio corporation alleged breaches of fiduciary duty and proxy statement violations (of the federal securities laws) in connection with the issuance of exchange options (with lower exercise prices than the options they replaced) that benefited certain officer-directors. Id. at 54-55. With respect to the proxy violations, the court said:

The role of management in educating the stockholder sufficiently to allow him to cast an intelligent vote is unique. Those managing the corporation have the greatest access to relevant factual information. They have most clearly in mind the corporation’s long-range plans. These factors and the directors’ status as fiduciaries usually cause stockholders to give statements from management greater weight than they accord to the statements of corporate dissidents. Obviously the goal of § 14(a) that communications from management be accurate and complete as to all material facts is a vital one. Its achievement would quite clearly be frustrated if a director who was made a defendant in a derivative action for providing inadequate information in connection with a proxy solicitation were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation. The very premises which give life to a derivative right of action to enforce § 14(a) must save it from a premature death. In short, we conclude that to the extent that a complaint states claims against directors under § 14(a) upon which relief may be granted, federal policy prevents the summary dismissal of those claims pursuant to the business judgment of those defendant directors.

Id. at 63-64.

170. See, e.g., In re 3Com Corp. Shareholders Litig., No. C.A. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999) (finding that plaintiff attacked option plan but failed to allege breach of the fiduciary duty of loyalty and waste where directors received stock options pursuant to a plan that had received shareholder approval, and that plaintiff also failed to allege proxy disclosure violations where proxy soliciting shareholder approval of plan amendment disclosed neither option value as calculated under the Black-Scholes Option Pricing Model, nor the possibility that the directors could “short” their options immediately).
Another effect of section 144\textsuperscript{171} on the area of executive compensation has been that corporations are likely to establish compensation committees composed of "disinterested and independent" directors.\textsuperscript{172} These committees often engage the services of a compensation consultant who may be called upon to assess the "fairness" of a compensation package.\textsuperscript{173} In so doing, the compensation consultant assists directors, not just in avoiding conflict, but also in meeting their duty of care, a concern which remains even in the absence of conflict. Prophylactic measures such as these have been in large part successful in insulating compensation decisions, including these involving stock options, from attack.\textsuperscript{174}

In summary, compliance with section 144 provides considerable insulation of an option repricing transaction against derivative attack.

C. Delaware’s Section 157

Delaware law presents another statutory hurdle for those seeking to challenge option repricing.\textsuperscript{175} In pertinent part, section 157 of the Delaware General Corporation Law, entitled “Rights and Options Respecting Stock,” provides:

Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

The terms upon which, including the time or times which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options, and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.\(^\text{176}\)

On its face, section 157 appears to impose no greater duty on directors in assessing whether the corporation has received adequate consideration for the grant of options than that of avoiding actual fraud.\(^\text{177}\) However, all else is not necessarily lost for prospective plaintiffs. First, it is unclear whether interested directors (i.e., directors suffering from a conflict of interest) get the benefit of the presumption in this statute.\(^\text{178}\) Moreover, notwithstanding section 157’s broad coverage, courts have held that it does not foreclose actions for waste (i.e., where the corporation receives none or grossly inadequate consideration for the issuance of stock options).\(^\text{179}\)

Despite this, section 157 spells doom for a considerable number of option repricing challenges, as the only openings will be for cases of actual fraud, egregious cases of outright waste, and perhaps those

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176. Id. (emphasis added). The Delaware Supreme Court has stated that section 157 is not limited to the issuance of options for the purpose of corporate financing. See Moran v. Household Int’l, Inc. 500 A.2d 1346, 1351 (Del. 1985).

177. Other jurisdictions have enacted similar statutes. See, e.g., KAN. STAT. ANN. § 17-6407 (1998); OKLA. STAT. tit 18, § 1038 (2000). Cf. MODEL BUS. CORP. ACT § 6.24 (1998) (“A corporation may issue rights, options, or warrants for the purchase of shares of the corporation. The board of directors shall determine the terms upon which the rights, options, or warrants are issued, their form and content, and the consideration for which the shares are to be issued.”).

178. See Pogostin v. Rice, 480 A.2d 619, 625-27 (Del. 1984) (stating that whether conflicted directors get the benefit of the irrebuttable presumption in section 157 is an open question under Delaware law), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). Even if section 157 were held not to apply to conflicted directors, it seems logical to presume that conflicted directors who availed themselves of section 144 might nonetheless have the protection of section 157 restored.

179. See Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979) (“We do not read § 157 as intended to erect a legal barrier to any claim for relief as to an alleged gift or waste of corporate assets in the issuance of stock options where the claim asserted is one of absolute failure of consideration.”).
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involving uncleansed conflicts of interest. As discussed above, waste cases are fairly forgiving in assessing director decision making, especially in light of Delaware's willingness to find intangible forms of consideration.

The business judgment rule and statutes like section 144 and section 157 combine to make a derivative plaintiff's task difficult, but not impossible. In addition to these legal obstacles, however, plaintiff may also have special problems of proof associated with his allegations of waste and self-dealing.

D. The Difficulty in Proving Waste and Self-Dealing

As discussed above, plaintiff's case is strengthened by allegations that the directors are responsible for the decline in stock price. If management is responsible for the drop in stock price, then repricing gives directors a benefit that is disproportionate to that received by others through the repricing. In such a case, management is arguably rewarding its own incompetence through essentially a gift of lower priced options.

Proof that mismanagement brought about the drop in the stock price will enhance a plaintiff's chances of prevailing on both theories of self-dealing and waste. Such would underscore the conflict of interest present in the directors' decision to reprice and introduce a strong

180. See supra note 178 and accompanying text. It may also be that section 157 will not insulate directors who breach their procedural duty of care (i.e., where directors are grossly negligent in informing themselves with respect to the repricing). See supra notes 73-96 and accompanying text.

181. See supra notes 98-108 and accompanying text.

182. In addition, the procedural hurdles in derivative litigation may also present considerable challenges to plaintiffs. See generally Ferrell, supra note 98. For example, in Delaware, the pleading burden is quite high where the plaintiff seeks to establish demand futility, especially in light of the fact that the plaintiff must make his allegations without the benefit of discovery. See supra notes 136-37 and accompanying text. See also infra note 220 and accompanying text.

183. See supra notes 122-25 and accompanying text.

184. See Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (declaring no self-dealing where parent company caused subsidiary to declare dividend but received nothing to the exclusion of subsidiary's minority stockholders; business judgment rule standard applied in assessing propriety of parent's conduct); see also supra notes 122-25 and accompanying text.

185. See Stone, supra note 44. One commentator has suggested that repricing a CEO's options is appropriate where the stock's decline is not the "CEO's fault and where the repricing creates no expectation of further repricings." Yablon, supra note 41, at 298.
element of self-dealing to the conflicting interest transaction. It would also strengthen a waste theory by arguably showing that, in light of management’s track record, there is no consideration for the repricing. However, even if the plaintiff can establish questionable or even horrible decision-making by management, the plaintiff still has the problem of demonstrating the causal link to the drop in stock price.

A legitimate criticism of some employee stock option plans is that they do not give consideration to the empirical evidence that executives have only limited influence over stock price. While this fact may provide a legitimate basis for criticism of the stock plan at inception, it also makes a derivative plaintiff’s repricing challenge difficult.

This is not unlike the problem confronted by a plaintiff bringing a securities fraud case under rule 10b-5. In such cases, the plaintiff must demonstrate that the defendant’s fraud caused the artificial inflation or suppression of the stock price and link the fraud to changes in stock price. Similarly, a plaintiff complaining of repricing in the face of gross mismanagement should identify the dates of “poor management events” and the corresponding drop in stock price, and eliminate non-

186. See supra notes 122-25, 183-85 and accompanying text.
187. Cf., e.g., Pommer v. Medtest Corp., 961 F.2d 620, 628 (7th Cir. 1992) (holding that plaintiff in section 10b-5 case “must establish that the misstatement caused him to incur the loss of which he complains,” and that Sections 11 and 12 of the Securities Act of 1933 allow the defendant to reduce award by showing that misstatement did not cause decline in stock’s value); Ziemack v. Centel Corp., 856 F. Supp. 430, 433-34 (N.D. Ill. 1994) (finding that class representatives adequately stated claim for relief where allegations were made that stock was artificially inflated due to misstatements and that when market learned of truth, market corrected for alleged artificial inflation of stock price).
188. See supra note 48. Cf. Robert A. Haugen et al., The Effect of Volatility Changes on the Level of Stock Prices and Subsequent Expected Returns, 46 J. Fin. 985, 1006 (1991) (suggesting that stock price volatility is related to investors’ emotions or intuitions, as opposed to “real economic events”).
189. 17 C.F.R. § 240.10b-5 (1999). The elements of a section 10b-5 claim under the federal securities laws are: “(1) a misstatement or omission (2) of material fact (3) occurring in connection with the purchase or sale of a security, that (4) was made with scienter and (5) upon which the plaintiff justifiably relied, (6) and that proximately caused injury to the plaintiff.” Trust Co. v. N.N.P., Inc., 104 F.3d 1478, 1488 (5th Cir. 1997).
190. See, e.g., Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996) (affirming jury instruction that loss causation could be found if misrepresentations or omissions caused market price of stock purchased by class members to be higher than it would have been if true facts were known); Endo v. Albertine, 863 F. Supp. 708, 723 (N.D. Ill. 1994) (finding that plaintiff in securities case must show that alleged fraud, as opposed to general industry factors, caused plaintiff’s loss). Cf. In re Oracle Sec. Litig., 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (finding that event study is necessary to isolate influence of information specific to company which defendants allegedly distorted).
191. While the precise formulation of such an “event study” is beyond the scope of this Article and would require the assistance of an economist, statistician, or financial
management related factors that led to the stock's decline. In this regard, the plaintiff may be assisted by expert testimony. However, whether any expert's techniques in this regard are sufficiently reliable to be entertained by a court of law is subject to question.

Furthermore, the defendant directors may argue that it is inappropriate for a plaintiff to link a series of business decisions together. This would essentially deprive them of business judgment rule protection in the context of the repricing decision. The director may assert that each transaction to which plaintiff attributes a drop in stock price should be evaluated on its own merits. In other words, defendants might assert that business judgment rule protection must be assessed on a transaction-by-transaction basis.

Theorist, the study should attempt to determine if there is a correlation between bad management decisions and declines in stock price. In doing so, it is important to remember that the stock price may not precipitously drop immediately following the event. Instead, the stock price may drift downward for some ensuing period as the market digests the information. Cf. 15 U.S.C. § 78u-4(e)(1) (1994 & Supp. IV 1998) (finding that damages in securities class actions are the difference between price paid or received for stock and mean trading price of security during 90-day period following revelation of the truth).

192. Cf. In re Executive Telecard, Ltd., 979 F. Supp. 1021, 1025-28 (S.D.N.Y. 1997) (rejecting expert testimony in securities fraud case due to expert's failure to isolate movement in stock price likely attributable to alleged fraud from movement reasonably attributable to other factors, and finding that defects in expert's work included his failure to incorporate an events study into his damage analysis, to consider how company-specific events affected decline in company's stock price, and to make a comparison of movement of company's stock to an appropriate composite index).

193. See supra notes 190-92 and infra note 194. If an expert does not make some effort to isolate the negative effect of management's performance on the market price of the stock, his opinion will be vulnerable to attack by defendants who will be able to demonstrate, through expert testimony and otherwise, that stock prices fluctuate for a variety of reasons. Hence, defendants will attempt to prove that the decline in stock price is related to factors other than management's performance. For example, defendants might point to the performance of other similarly situated companies in an effort to show that the stock price decline was the result of something as innocuous as the company's sector being out of favor. Cf. Executive Telecard, 979 F. Supp. at 1027-28 (rejecting use by expert witness of Telecom Index, as opposed to "small cap" index, because latter index would have more reliably factored in market risk on company's stock price and on damages sustained by class).


In fact, defendants might point out that the business judgment rule protects even decision-making that seems poor with the benefit of hindsight.\textsuperscript{196} If plaintiff is permitted to aggregate these transactions, then a fundamental policy of the business judgment rule will be seriously eroded. Plaintiffs who believe that management is “underperforming” over a period of time should not be filing derivative claims, but instead should be voting at shareholders’ meetings to replace the board of directors.\textsuperscript{197}

This argument, however, overlooks the element of self-dealing and waste identified above. Plaintiff’s purpose in demonstrating defendant’s incompetence over a period of time is not to strip \textit{those} transactions of business judgment rule protection, but instead, to demonstrate the impropriety of the directors’ repricing of their own options. The historical context of the poor decisions and their negative effect on the stock price reveals both the waste associated with repricing the defendant’s options and the self-dealing of awarding themselves an inappropriate and disproportionate benefit.\textsuperscript{198} It also reveals the directors’ possible breach of the procedural duty of care in approving the repricing without considering management’s poor track record.\textsuperscript{199} Plaintiff might even go so far as to concede \textit{arguendo} that the business judgment rule applies to each of the poor decisions preceding the repricing, while at the same time maintaining that the business judgment rule does not justify protection for a decision to reward a series of bad performances.\textsuperscript{200}

Such an argument might also be used by a plaintiff in the context of “independent and disinterested” directors who decide to reprice another director’s options. Here, disregarding concerns about structural bias discussed below,\textsuperscript{201} the element of self-dealing is not present.\textsuperscript{202} The

\textsuperscript{196} See Mary Siegel, \textit{Tender Offer Defense Tactics: A Proposal for Reform}, 36 HASTINGS L.J. 377, 380 (1985) (arguing that business judgment rule protects directors from liability for “decisions that, although properly made, produce poor results”). See also Bogart, supra note 103, at 746.

\textsuperscript{197} See \textit{Block et al.}, supra note 128, at 18. See also supra note 131 and accompanying text.

\textsuperscript{198} See supra notes 122-25 and accompanying text.

\textsuperscript{199} See supra notes 73-96 and accompanying text.

\textsuperscript{200} See supra notes 198-99 and accompanying text.

\textsuperscript{201} See infra notes 203-20 and accompanying text.
plaintiff, however, may still make a convincing argument of breach of the procedural or substantive duty of care. Plaintiff may be able to establish that these directors did not adequately consider the “track record” of the director who is to benefit from the repricing. Alternatively, plaintiff may assert that the repricing constitutes waste in light of the directors’ “track record.”

E. The Problem of Structural Bias

The problem of structural bias must also be examined in the context of option repricing. Structural bias is a group phenomenon associated with the fact that directors share much in common and that even if those making a given decision appear to be disinterested and independent, or even are so under current law, they are not in reality free from influence because of their inherent empathies and sympathies toward one another. An example of the effect of such criticism on the law can be seen in the tests employed by courts to evaluate the reports of special litigation committees. Some courts refuse to give any special

202. This assumes not only a lack of conflict of interest on the part of the repricing directors, but also that they are not controlled or dominated by the directors who will benefit from the repricing. See supra notes 72, 118 and accompanying text.


204. See James D. Cox, Searching for the Corporation’s Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 DUKE L.J. 959, 962, 1008. As one commentator observed:

Even if the independent directors are not actually biased in favor of the insiders, the former often are predisposed to favor the latter. Most of the learning on this phenomenon, known as structural bias, arises out of the use of special litigation committees to terminate shareholder derivative litigation against officers or directors. Independent directors tend to be corporate officers or retirees who share the same views and values as the insiders. A sense of “there but for the grace of God go I” is the likely response to litigation against fellow directors.


205. Special litigation committees are those empowered by a board of directors to assess whether a pending derivative action should continue. See Zapata Corp. v. Maldonado, 430 A.2d 779, 785-89 (Del. 1981). If such a committee decides that it should not, the corporation moves to dismiss the action on the basis of the committee’s report. See id. at 788.
deference to the reports of these committees, despite the fact that their members are ostensibly "disinterested" and "independent." Even Delaware, often criticized as being pro-management, does not give the traditional business judgment rule deference to such reports.

If credence is given to structural bias, the option repricing problem is further complicated. Structural bias may lead to repricing decisions that are not necessarily in the best interests of the corporation, but instead are empathetic (albeit perhaps subconscious) responses to a "fellow" director. Such decision making may also include some strategic thinking by the deciding director, who may realize that compensation, bonus, or benefit questions concerning him will inevitably arise and his fate will then be in the hands of those whose fate he is currently deciding. In this sense, the decision becomes an

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206. One court held that the directors whose conduct is in question cannot choose the members of the special litigation committee. See Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 716-18 (Iowa 1983).

207. See Zapata, 430 A.2d at 788-89.

The Court should apply a two-step test to the motion. First, the Court should inquiere into the independence and good faith of the committee and the bases supporting its conclusions. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the Court is satisfied that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.

The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted.

Id. 208. See Jennifer J. Johnson & Mary Siegel, Corporate Mergers: Redefining the Role of Target Directors, 136 U. PA. L. REV. 315, 397 (1987) (stating that even proponents of structural bias theory must acknowledge that independent/outside directors are a "better safeguard of the shareholders' interests than are directors who are not independent"). But see Daniel R. Fischel, The Corporate Governance Movement, 35 VAND. L. REV. 1259, 1282-83 (1982) (because independent directors may lack expertise or familiarity with company's affairs, they may rubber stamp management's decisions and thus not function as an effective curb on management's discretion).

209. Indeed, where a company's directors are also managers, they are "dependent on superior officers for promotion and retention." Franklin A. Gevurtz, Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits, 46 U. PIT. L. REV. 265, 278 (1985).

210. See supra notes 203-07 and accompanying text.


In these circumstances, the complaint can fairly be read to allege that both Plans were part of a unified scheme to provide all board members with incentive options. Therefore, the vote approving the two plans should not be "separated" to enable the defendants to avoid the conclusion of demand futility. Were the Court to hold otherwise, a board of directors could confer
indirect or attenuated *quid pro quo*. No conscious agreement is necessary. It might simply be a tacit understanding born out of a common position, experience, and expectations.

The structural bias argument also suggests that commonly employed procedures, such as "disinterested and independent" director or committee approval, do not "cleanse" the repricing decision in a meaningful sense. Problems of structural bias might emerge even with "disinterested" shareholder approval, depending on the relationship of the shareholders to the directors.

Despite the legitimate observations regarding human behavior upon itself any degree of benefit it desired, yet escape scrutiny by creating a separate plan for each director and then by having all directors other than the benefiting director vote to approve each plan.

Nor is there merit in the defendants' argument that the Court cannot infer that the four directors who benefitted under the Director Plan, and the one director who benefitted under the Employee Plan, would improperly influence one another in reviewing the plaintiff's challenges to the separate plans. The argument misses the point, for the issue is not whether those defendants would improperly influence each other. Rather, the issue is whether those directors could disinterestedly assess the challenge to the individual Plan under which they did not benefit. Because the particularized factual allegations in the complaint permit the inference that the Plans were adopted as a single transaction, those allegations create a reason to doubt that they could. For that reason, demand is excused.

Id. See also supra note 209 and accompanying text.

212. The implications of game theory may also be significant. In this regard, the director may think that if she votes for the repricing, she is more likely to receive favorable treatment when the subject of her own compensation (or option repricing) is addressed by those persons whose repriced options she approved. For an interesting discussion of game theory, see Martin Shubik, *Game Theory, Law, and the Concept of Competition*, 60 U. Cin. L. Rev. 285 (1991).

213. This is not to say that there would not be isolated instances where a conscious agreement is reached.

214. See supra notes 203-07 and accompanying text.


216. In some companies, large shareholders have long-standing relationships with the company's officers and directors. Under such circumstances, these large shareholders may have some allegiance to management when they vote on corporate matters.
incorporated into the structural bias analysis, the effect of structural bias is one that is difficult for a plaintiff to demonstrate in the context of litigation. Indeed, the condensed and adversarial nature of litigation and the law defining "disinterested and independent" often make proof of such subtleties extremely difficult, if not impossible. Moreover, in a jurisdiction such as Delaware, a plaintiff must make his allegations in large part without the benefit of discovery.

As the above discussion demonstrates, a derivative plaintiff has an uphill battle in an option repricing case. Hence, consideration of alternatives to litigation to deal with the issue of repricing is warranted.

V. ALTERNATIVES TO DERIVATIVE LITIGATION

While the above discussion does not entirely foreclose shareholder derivative actions as an avenue of redress for questionable decisions to reprice, it nonetheless realistically portrays such litigation as difficult. Thus, it is not surprising that institutional shareholders have sought to


218. However, some courts have recognized this problem when confronted with it. See, e.g., Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983) ("We believe that the potential for structural bias on the part of a litigation committee appointed by directors who are parties to derivative actions is sufficiently great and sufficiently difficult of precise proof in an individual case to require the adoption of a prophylactic rule.").

219. Additionally, outside the litigation context, shareholders rely in large part on management for information concerning the company and the matters on which they are called upon to vote. Title 8, section 144(a)(2) of the Delaware Code provides that shareholder approval is effective only if "[t]he material facts as to the [conflicted] director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders . . ." DEL. STAT. ANN. tit. 8, § 144(a)(2) (1991). The information is within the knowledge and under the control of the directors who make the judgment as to what to disclose. See supra notes 158-74 and accompanying text. In so doing, however, they must consider the demands of fiduciary duty and section 144, as well as the Securities and Exchange Commission's ("SEC") recent pronouncements on repricing disclosure. The SEC regulates such disclosure through its proxy rules. See, e.g., Director's Alert, SEC Slams Option Repricers with New Ruling (Jan. 1999) <http:lwww.directorsalert.com/9901/990101.htm> (reporting that the SEC no longer considers option repricing an ordinary business decision). The reason for this is that, as a practical matter, due to the widespread ownership of public companies, they can only effectively and reliably communicate with shareholders through the proxy process. See also supra note 168 and accompanying text.

220. See Levine v. Smith, 591 A.2d 194, 208-10 (Del. 1991) (finding that derivative plaintiffs were not entitled to discovery to assist compliance with Rule 23.1), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

221. An institutional investor is an "organization that trades large volumes of securities. Some examples are mutual funds, banks, insurance companies, pension funds, labor union funds, corporate profit-sharing plans, and college endowment funds." See BARRON'S, supra note 2, at 371.
fight the option repricing battle primarily on other fronts.222

Institutional shareholders have issued policy statements generally against repricing and have actively lobbied some boards to refrain from option repricing.223 Through these efforts, some of these shareholders have succeeded in convincing companies to voluntarily change their policies regarding repricing.224 In 1998, the State of Wisconsin Investment Board sponsored a shareholder resolution to require shareholder approval for option repricing at Cardio Thoracic Systems.225 The proposal received a substantial amount of support.226 Where such change has not been undertaken voluntarily, at least one institutional shareholder has made a shareholder proposal to amend a company’s bylaws to require management to seek the approval of the stockholders before any repricing can take place.227

In this instance, management brought litigation to bar the proposal.228 One interesting legal question presented in the context of this battle was whether shareholders may mandate such a course of action. In opposing the institutional investor’s actions, management asserted that any such amendment to the company’s bylaws would be void as an impermissible infringement on the board’s authority to manage the corporation under

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222. See, e.g., Richard H. Koppes, Corporate Governance, Nat’l L.J., July 6, 1998, at B6 (reporting in connection with the 1998 proxy season that “[i]n most cases, the increasing power of pension funds and other institutional investors has made management more willing to listen to the complaints of company shareholders. One factor is the fundamental shift over the last decade in the power dynamics of shareholders and corporations.”). See also supra note 242 and accompanying text.

223. See, e.g., SWIB Urges Auspex Shareholders to Reject Excessive Option Dilution and Option Repricing (visited Sept. 29, 2000) <http://badger.state.wi.us/agencies/invbdlhtml/auspex.html> (reporting that the State of Wisconsin Investment Board asked 22 companies to adopt a policy requiring shareholder approval of repricing).

224. See Roberta D. Fox, Technical Developments in Executive Compensation, ALI-ABA Course of Study: Compensation for Executives and Broad-Based Employee Groups, June 10, 1999, at 33, 95, available in Westlaw, SD82 ALI-ABA 33 (reporting that just under 75% of the companies approached by the State of Wisconsin Investment Board took voluntary actions regarding option repricing); Keith L. Johnson, Wisconsin’s Investor Responsibility Program, ALI-ABA Course of Study: Corporate Governance Institute, Oct. 7, 1999, at 1, 3, available in Westlaw, SE 39 ALI-ABA 1.

225. See Zanglein, supra note 46, at 83-84.

226. See id.


228. See General Datacomm, 731 A.2d at 818-20.
If such a bylaw provision were held to violate this statute, then to accomplish their objectives shareholders would have to effect an amendment to the certificate or articles of incorporation, which is not an easy task because under Delaware law the board of directors must initiate amendments to the articles of incorporation. Despite this argument, the court refused to declare whether the bylaw was invalid and allowed the proposal to be presented to the shareholders who approved it.

The success of institutional shareholders' efforts to curb option repricing is less a statement of the strength of any legal position of institutional shareholders than it is an illustration of their economic muscle—the fact that management must be sensitive to their threat of withdrawing their substantial investments. Such withdrawal would cause not only public relations issues, but perhaps also an adverse affect on stock price—a nightmarish combination from the perspective of management.

In contrast, a derivative suit may present less of a threat. First, there are all the obstacles discussed above. There is also the reality that, even if directors are unsuccessful on a motion to dismiss (for plaintiff's failure to make demand or otherwise state a cause of action), they still...
have the reserve weapon of a special litigation committee's recommendation of dismissal. If that fails, indemnification, insurance, and exculpation statutes offer additional lines of defense. Considered together, some directors may conclude that derivative litigation is more of a nuisance than a substantial threat. On the other hand, the institutional shareholder, even one not threatening litigation, is a force to be reckoned with.

VI. CONCLUSION

Option repricing presents a scenario that may, at first glance, appear to be nothing other than another opportunity for shareholders to complain about executive compensation. From this perspective, option repricing does not present unique or novel legal issues. The law of fiduciary obligation and the business judgment rule must each have some room in the analysis. How much room each should have is a question that figures prominently in most cases and commentary discussing director misconduct. This question isolates a tension that inevitably exists in a corporation between its shareholders and directors.

Option repricing does present, however, something different than

235. See generally Robert K. Payson et al., After Maldonado: The Role of the Special Litigation Committee in the Investigation and Dismissal of Derivative Suits, 37 Bus. Law. 1199 (1982). See also, e.g., Lewis v. Fuqua, 502 A.2d 962, 971 (Del. Ch. 1985) (discussing committee that recommended company move to dismiss derivative action based upon factors such as expense and disruptive effect on corporate management).


238. See, e.g., Del. Stat. Ann. tit. 8, § 102(b)(7) (1991) (providing that certificate of incorporation may contain provision which, apart from certain exceptions including breaches of the duty of loyalty, eliminates or limits the "personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director").


241. See supra notes 221-34 and accompanying text.
other cases of executive compensation, involving salary or bonuses. Here, a director who is the grantee of stock options is placed, for the purposes of compensation, in the position of a shareholder. The purpose in doing this is to provide the director with the incentive to increase shareholder wealth (i.e., stock price) in which the director will share. Repricing, whatever its other vices or virtues may be, empowers a director to extricate herself from the shareholder’s dilemma of holding or selling after a drop in stock price. She can step back into her role as director and rescue herself from being a shareholder. The lifeboat she has, however, holds only a select few, and the common shareholder is not among them.

It may be that the law of derivative litigation and fiduciary obligation has not adequately maintained the balance of power between shareholders and directors and that the effect of structural bias has been underestimated. This may explain the emerging role of the institutional shareholder. In fact, the very appearance of such players, their active efforts to lobby management on such issues as option repricing, and their success suggest that the investment of the common shareholder is not otherwise adequately protected. Only when the power of common shareholders is aggregated through financial investors is the voice of the common shareholder heard.

Ultimately, the institutional shareholder may provide a means of negotiating problems such as option repricing that is more efficient and effective than derivative litigation. One might say, therefore, “problem solved.” Institutional shareholders are not, however, watchdogs for all corporations. There are many companies that cannot rely on institutional investors and must be able to reasonably rely on law and derivative litigation for protection. Courts, therefore, might also profit from the lessons institutional investors seek to teach management regarding option repricing.

None of the foregoing should suggest that, in any given circumstance, option repricing decisions are not subject to business judgment rule protection. They may, however, constitute self-dealing or waste. The law of fiduciary obligation and derivative litigation should strive to reliably discern the difference. In the context of option repricing, this

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242. Even in the settlement context, institutional investors have made their presence known. As part of a recent settlement of a securities class action, the State of Wisconsin Investment Board successfully obtained certain corporate governance changes, including a prohibition of repricing underwater stock options without shareholder approval. See Keith L. Johnson & Richard H. Koppes, Cellstar and Cal Micro Cases Provide New Model for Securities Fraud Litigation, ALI-ABA COURSE OF STUDY: CORPORATE GOVERNANCE INSTITUTE, Oct. 7, 1999, at 537, 542, available in Westlaw, SE39 ALI-ABA 537.
requires an understanding of the need for the repricing and of who benefits from the repricing, as well as the circumstances (including management's performance) preceding and attending the repricing. Only by closely examining these things may a court make a determination as to whether the traditional deference to managerial decision-making is appropriate.