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# Secret Compensation

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# SECRET COMPENSATION

IMAN ANABTAWI\*

*Compensation is the principal means by which companies in the United States seek to motivate managers to act in the best interests of shareholders. The emphasis on stock options as a component of executive pay in the United States also, however, encourages opportunistic behavior by managers. Exercise prices of executive stock options are typically established as the company's stock price on the date the options are granted. Managers can therefore enhance the value of their option awards by timing grant dates to precede the release of favorable corporate news. In fact, evidence suggests that they do so. There has been considerable uncertainty over whether such behavior constitutes insider trading. This Article attributes such uncertainty to gaps in current law. In particular, insider trading doctrine easily handles open-market transactions, but it does a poor job of addressing situations in which managers deal with their own corporations, such as in the case of executive stock option grants. In these circumstances, numerous questions arise, including whether the corporation or its shareholders have been deceived. Drawing on current doctrine and the purposes of the insider trading laws, this Article suggests that both executives and boards of directors have at least some disclosure obligations to shareholders regarding the compensatory element of favorably timed grants. Moreover, it may well be that such grants are subject to the same "disclose or abstain" rule applicable in the traditional insider trading context.*

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### INTRODUCTION

Equity-based compensation, in particular stock option awards, have conventionally been viewed as an effective way of linking managerial pay to company performance.<sup>1</sup> Based on the widespread belief that they operate to align managers' interests with those of shareholders, stock options became the centerpiece of the vast majority of executive compensation packages beginning in the early 1990s.<sup>2</sup> Such reliance on stock options to pay executives was the primary factor underlying dramatic increases in executive compensation during this period.<sup>3</sup>

The importance of stock options as a component of executive compensation makes it attractive for managers to maximize their firms' stock prices because the value of stock options increases as stock prices increase.<sup>4</sup> Stock prices are, however, only one

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1. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323 (1976) (discussing the use of incentive compensation systems to align managerial interests with those of outside equity holders).

2. See, e.g., Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 653 (1998) (finding that the level of CEO compensation and such compensation's sensitivity to firm performance has risen dramatically, largely because of increases in stock option grants); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847 (2002) (reporting that during the 1990s median total compensation of CEOs nearly tripled from \$2.3 million to over \$6.5 million and that the increase in CEO pay over this period primarily reflected growth in stock options, which rose from twenty-seven percent to fifty-one percent of total compensation).

3. See Hall & Liebman, *supra* note 2, at 653; Murphy, *supra* note 2, at 847.

4. Nevertheless, compensation programs that depend heavily on stock price behavior may not be in the best interests of shareholders. See STUART L. GILLAN & JOHN D.

determinant of stock option value. The exercise price of an option; that is, the price at which the option holder is entitled to purchase the underlying stock during the option's life, is another key element of stock option value. Specifically, a lower exercise price increases the value of an executive's stock options.<sup>5</sup>

Several finance scholars have noted unusual stock price behavior shortly following stock option awards, which are the dates on which exercise prices are typically set.<sup>6</sup> In particular, top managers receive stock option awards not long before statistically significant increases in stock prices occur. Such post-grant stock price increases enhance the value of the managers' options.

The foregoing evidence suggests that the timing of stock option grants may be designed to precede favorable firm-specific news announcements. There are numerous accounts of opportunistic behavior by corporate managers.<sup>7</sup> However, none focus on whether compensating managers through the beneficial timing of option grants is an appropriate use of inside information under the federal law of insider trading. Moreover, the possibility that granting

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MARTIN, CENTER FOR CORP. GOVERNANCE, COLLEGE OF BUS. & ECON., UNIV. OF DEL., FINANCIAL ENGINEERING, CORPORATE GOVERNANCE AND THE COLLAPSE OF ENRON 31 (2002) (questioning whether such programs align managerial and shareholder interests or lead to a myopic focus on short-term stock prices), *available at* [http://www.be.udel.edu/ccg/research\\_files/CCGW2002-1.pdf](http://www.be.udel.edu/ccg/research_files/CCGW2002-1.pdf) (on file with the North Carolina Law Review); *see also* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 681 (1988) (discussing management's incentive to focus on the stock price of a corporation, as opposed to the corporation itself, when management's pay depends on stock price).

5. For a discussion of the determinants of stock option value, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 494–98 (7th ed. 2003).

6. *See infra* Part II.A.

7. *See, e.g.*, MATTHIAS BENZ ET AL., UNIV. OF ZURICH INST. FOR EMPIRICAL RESEARCH IN ECON., ARE STOCK OPTIONS THE MANAGERS' BLESSING? STOCK OPTION COMPENSATION AND INSTITUTIONAL CONTROLS 18–19 (2001) (finding that in Standard & Poors 500 firms, a higher concentration of shareholders results in fewer options granted to top executives), *available at* <http://www.iew.unizh.ch/wp/iewwp061.pdf> (on file with the North Carolina Law Review); MARIANNE BERTRAND & SENDHIL MULLAINATHAN, NAT'L BUREAU OF ECON. RESEARCH, DO CEOs SET THEIR OWN PAY? THE ONES WITHOUT PRINCIPALS DO (2000) 37 (finding that CEOs at firms without large shareholders do not give up as much cash compensation as those at firms with large shareholders when their option-based compensation increases), *available at* <http://papers.nber.org/papers/w7604.pdf> (on file with the North Carolina Law Review). *See generally* David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997) (offering evidence supporting the proposition that managers manipulate stock option grant dates around favorable corporate news announcements).

favorably timed stock options constitutes insider trading has hovered below the radar screens of both regulatory authorities and the practicing bar.<sup>8</sup> In addressing the subject, this Article discusses important implications for both insider trading theory and compensation policy.

Part I of this Article looks at the role of stock options in executive compensation programs and explores managerial influence over the executive compensation process. Part II reviews the empirical data relating to the opportunistic timing of executive stock option grants. Looking solely at non-periodic grants, which are assumed to be timed with discretion,<sup>9</sup> supports the view that grant dates are systematically set to benefit executives. Such good timing allows managers to reap profits that are difficult for shareholders to detect; that is, to earn "secret compensation." The result is that careful timing of option grants potentially allows corporate executives to extract substantial amounts of compensation from firms that may well increase their total compensation beyond what shareholders would approve.

Part III examines whether the practice of timing option awards to precede the announcement of good news can be treated as a form of insider trading. It then addresses the more difficult question whether board knowledge of the information matters to this determination. The analysis then turns to whether a board of directors possessing inside information when making a favorably timed option award violates Rule 10b-5.

Part III also analyzes two additional requirements of Rule 10b-5 that are controversial in the option grant setting. It asks whether an option grant is a "purchase or sale" of a security and whether the fraud associated with an insider's failure to disclose inside information when dealing in an option grant is "in connection with" such a purchase or sale, concluding that an option grant satisfies both requirements. The Article concludes with a brief summary and suggestions for possible implementation of Rule 10b-5 against insider option grants.

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8. Commenting on favorably timed option grants made by Fore Systems, Inc., *see infra* note 185, Peter Romeo, former chief counsel of the SEC, was quoted as stating that he did not believe the insider trading rules would apply to the grants because actual share trading was not involved. Timothy D. Schellhardt, *Options Granted During Takeover Talks Are Boon for Executives at Fore Systems*, WALL ST. J., May 14, 1999, at C1. The same article quoted an SEC spokesman as believing that the SEC had never brought an action against a company that granted stock option awards while private takeover talks were underway. *Id.*

9. *See infra* notes 31-32 and accompanying text.

## I. STOCK OPTIONS AND THE OPTION AWARD PROCESS

A. *The Role of Stock Options in Compensating Executives*

It is well understood that managers have their own objectives in executing their functions, which do not necessarily coincide with the objectives of a corporation or its shareholders.<sup>10</sup> There are numerous reasons why mechanisms might be needed to better align managers' interests with those of shareholders. Managers may neglect their duties unless they are held responsible for their companies' performance. Even those managers that are dedicated to their jobs may make decisions that fail to maximize shareholder wealth. For example, without incentives to do otherwise, managers might grant exorbitant pay increases or increases in benefits to subordinates, spend lavishly on their work environments or business travel, or use firm resources to select projects that enhance their status in their communities or in which they have a personal interest.<sup>11</sup>

If shareholders could observe executives' actions perfectly and without cost, they could specify every one of the executives' decisions to maximize shareholder value.<sup>12</sup> The presence of agency costs—the costs incurred to prevent shirking by agents—keeps shareholders from doing so.<sup>13</sup> Instead, the agency cost model predicts that they will make executive pay depend on the firm's financial performance.<sup>14</sup> There are various devices through which shareholders can do so including performance-based bonuses, restricted stock, and stock options.<sup>15</sup> In the United States, however, stock options are the incentive device of choice.<sup>16</sup>

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10. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1932).

11. See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 214 (1992).

12. See Bengt Holmström, *Moral Hazard and Observability*, 10 *BELL J. ECON.* 74, 89 (1979).

13. See Jensen & Meckling, *supra* note 1, at 308.

14. See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777, 782 (1972) (noting that, for example, offering the executive any "residual product above prescribed amounts" will give the executive an incentive not to shirk his duties).

15. For a review of executive compensation possibilities, see BRUCE R. ELLIG, *THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION* 301–460 (2002).

16. See Joseph A. McCahery & Luc Renneboog, *Managerial Remuneration: The Indirect Pay-For-Performance Relation*, 1 *J. CORP. L. STUD.* 317, 322 (2001) (stating that top managers in the United States receive a higher proportion of their total income in stock options than in any other form). Recently, Microsoft abandoned options in favor of restricted stock in part to respond to mounting criticism of options. Robert A. Guth & JoAnn S. Lublin, *Microsoft Ushers Out Era of Options*, *WALL ST. J.*, July 9, 2003, at A1.

A stock option is the right to purchase (through the “exercise” of the option) a stipulated number of shares of the stock of a company (the issuer) at a stated cost (the exercise or strike price) over a prescribed period of time (the exercise period) in accordance with stated eligibility requirements (vesting requirements).<sup>17</sup> For example, suppose an executive is granted options to purchase 400,000 shares at an exercise price of \$50 per share that vest in equal installments over four years and that are exercisable for a term of ten years measured from the date of the grant. Then each year, the executive will acquire the right to purchase 100,000 shares at \$50 per share at any time before the options expire ten years from the grant date. If, after one year, the executive exercises 100,000 options and sells the stock when the stock is trading at \$55 per share, his pre-tax profit is \$500,000.

An attractive feature of options from the perspective of shareholders is that their value, like shareholder wealth, is at risk with the price of the company’s stock. Stock options have, however, been increasingly criticized in recent years.<sup>18</sup> One difficulty with options, for example, is that they do not necessarily provide managers with incentives for pursuing the long-term interests of shareholders or the firm.<sup>19</sup> In other words, conflicts of interest are intrinsic to option-based compensation.

Recent accounting and corporate scandals, involving companies such as Enron, Worldcom, and Tyco, have focused attention on the potential for executive manipulation of short-term stock prices in order to enhance stock option values.<sup>20</sup> Other methods available to managers for increasing the value of stock options have received far less attention. In particular, when conditions permit managers to exert sufficient influence over the option award process, managers are motivated to enhance the value of their options by encouraging awards to be made before upcoming favorable company news announcements. Because an option’s exercise price is typically set at the time of the grant, stock price increases resulting from the subsequent release of such news raise the option’s value. Yet, such

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This move has not yet been widely followed. *See id.* Moreover, the favorable timing of restricted stock grants raises the same insider trading concerns discussed with respect to options in this Article.

17. ELLIG, *supra* note 15, at 357.

18. *See* Jennifer Hill & Charles M. Yablon, *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, 25 U. N.S.W. L.J. 294, 302 (2002).

19. *See supra* note 4.

20. *See generally* GILLAN & MARTIN, *supra* note 4 (outlining Enron’s accounting and reporting procedures).

value is attributable under these circumstances not to the efforts of managers but, rather, to good timing.<sup>21</sup> Parts I.B and II below contend that managers can and do influence the timing of stock option awards to their personal advantage, and that this behavior is costly to shareholders.

### B. *The Stock Option Award Process*

Shareholders, institutional activists and government regulators have increasingly focused their agendas on executive pay.<sup>22</sup> Because the process of setting executive compensation is often complex and partially informal in nature, however, executives at large public companies retain numerous opportunities for influencing the terms of their own remuneration. The discussion below describes the various ways in which managers can exert power over the terms of their compensation packages in general and their stock option awards in particular.

Nominally, the board of directors of a corporation has ultimate responsibility for determining the compensation of its key executives.<sup>23</sup> A majority of the board may, however, broadly delegate its authority to one or more committees.<sup>24</sup> Except as to certain matters enumerated by statute, such committees may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation to the extent conferred

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21. See generally Yermack, *supra* note 7 (investigating the hypothesis that “managers influence the terms of their own compensation”).

22. See Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 284–87 (2000). Under immense public pressure stemming from various accounting and corporate scandals, Congress passed the Sarbanes-Oxley Act of 2002—which President George W. Bush signed into law on July 30, 2002—containing civil, criminal, and administrative reforms designed to alter accounting, corporate governance, and securities industry practices. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

23. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2001) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”). References to state corporate law are to the Delaware General Corporation Law on the ground that more than fifty percent of all public companies in the United States are incorporated in Delaware. See Lucian Arye Bebchuck & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW. 1047, 1054 tbl.2 (2002); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1804 (2002).

24. See, e.g., DEL. CODE ANN. tit. 8, § 141(c) (providing that the majority of a board may designate committees).



upon them by the board or in the corporation's bylaws.<sup>25</sup>

Public companies commonly establish a compensation committee and delegate to it the responsibility for overseeing the compensation of executive officers.<sup>26</sup> Although the precise responsibilities of any given compensation committee depend on the board's specific delegation of authority, typical responsibilities of a compensation committee involve: (1) recommending compensation programs and pay levels for the CEO and other top executives; (2) approving employment agreements and other contracts with such executives; and (3) administering equity-based and other long-term incentive compensation plans, including making individual equity grants.<sup>27</sup>

When a compensation committee recommends option-based compensation for company executives, the company's board of directors will typically adopt a stock option plan setting forth the basic terms of the awards. Virtually all stock option plans are then submitted to the corporation's stockholders for approval.<sup>28</sup> The responsibility for making specific awards pursuant to the plan is typically then delegated to the compensation committee.<sup>29</sup>

For purposes of this Article, it is relevant to distinguish between option awards that are made at about the same time each year, or "periodic" awards, and option awards that are made at unpredictable

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25. *Id.* (stating that committees created by the board may exercise the full power and authority conferred upon them).

26. The establishment of a committee of the board of directors responsible for the design and level of executive pay has become commonplace as a result of both the complexity of executive compensation issues and regulatory requirements. *See* ELLIG, *supra* note 15, at 510-12.

27. For example, under its current charter, the Compensation Committee of Qwest Communications International Inc.: (1) determines the salaries, cash bonuses and fringe benefits of Qwest's executive officers; (2) reviews Qwest's salary administration and benefit policies; and (3) administers Qwest's equity incentive plans. QWEST COMMUNICATIONS INT'L INC., PROXY STATEMENT 6 (2002) (on file with the North Carolina Law Review).

28. The reasons that stock option plans are submitted to stockholders include requirements for such approval: (1) in the listing standards of the New York Stock Exchange and the Nasdaq Market, N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.08 (2003) [hereinafter NYSE MANUAL], available at <http://www.nyse.com/listed/p1020656067970.html> (on file with the North Carolina Law Review); NAT'L ASSOC. OF SEC. DEALERS, ("NASD") MANUAL § 4350(i) (2003), available at [http://www.nasdr.com/pdf-text/nasd\\_manual.pdf](http://www.nasdr.com/pdf-text/nasd_manual.pdf), at 683-85 (on file with the North Carolina Law Review); (2) in certain state corporate laws, *see* N.Y. BUS. CORP. LAW § 505(d) (McKinney 2003); and (3) to qualify for the deductibility of performance-based compensation over \$1 million under I.R.C. § 162(m) (2000), *see* DANIEL NIEHANS & SHAWN E. LAMPRON, 2 EXECUTIVE COMPENSATION FOR EMERGING COMPANIES 7-5 to 7-6 (2d ed. 2002).

29. *See* ELLIG, *supra* note 15, at 510-12.

times, or “non-periodic” awards. Based on surveys of option grant dates, about forty percent of awards are non-periodic.<sup>30</sup> A periodic award is generally not deemed to present an opportunity for manipulating the timing of the award.<sup>31</sup> A non-periodic award, however, can be made at any time the compensation committee selects. Consequently, the timing of these awards is subject to discretion.

The timing of an award is significant because most options are granted as of the date the award decision is made with an exercise price that is equal to the market price of the company’s stock on that date (that is, “at the money”).<sup>32</sup> One important reason for granting at-the-money options is their advantageous accounting treatment. In 1972, the Accounting Principles Board, the predecessor of the Financial Accounting Standards Board,<sup>33</sup> issued Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”), a landmark ruling on executive pay.<sup>34</sup> Under APB 25, a company that issues executive stock options where the number and exercise price per share of stock underlying the options are known on the grant date (subject only to the contingency that the options vest over time) recognizes a compensation expense on its income statement equal to the difference, if any, between the market price of the stock on the date of the grant and the option’s exercise price.<sup>35</sup> The net result is that there is no requirement for a charge to company earnings for “at-the-money” options.<sup>36</sup> “Discount options” (options with an exercise

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30. See David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 80–81 (2000); Keith W. Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock Option Grants*, 103 J. CORP. FIN. 1, 22 (2000); Yermack, *supra* note 7, at 459.

31. See SEC Rule 10b-5(1), 17 C.F.R. § 240.10b-5(1)(c)(1) (2002) (providing an affirmative defense from liability for the purchase or sale of a security by an individual who was aware of material nonpublic information where the transaction occurred pursuant to a binding contract, trading instruction, or written plan that came into existence before the person became aware of material nonpublic information).

32. See Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2508 (Orley Ashenfelter & David Card eds., 1999) (stating that ninety-five percent of options have exercise prices at grant-date fair market value).

33. The Financial Accounting Standards Board (“FASB”) is an independent accounting authority financed by the accounting industry. Although the SEC has formal supervisory authority over auditing standards and procedures, it has generally acquiesced to the rules and standards adopted by the FASB. Manuel A. Rodriguez, *The Numbers Game: Manipulation of Financial Reporting by Corporations and Their Executives*, 10 U. MIAMI BUS. L. REV. 451, 454–55 (2002).

34. FINANCIAL ACCOUNTING STANDARDS BOARD, APB OPINION NO. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES (2001) [hereinafter APB 25].

35. *Id.* at 285.

36. In 1995, the FASB issued a statement under which companies could either

price below the market price of the stock on the grant date) do, however, trigger an expense equal to the amount of the discount.

In addition, options that qualify as incentive stock options generally provide grantees with favorable tax treatment relative to options that fail to so qualify.<sup>37</sup> One requirement necessary for an option to qualify as an incentive stock option is that its exercise price be at least equal to the fair market value of the stock on the grant date.<sup>38</sup> Moreover, in the case of public companies, options must be granted at or above the fair market value of the stock in order to be considered “performance-based compensation” under section 162(m) of the Internal Revenue Code.<sup>39</sup> Such options are tax deductible compensation to the employer even if an executive’s total nonperformance-based compensation exceeds \$1 million per year.<sup>40</sup>

Given that compensation committees select the timing of non-periodic option awards, and that the exercise prices of such awards are generally the price at which the stock is trading on the award date, managers have an interest in influencing compensation committees to award non-periodic grants shortly before favorable firm-specific news announcements in the hope that the news release will raise the company’s stock price. Revisiting the example given in Part I.A, suppose that a CEO is granted options to purchase 400,000 shares at

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continue accounting for stock options under APB 25 or determine the cost of those options on the grant date using a “fair value based” formula, taking into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123, § 19 (Financial Accounting Standards Bd. 1995) [hereinafter FAS 123]. FAS No. 123 required even companies choosing to report under APB 25 to show the fair value impact of their option grants in their financial footnotes as if FAS 123 were being used. *Id.* § 13. In a separate statement, the FASB amended FAS 123’s treatment of methods of transitioning to fair value accounting and FAS 123’s disclosure requirements. *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 148 *passim* (Financial Accounting Standards Bd. 1995). More recently, the FASB undertook a project to resolve: (1) whether compensation paid in the form of equity instruments (and other equity-based compensation arrangements) should be recognized in the financial statements; and (2) how such compensation should be measured in the financial statements. The ultimate goal is the establishment of one method for the recognition and measurement of equity-based compensation transactions that would be followed by all companies applying United States GAAP and international accounting standards. FASB, PROJECT UPDATES: EQUITY BASED COMPENSATION, at [http://www.fasb.org/project/equity-based\\_comp.shtml](http://www.fasb.org/project/equity-based_comp.shtml) (last visited Feb. 24, 2004) (on file with the North Carolina Law Review).

37. *See infra* notes 106–07 and accompanying text.

38. *See* I.R.C. § 422(b)(4) (2000).

39. *See* Treas. Reg. § 1.162-27(e)(2)(vi)(A) (as amended in 1996).

40. *Id.*

an exercise price of \$50 per share. For simplicity, now assume that the options vest immediately and, further, that the CEO is successful in persuading the compensation committee to grant the options while the CEO knows, but shortly before any public announcement is made, that the Food and Drug Administration has decided to approve for commercial sale a promising drug developed by the company. If, upon announcement of the news, the company's stock price rises by forty percent to \$70, the dollar value attributable to the fact that the option exercise price was set at \$50, instead of its full-information price of \$70, is \$8 million  $[(\$70-\$50) \times 400,000]$ . In other words, timing the option grant to precede the release of good corporate news enhanced the option's value.

The inclusion of only outside (non-employee) directors who are considered to be independent of management (independent directors) on compensation committees limits the influence managers can bring to bear on executive compensation matters. Numerous forces encourage compensation committees to be composed of independent directors. These forces include recently adopted modifications to the listing standards of the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market that require, within prescribed transition periods, the compensation committee of listed companies to be composed entirely of independent directors.<sup>41</sup>

Section 162(m) of the Internal Revenue Code also encourages companies to appoint outside directors to their compensation committees.<sup>42</sup> Under that provision, publicly held corporations are generally not permitted to deduct compensation exceeding \$1 million paid to their CEOs or the next four highest compensated officers.<sup>43</sup> An exception to this limit exists for performance-based compensation payable solely on account of the attainment of one or more pre-established performance goals, but only if, among other requirements, the performance goals are determined by a

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41. NASDAQ, RECENT RULE CHANGES, at <http://www.nasdaq.com/about/RecentRuleChanges.stm> (last visited Feb. 25, 2004) (on file with the North Carolina Law Review); NYSE MANUAL, *supra* note 28, §§ 303A.00, 303A.05. The two sets of listing standards define independence slightly differently, but have substantially the same requirements. NYSE MANUAL, *supra* note 28, § 303A.02; see N.Y. STOCK EXCH., FINAL NYSE CORPORATE GOVERNANCE RULES, (Nov. 4, 2003), *available at* <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>, at 4-7 (on file with the North Carolina Law Review); NASDAQ, BULLETIN ON SEC APPROVAL OF CORPORATE GOVERNANCE RULES 1 (November 4, 2003), *available at* [http://www.nasdaq.com/about/NASDAQ%20Bulletin\\_110403.pdf](http://www.nasdaq.com/about/NASDAQ%20Bulletin_110403.pdf) (on file with the North Carolina Law Review).

42. I.R.C. § 162(m).

43. *Id.* § 162(m)(1).

compensation committee comprised solely of two or more outside directors.<sup>44</sup>

Another influential factor in the composition of compensation committees is Rule 16b-3,<sup>45</sup> promulgated under section 16(b) of the Securities Exchange Act of 1934 ("1934 Act").<sup>46</sup> Section 16(b) is a strict liability provision allowing recovery from insiders of any profits from any purchase and sale, or sale and purchase, within six months of each other, involving equity securities of their company.<sup>47</sup> Under Rule 16b-3, transactions between a company and its officers or directors are exempt from section 16(b) if any of certain conditions are met.<sup>48</sup> The exemption relevant for purposes of this Article, and the one most commonly used, is Rule 16b-3(d).<sup>49</sup> This provision exempts grants of stock options or other acquisitions from the issuer that have received advance approval by a committee of two or more "Non-Employee Directors."<sup>50</sup>

In 1992, the SEC adopted rules relating to the disclosure of executive compensation that also encourage independent compensation committees. According to these rules, companies must disclose in certain filings specified information regarding relationships of compensation committee members potentially bearing on the

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44. *Id.* § 162(m)(4)(C)(i). For purposes of section 162(m), the term "outside directors" is defined in section 1.162-27(e)(3) of the Treasury Regulations. It specifies that a director is an "outside director" if the director: (1) is not a current employee of the company; (2) is not a former employee of the company who receives compensation for prior services; (3) has not been an officer of the company; and (4) does not receive compensation from the company, either directly or indirectly, in any capacity other than as a director. Treas. Reg. § 1.162-27(e)(3).

45. SEC Rule 16b-3, 17 C.F.R. § 240.16b-3 (2002).

46. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2000).

47. *Id.*

48. 17 C.F.R. § 240.16b-3.

49. *Id.* § 240.16b-3(d).

50. In order to qualify as a Non-Employee Director, a person must not: (1) currently be an officer or employee of the issuer or a parent or subsidiary of the issuer; (2) receive compensation, directly or indirectly, from the issuer or a parent or subsidiary of the issuer for services rendered as a consultant or in any capacity other than a director, except for an amount that does not exceed \$60,000 (the threshold for which disclosure would be required under Item 404(a) of Regulation S-K, 17 C.F.R. § 229.402); (3) possess any interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K; or (4) be engaged in a business relationship with the issuer or its subsidiaries that would be disclosable under Item 404(b) of Regulation S-K. *Id.* § 240.16b-3(b). Although these standards resemble the "outside director" standards of I.R.C. § 162(m), they are independent of them. *Id.* § 240.16b-3(d)(1). Rule 16b-3(d) does not exempt "Discretionary Transactions," defined as a volitional intra-plan transfer involving an issuer equity securities fund or a cash withdrawal funded by a volitional disposition of an issuer equity security. *See id.* § 240.16b-3(b), (d); *see also* PETER J. ROMEO & ALAN L. DYE, COMPREHENSIVE SECTION 16 OUTLINE 322 (2001).

independence of executive compensation decisions.<sup>51</sup> Specifically, corporations must identify each member of the compensation committee who: (1) was an officer or employee of the company or any of its subsidiaries during the last fiscal year; (2) was formerly an officer of the company or any of its subsidiaries; or (3) had certain financial or business ties to the company during the last fiscal year.<sup>52</sup> The company is also required to describe any interlocking relationships between its executive officers and the executive officers of another company.<sup>53</sup>

Finally, institutional shareholders and other influential bodies have demanded the application of stricter membership standards to compensation committees.<sup>54</sup> In response to ever-increasing levels of executive compensation during the late 1980s and early 1990s,<sup>55</sup> these constituents began publishing policy statements on executive compensation practices and submitting shareholder proposals promoting compensation committees composed solely of outside directors.<sup>56</sup>

Taken together, the foregoing factors have already succeeded in persuading many public companies to appoint compensation committees whose members are entirely independent of management.<sup>57</sup> There are serious questions, however, about how independent-minded so-called “independent” directors really are. Indeed, both theory and evidence suggest that, despite their nominal independence, compensation committee members may be subject to

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51. 17 C.F.R. § 229.402(j).

52. *Id.* § 229.402(j)(1).

53. *Id.* § 229.402(j)(3).

54. *See, e.g.*, TIAA-CREF, TIAA-CREF POLICY STATEMENT ON CORPORATE GOVERNANCE, at <http://www.tiaa-cref.org/libra/governance/> (2000) (“The company’s executive compensation program should be under the direction and oversight of a committee of the board of directors consisting of independent directors . . .”) (on file with the North Carolina Law Review). Other influential bodies also recommend that compensation committees be independent of management. *See* COMM. ON CORP. LAWS, AM. BAR ASS’N, CORPORATE DIRECTOR’S GUIDEBOOK 43 (3d ed. 2001) (“The compensation committee should be composed solely of nonmanagement directors.”).

55. *See* Murphy, *supra* note 2, at 847.

56. *See* Gillan & Starks, *supra* note 22, at 278–79; Tod Perry & Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts 4* (June 2000), available at <http://papers.ssrn.com/sol3/delivery.cfm/000613500.pdf?abstractid=60956> (on file with the North Carolina Law Review); Deon Strickland et al., *A Requiem for the USA: Is Small Shareholder Monitoring Effective?*, 40 J. FIN. ECON. 319, 328–30 (1996).

57. BUREAU OF NAT’L AFFAIRS, INC., CORPORATE GOVERNANCE MANUAL 1:A-16 (2002).

managerial influence.<sup>58</sup>

The potential for managers to engage in opportunistic behavior in large corporations has long been apparent to legal scholars.<sup>59</sup> This potential is especially likely to be realized in the stock option award process. The reasons for this begin with the process of board member selection itself, from whose ranks members of the compensation committee are appointed. Directors are elected each year at the annual meeting of shareholders.<sup>60</sup> Publicly held corporations often have nominating committees composed of independent directors whose function is to recommend to the board candidates for all directorships to be filled.<sup>61</sup> “The nomination function assumes particular importance because . . . nomination by the board is normally tantamount to election.”<sup>62</sup>

While not a member of the nominating committee, the CEO of a company plays an active role in the selection process. The CEO is generally expected to recommend and discuss candidates with the nominating committee and to recruit candidates for the board.<sup>63</sup> By one estimate, eighty-nine percent of nominating committees “depend on the recommendations of the chairman of the board—in many cases the CEO—to select board members.”<sup>64</sup> Board members who

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58. See *infra* notes 59–79 and accompanying text.

59. See BERLE & MEANS, *supra* note 10, at 277–87 (discussing the degree of management control over the corporation). More recently, Lucian Bebchuk, Jesse Fried, and David Walker have put forward a “managerial power” model of executive compensation that predicts that managers will systematically use their power to influence boards to give them compensation packages that are suboptimal, i.e., that fail to establish incentives for managers to maximize shareholder wealth. Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 784–85 (2002). But see Murphy, *supra* note 2, at 858 (explaining the prevalence of option-based compensation in the United States on the alternative basis of options’ low perceived cost).

60. E.g., DEL. CODE ANN. tit. 8, § 211 (2001).

61. See AM. LAW INST., 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.04, at 121, 123 (1994) [hereinafter ALI PRINCIPLES]; see also Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, 17 C.F.R. §§ 228, 229, 240, 249, 270, 274 (2003) (requiring disclosure in proxy statements of information regarding director nomination procedures). But see Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 14 C.F.R. §§ 240, 249, 274) (proposing new Rule 14a-11 to the Securities Exchange Act of 1934 granting security holders a limited right to nominate directors).

62. ALI PRINCIPLES, *supra* note 61, § 3A.04, at 123.

63. *Id.* § 3A.04, at 122.

64. Walter J. Salmon, *Crisis Prevention: How to Gear Up Your Board*, HARV. BUS. REV., Jan.–Feb. 1993, at 68, 71; see also Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1851 (1999) (describing CEO influence over the board).

are hand-picked by the CEO are often senior executives at other companies<sup>65</sup> or individuals who share the same world-view as the CEO.<sup>66</sup> The result is that even independent directors may be predisposed toward insiders.

Informational asymmetries between managers and compensation committee members also play a role in conferring upon managers a strategic advantage in compensation decisions.<sup>67</sup> In particular, the CEO, supported by senior human resources executives, generally makes specific recommendations to the compensation committee regarding the compensation of the company's officers.<sup>68</sup> Although the compensation committee should independently and objectively evaluate these recommendations, if the CEO's recommendations are thorough and well-supported, they will naturally receive deference.<sup>69</sup>

Compensation committee members are also at a disadvantage relative to managers in terms of their expertise in compensation matters. To be effective, a compensation committee member must be knowledgeable in the areas of compensation design and basic accounting and tax matters. However, as one author in the executive compensation field put it, "Unfortunately, too few committee members are well schooled in executive pay programs before joining the committee . . . ."<sup>70</sup> Compounding the expertise problem are the time constraints of directors, including compensation committee members. The vast majority of directors are not professional directors as they are often otherwise fully employed.<sup>71</sup> Members of

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65. A recent survey found, for example, that one quarter of the members of the compensation committees it studied were CEOs of other companies. CONFERENCE BD., THE COMPENSATION COMMITTEE OF THE BOARD: BEST PRACTICES FOR ESTABLISHING EXECUTIVE COMPENSATION 19 (2001).

66. See Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 389 (2002) (discussing reasons for which independent directors might be predisposed to favor insiders).

67. See, e.g., Tom Giles & Katherine Reynolds Lewis, *Qwest Directors Outlined 'Credibility' Gap for Nacchio in 2001*, BLOOMBERG NEWS, Oct. 2, 2002 (reporting results of survey of Qwest directors in which comments about former CEO Joseph Nacchio included references to "haphazard" information flows and inability of board to "perform basic governance responsibilities") (on file with the North Carolina Law Review).

68. LAWRENCE K. CAGNEY, BUREAU OF NAT'L AFFAIRS, INC., COMPENSATION COMMITTEES A-7 (1998); CONFERENCE BD., *supra* note 65, at 23-24.

69. Carol J. Loomis, *This Stuff Is Wrong*, FORTUNE, June 25, 2001, at 73, 74-80 (suggesting that compensation committee members are reluctant to micro-manage management).

70. ELLIG, *supra* note 15, at 511. Ironically, this problem is exacerbated by factors encouraging independent compensation committees because management directors are likely to be more knowledgeable about compensation matters and about the company than are independent directors. CONFERENCE BD., *supra* note 65, at 19.

71. Bainbridge, *supra* note 66, at 388.



compensation committees meet only occasionally and do not analyze in detail compensation issues.<sup>72</sup> Given competing demands, compensation committee members are even more inclined to rely heavily on management's proposals.

Due to the complexity of executive compensation matters, compensation committees typically rely on professional compensation consultants for advice.<sup>73</sup> Although using consultants alleviates the expertise and time limitations that face directors, consultants do not necessarily introduce objectivity into the review process. Frequently, consultants are hired to evaluate the compensation of the CEO who hired them.<sup>74</sup> Under these circumstances, it is difficult to believe that a consultant would challenge management's recommendations to a meaningful extent. Instead, compensation consultants are more likely to work to justify management's recommendations.

Informal and empirical data suggest that the foregoing factors do, indeed, allow managers to exert influence over compensation matters. In an interview of seven directors of large companies who were promised anonymity, numerous comments underscored the pressures that CEOs can bring to bear on compensation committee members. One CEO described bluntly his ability to win approval for favorable compensation arrangements:

On my own board we have very sophisticated people, and we expose the full board to what's going on about compensation. Even so, since I know more than they do about this subject . . . .<sup>75</sup>

While acknowledging that modern board members are vigilant, the above-quoted CEO nevertheless felt that boards were at a strategic disadvantage relative to management when overseeing management-supported initiatives:

I think the day of packing the board with patsies is over, if for no other reason than appearances. In any case, the odds are so stacked in favor of management that you don't need patsies.<sup>76</sup>

Another executive with wide experience on boards spoke in the same vein:

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72. GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 224 (1991).

73. CAGNEY, *supra* note 68, at A-15 to A-16.

74. *Id.* at A-16; CRYSTAL, *supra* note 72, at 220.

75. Loomis, *supra* note 69, at 74-80.

76. *Id.* at 74.

When it comes to relating pay to performance, compensation committees are really in the pockets of CEOs. There are all kinds of cozy relationships involved. And when a CEO wants the rules changed as to how people are paid, the rules simply get changed. . . .

. . . .  
. . . Basically, what people understand they have to do is go along with management, because if they don't they won't be part of the club. You sort of get rolled over by the system even if you try to do well. What it comes down to is that directors aren't really independent. CEOs don't want independent directors.<sup>77</sup>

Recent empirical evidence is consistent with the view that managers exert influence over executive compensation decisions notwithstanding the presence of independent directors on compensation committees. These studies fail to find statistical support for the proposition that increased representation of independent directors on compensation committees curtails CEO pay.<sup>78</sup>

Certainly, bias of compensation committee members in favor of management is not assured and can easily be overstated.<sup>79</sup> Not all independent directors are susceptible to managerial influence. Nor are all independent directors unable to monitor executive compensation matters in an informed and dispassionate manner. All that it is necessary to establish to warrant further inquiring into the opportunistic timing of stock option awards, however, is that independent directors will often be subject to strategic disadvantages—whether as a result of institutional pressures,

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77. *Id.* at 75.

78. See generally Ronald C. Anderson & John M. Bizjak, *An Empirical Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay*, 27 J. BANKING & FIN. 1323, 1346 (2003) (finding that the sensitivity of CEO pay and equity is not affected by the fraction of outsiders on the compensation committee); Catherine M. Daily et al., *Compensation Committee Composition as a Determinant of CEO Compensation*, 41 ACAD. MGMT. J. 209 (1998) (finding “no evidence that ‘captured’ directors led to greater levels of, or changes in, CEO compensation”); Harry A. Newman & Haim A. Mozes, *Does the Composition of the Compensation Committee Influence CEO Compensation Practices?*, 28 FIN. MGMT. 41 (1999) (concluding that compensation is no greater when the compensation committee is comprised of insiders). *But see* Murphy, *supra* note 2, at 851–54 (supporting the theory that outside directors help curb CEO pay).

79. STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 228 (2002) (noting that independent directors have affirmative incentives to monitor management effectively so that the company does not perform adversely on their watch).

informational asymmetries, or otherwise—relative to managers that permit managers to influence them to grant non-periodic stock option awards to key executives at favorable times.

## II. OPPORTUNISTIC TIMING OF STOCK OPTION AWARDS

### A. Evidence

If the foregoing account that managers can, even in the presence of independent compensation committees, influence the terms of their compensation, is accurate, then managers will be able to time their option grants to precede favorable news announcements, thereby reducing the riskiness and increasing the value of their options.<sup>80</sup> There are, of course, constraints that check the extent to which the level and structure of executive compensation can deviate from what would be optimal for shareholders. At some point, even directors who are inclined to favor management in the compensation process will refuse to approve a compensation package, or shareholders might seek to impose limits on executive compensation.<sup>81</sup> To circumvent such pressures, managers will want to enhance their compensation as discreetly as possible. By “camouflaging”<sup>82</sup> elements of their pay, managers can maximize their compensation while minimizing adverse reaction. Timing option grants is an especially attractive way to enhance executive compensation both because it is difficult to detect and because it has generally eluded attention.<sup>83</sup>

Empirical studies of stock price behavior following stock option awards support the hypothesis that managers of public companies in the United States systematically receive stock option awards with favorable exercise prices.<sup>84</sup> Such exercise prices are favorable in the sense that they are purportedly market prices on the date the options are granted but do not reflect favorable nonpublic information on the date of the award. If this information were to have been incorporated into stock prices on the award dates, awards granted “at-the-money” would have been made with exercise prices equal to the higher (full-

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80. Yermack, *supra* note 7, at 453.

81. See Bebchuk et al., *supra* note 59, at 786–87 (referring to this constraint as the “outrage” factor).

82. Bebchuk et al. use this term to describe the process by which managers are inclined to extract economic rent, i.e., pay in excess of what would be optimal for shareholders, while minimizing adverse shareholder “outrage.” *Id.* at 786–89.

83. See *supra* note 8 and accompanying text.

84. See *infra* notes 89–102 and accompanying text.

information) stock prices.

The evidence on the timing of executive stock option awards relative to movements in stock prices is consistent with two possible theories. First, insiders might manipulate the timing of the release of information to the market by revealing good news after a given award date. For example, an executive with favorable information about his company who knows he will receive stock options on a pre-established date can enhance the value of those options if he is able to delay disclosure of positive news until after the options are granted and the exercise price is established.<sup>85</sup> Second, insiders might manipulate the timing of award dates such that awards are made before a given date on which good news is released.<sup>86</sup>

By distinguishing between option awards made on a predictable schedule and those that are not, it is possible to test the foregoing theories.<sup>87</sup> Significant positive abnormal stock price returns following predictable awards suggest opportunistic timing of disclosure around award dates because, by definition, the award dates were fixed. The same stock price behavior following unpredictable awards suggests opportunistic timing of awards prior to positive news announcements. In fact, empirical studies on stock price movements and option awards suggest that both types of opportunistic behavior occur.<sup>88</sup> The

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85. For a discussion of evidence on manipulative disclosure around predictable award dates, see generally Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83 (2000).

86. Yermack, *supra* note 7, at 451.

87. For example, David Aboody and Ron Kasznik define “scheduled” awards as those made periodically each year within one week of each other. Aboody & Kasznik, *supra* note 30, at 81 n.8.

88. *Id.* at 98. During the sample period 1992–1996, Aboody and Kasznik investigate stock price behavior around the time of 2,039 “scheduled” awards made to the CEOs of 572 firms to test whether CEOs manage the timing of their voluntary disclosures around award dates, rushing bad news forward ahead of awards and delaying the release of good news until after awards. *Id.* at 74–76, 98. Aboody and Kasznik find evidence “that CEOs of firms with scheduled awards make opportunistic voluntary disclosures that maximize their stock option compensation.” *Id.* at 98. Although the authors focus on scheduled awards to mitigate the possibility that their findings are attributable to opportunistic timing of awards around company news announcements, they replicate all of their tests using the subsample of 1,402 awards made to the CEOs of 562 firms with unscheduled awards. *Id.* at 86. Aboody and Kasznik found no evidence that the significant stock price decreases (increases) in the period immediately before (after) the unscheduled awards reflect an opportunistic disclosure strategy. *Id.* They therefore conclude that the asymmetric stock price movements that they observe around option awards reflect: (1) opportunistic timing of disclosures around award dates for firms with scheduled awards; and (2) opportunistic timing of awards around disclosures for firms with unscheduled awards. *Id.* at 76; see also Steven Balsam et al., *Earnings Management Prior to Stock Option Grants*, (last visited Feb. 25, 2004) (finding evidence that firms make income-

remainder of this Part explores in greater detail the evidence that has been gathered regarding the deliberate timing by insiders of stock option awards before favorable news announcements.

In his study of 620 CEO stock option awards made by Fortune 500 companies in the 1992–93 and 1993–94 fiscal years, David Yermack theorizes that CEOs influence the timing of their option-based compensation to increase its value and reduce its riskiness.<sup>89</sup> One testable prediction of Yermack's theory is that managers receive option awards shortly before favorable firm-specific news pushes their companies' stock prices higher.<sup>90</sup> In fact, Yermack finds that stock prices of companies in his sample begin rising just after CEOs receive their option awards, with such stock prices exhibiting mean cumulative abnormal returns ("CARs") over the next ten weeks.<sup>91</sup> Cumulative abnormal returns thereafter level off and become permanently embedded in stock prices.<sup>92</sup>

As discussed above, Yermack's evidence of abnormal stock price returns following option awards is consistent with the manipulation by managers of either the timing of news announcements around award dates or of award dates around news announcements.<sup>93</sup> When

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decreasing accruals to earnings prior to stock option grants), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=378440](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=378440) (on file with the North Carolina Law Review); Chauvin & Shenoy, *supra* note 30, at 73–74 (finding evidence consistent with the proposition that executives time the release of bad news shortly before option grant dates in order to depress the exercise prices of their stock options).

89. Yermack, *supra* note 7, at 449, 453–54.

90. *Id.* at 454–55.

91. *Id.* Yermack does not find evidence that option awards are made following stock price declines. *Id.* at 457–58. *But see* Chauvin & Shenoy, *supra* note 30, at 73–74 (reporting evidence to the contrary on the basis of a different market portfolio index). Yermack's hypothesis does not, however, depend on whether stock prices move downward before option awards because option recipients benefit from the timing of their awards only if stock prices subsequently rise. Yermack, *supra* note 7, at 457–58.

92. Yermack, *supra* note 7, at 455–57. Yermack also considers and rejects numerous competing explanations for his test results, including the possibilities that: (1) news of options being awarded leads to increased stock purchases, which itself drives stock prices higher; (2) shareholders implicitly acquiesce in rewarding deserving CEOs by allowing them to time favorably their option awards; (3) boards deliberately award options to their companies' CEOs before favorable news as a way of enhancing the incentive impact of the options or as a way of rewarding CEOs for their role in generating the favorable news; and (4) companies and executives enjoy tax benefits from the award of options that move into the money relative to cash compensation. *Id.* at 467–72. Yermack rejects the first of these explanations because he finds no evidence of increased trading around stock option award dates. *Id.* at 470. He dismisses the remaining theories for several reasons, including what he perceives as their legal questionability, bluntness as a device for incentivizing executives, and lack of evidence that firms target the optimal exercise price of executive stock options. *Id.* at 471–72.

93. The suggestion that managers influence grant dates is supported by Yermack's

Yermack disaggregated his data into predictable and unpredictable award dates,<sup>94</sup> he found that both subsamples exhibited positive and significant mean CARs, but that the unpredictable awards had higher mean CARs.<sup>95</sup> In other words, both strategies enhance option values, but manipulating award date timing is more effective than manipulating the timing of disclosure.

There is also evidence in the form of data on the timing of “underwater option” re-pricing to support the proposition that managers influence the timing of option awards to their financial advantage. An underwater option is an option to purchase stock at an exercise price that is above the stock’s current market price.<sup>96</sup> As discussed in Part I.B, exercise prices for stock options are typically set at the market price. When stock options go underwater, the options are more likely to expire worthless.

Firms with options that are underwater confront incentive and retention issues.<sup>97</sup> As a result, companies often wish to reduce the exercise prices of underwater options to the prevailing market price of the underlying stock. Until recently, it was common for companies simply to reduce the exercise prices, or “reprice,” stock options to preserve their value to employees. Effective July 1, 2000, for any option that was repriced after December 15, 1998, however, any options a company offers to reprice are subject to “variable accounting,” which requires the company to “mark-to-market” all options included in the repricing offer at the end of each quarterly reporting period.<sup>98</sup> As a result, instead of the compensation expense of the option being measured on the grant date, any increase in the stock price over the exercise price as of each quarterly measurement date while the option is outstanding results in a compensation

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findings that the more influence the CEO exerts over the governing body awarding the grants, the greater are the CARs following the awards. *Id.* at 459–62.

94. Yermack classifies awards as “predictable” if the awards are made in each of the two fiscal years of his sample, with the two awards being separated by at least eleven months but no more than thirteen months. *Id.* at 459.

95. *Id.*

96. Gary N. Sutton & Jeffrey P. Donahue, *Repricing Underwater Stock Options*, VENTURE CAPITAL J., Nov. 1, 2001, at 18, available at 2001 WL 2277879.

97. An executive whose options are severely underwater may believe that no amount of effort will bring the options back into the money, thereby severing the link between performance and pay as to those options. Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 267–68 (1999). In addition, if the executive holds underwater options that remain unvested, his financial incentive to remain with his current employer diminishes. Sutton & Donahue, *supra* note 96, at 19.

98. See Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation, An Interpretation of APB Opinion No. 25 (2000) ¶¶ 38–39.

expense to the company. Companies that wish to reduce the exercise prices of their options without subjecting the options to variable accounting must insert a six-month waiting period between the dates that the underwater options are cancelled and those on which the replacement options are issued.<sup>99</sup>

Unlike the decision *whether* to reprice stock options, the *timing* of option repricing has received scant attention. Yet it is the price of the stock on the date of the repricing that redetermines the value of the option. Given that the decision-making process for option repricing is the same as that for granting an option, evidence that stock option repricing precedes favorable movements in the underlying stock is consistent with the theory that executives opportunistically manage the timing of the initial option grant.

In their study on the timing of stock option repricing, Callaghan et al. examined a sample of 236 repricing events from 1992 through 1997 involving high level managers.<sup>100</sup> The authors found that stock prices of firms that repriced their options exhibited statistically significant declines for several months before the repricing and statistically significant increases after the repricing.<sup>101</sup> Callaghan et al. conclude that “management tends to reprice options as the stock price reaches a minimum, and just prior to a period with abnormal positive returns. It seems unlikely that this pattern consistently occurs by chance.”<sup>102</sup>

In summary, there is substantial evidence indicating that stock option grants are systematically made just before stock prices increase. Managers benefit from such timing because the exercise price of their stock options is typically set on the grant date at the then-prevailing price of the stock. Thus, when managers are eligible to exercise their options, they enjoy not only any increase in stock price resulting from events that occur after their grants but also increases in stock price attributable to any events that occurred before their grants but that were announced after the grant date. The latter portion of the spread between the market price of the stock on the date of exercise and the exercise price appears solely to be the product of good timing.

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99. See *id.* ¶¶ 38–45.

100. Sandra R. Callaghan et al., *The Timing of Option Repricing 1* (2002), available at <http://www.afajof.org/pdf/forthcoming/subramaniam.pdf> (unpublished manuscript, on file with the North Carolina Law Review).

101. *Id.* at 13–14.

102. *Id.* at 16.

*B. Direct Costs to Shareholders of Favorably Timed Grants*

The beneficial timing of stock option grants imposes direct costs on shareholders. These costs are not the full cost of the options but only the excess of the cost of a beneficially timed option over the cost of a fully priced option (where the exercise price reflects inside information). Offsetting this amount is the present value of any tax benefits to the company resulting from the fact that the grant was made at the lower exercise price.<sup>103</sup>

The Black-Scholes option pricing formula is the most widely used model for estimating the present value of stock options granted by a company to its employees.<sup>104</sup> Although a precise derivation of the sensitivity of the Black-Scholes option value to changes in the exercise price of an option is beyond the scope of this Article, it is possible to make some observations about it. First, a decrease in the option's exercise price, other things equal, increases the value of the option. Second, the upper bound of the wealth transfer from shareholders to executives for a given reduction in an option's exercise price is the product of the reduction in the exercise price and the number of options granted.<sup>105</sup> In other words, every dollar for which the exercise price of an option is below its full-information exercise price represents a maximum one dollar wealth transfer from shareholders to executives.

Take the example given earlier in which a CEO is granted options to purchase 400,000 shares at an exercise price of \$50 per share.<sup>106</sup> In that example, the options vested immediately and the announcement that the FDA approved the company's new drug for commercial sale raised the stock price to \$70. If the option is exercised, timing the grant before the release of the good corporate news results in the CEO's purchasing the shares underlying the option for \$50, which is \$20 less than the CEO would have paid had the options been granted after the news release. The direct pre-tax cost to shareholders of this benefit is \$ 8 million.

Under section 162 of the Internal Revenue Code, however, upon exercise of a nonqualified stock option,<sup>107</sup> a company is typically

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103. See *infra* note 107 and accompanying text.

104. See, e.g., Stuart L. Gillian, *Option-Based Compensation: Panacea or Pandora's Box?*, J. APPLIED CORP. FIN., Summer 2001, at 118-20 (using the Black-Scholes method to calculate present value).

105. Yermack, *supra* note 7, at 458; Chauvin & Shenoy, *supra* note 30, at 67.

106. See example discussed *supra* pp. 844-45.

107. A nonqualified stock option is a stock option that does not comply with the requirements applicable to an incentive stock option. Eric L. Johnson, *Waste Not, Want*



entitled to a deduction equal to the difference between the market price of the stock at the time of exercise and the exercise price of the stock.<sup>108</sup> Thus, to the extent that the exercise price is lower than it would have been had the nonpublic information been incorporated into it on the grant date, the company benefits from a greater deduction. Assuming that this corporate tax benefit is a combined state and federal rate of forty percent, the incremental deduction that the insider grant generates for the company reduces the wealth transfer to shareholders from failing to disclose the inside information before the grant by \$3.2 million to \$4.8 million.

Of course, one can argue that in the more realistic scenario where the options vest over time, various economic shocks may reduce or eliminate the value of the below-market grant. Yermack, however, finds that post-award CARs become permanently embedded in stock prices.<sup>109</sup> Thus, good timing appears to benefit managers at shareholder expense through the option exercise date.

Another possible objection to the claim that shareholders suffer direct costs associated with favorably timed option grants is that the value to managers associated with favorable timing would, if unavailable, be demanded by managers in consideration for their services in some other form, such as salary. In other words, suppose that a given CEO commands total compensation of \$5 million a year. As one component of his compensation package, the CEO might be willing to accept either \$1 million in value attributable to the favorable timing of an option grant or \$1 million in salary. In other words, favorable timing may not operate to enhance executive compensation but rather to substitute for an alternative form of pay.

While the possibility of such a substitution effect exists, it seems unlikely. If favorably timed options were a substitute for other forms of compensation, one would expect to observe companies awarding discount options during periods when there is no significant favorable information pending release. Discount options are similar to favorably timed market options in that they are in the money at the time of issuance, while favorably timed market options are highly likely to be in the money upon expected announcement of expected positive news. However, discount options are only rarely granted.<sup>110</sup>

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*Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 147 (2000).

108. I.R.C. § 83 (2000); Treas. Reg. § 1.83-7 (as amended in 1996); Treas. Reg. § 1.83-7T (temporary provision applying to all grants after July 2, 2003).

109. Yermack, *supra* note 7, at 455-57.

110. Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J.

Rather than serve as a substitute for other forms of compensation, it is more likely that favorably timed option grants represent a way for managers to enhance their compensation. As discussed in Part I, managers have incentives to camouflage their pay to the extent it deviates from that associated with the optimal contract. By timing option grants, managers can enhance their compensation with minimal potential for detection by outsiders.<sup>111</sup>

### III. SITUATING STOCK OPTION AWARDS WITHIN THE LAW OF INSIDER TRADING

Part I.B of this Article made the case that managers can exercise considerable influence over key elements of their compensation, including the timing of stock option awards. The evidence reviewed in Part II.A is consistent with the theory that executives do in fact use their influence over the option award process to secure exercise prices that do not incorporate fully favorable nonpublic information known to them on grant dates. In other words, managers are able to obtain options that are “mispriced” to their advantage. By influencing the timing of executive option grants, managers can systematically increase the value of their stock option awards and reduce their risk based solely on the future release of favorable nonpublic information. As described in Part II.B, shareholders bear direct costs associated with these mispriced options. This Part considers whether the grant of executive options pending disclosure of material nonpublic information gives rise to insider trading liability under Rule 10b-5, confronting the most difficult issues such a claim will likely raise.

#### A. *The Fiduciary Duty and Deception Requirements of Rule 10b-5*

Section 10(b) of the 1934 Act delegates broad rulemaking authority to the SEC to protect investors and the public from the use of any “manipulative or deceptive device or contrivance” in connection with the purchase or sale of securities.<sup>112</sup> Pursuant to this authority, the SEC promulgated Rule 10b-5, which broadly proscribes fraud in connection with the purchase or sale of a security.<sup>113</sup> As

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ACCT. & ECON. 3, 25–26 (2002).

111. Even if a substitution effect did exist, the fact remains that favorably timed option grants are a disguised form of compensation to the extent their compensatory function is generally not disclosed.

112. 15 U.S.C. § 78j(b) (2000).

113. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002). Two other provisions of the federal securities laws that regulate insider trading deserve mention. As discussed above, section 16(b) of the Securities Exchange Act allows an issuer of equity securities to

Professor Steve Thel states, “[Rule 10b-5] is as broad as almost any statute, a sort of long-arm provision in which the SEC forbids everything the statute gives it power to forbid.”<sup>114</sup> Given the open-ended nature of section 10(b) and Rule 10b-5, the courts have been particularly influential in developing their scope.<sup>115</sup>

In its initial incarnation, modern-day federal insider trading law held that an insider possessing material nonpublic information must either disclose such information before trading or abstain from trading until the information has been disclosed. The earliest conception of the “disclose or abstain rule,” as it is commonly known, was based on the premise underlying the decision of the Second Circuit Court of Appeals in *SEC v. Texas Gulf Sulphur Co.*<sup>116</sup> that all members of the investing public are entitled to equal access to material information.<sup>117</sup> In *Chiarella v. United States*,<sup>118</sup> however, the Supreme Court limited the application of the disclose or abstain rule to only those instances in which a person has an affirmative disclosure obligation prior to trading.<sup>119</sup>

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recover short-swing profits of an insider. See *supra* notes 45–50 and accompanying text. Because, under Rule 16b-3(d), a stock option grant made by an independent compensation committee is generally exempt from section 16(b), and because section 16(b) reaches only transactions that occur within six months of each other, it is of limited relevance to the award of executive stock options. Rule 14e-3, promulgated by the SEC pursuant to its authority under section 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (2000), makes it illegal to trade on the basis of material nonpublic information of a tender offer if knowledge of the offer comes from the offering party, the issuer of the securities, or any officer, director, partner, or employee of either the offering person or the issuer. 17 C.F.R. § 240.14e-3(a). Under this rule, it is illegal, for example, for a tippee of a bidder to trade in either the bidder’s or the target’s stock even if the tippee owes no fiduciary duty to the shareholders of the target company and regardless of the motive of the tipper. *Id.* Rule 14e-3 is based on the SEC’s view that trading by persons in possession of material nonpublic information relating to a tender offer results in unfair disparities in market information and market disruption. Tender Offers, 45 Fed. Reg. 60,410, 60,412 (Sept. 12, 1980) (codified at 17 C.F.R. § 240). Again, however, it is applicable only in limited circumstances.

114. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463 (1990) (citations omitted). Because the scope of Rule 10b-5 is coextensive with the coverage of section 10(b), I refer to the rule and the statute interchangeably. See *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002).

115. Generally, the courts have held that a Rule 10b-5 claim consists of five principal elements: (1) fraud or deceit (2) by any person (3) in connection with (4) the purchase or sale (5) of any security. The fraud or deceit element in turn requires a showing of the elements of scienter, materiality, reliance, causation, and damages. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 13.2.1, at 770 (3d ed. 1995).

116. 401 F.2d 833 (2d Cir. 1968).

117. *Id.* at 848.

118. 445 U.S. 222 (1980).

119. *Id.* at 228. The disclose or abstain rule, as so limited, is hereinafter referred to as the “classical theory.”

In so limiting the disclose or abstain rule, the *Chiarella* Court cited with approval the SEC's conception of an underlying fiduciary obligation in an earlier administrative ruling.<sup>120</sup> In *In re Cady, Roberts & Co.*,<sup>121</sup> the SEC decided that a corporate insider must abstain from trading in the shares of her corporation unless she has first disclosed all material inside information known to her.<sup>122</sup> This obligation to disclose inside information or abstain from trading on it was deemed to apply, however, only because of the insider's "special relationship" with a corporation and its shareholders.<sup>123</sup> In other words, an insider must disclose or abstain from trading only when she is under some independent duty to do so as a result of a "fiduciary or other similar relation of trust and confidence."<sup>124</sup>

In *Dirks v. SEC*,<sup>125</sup> the Supreme Court reaffirmed its holding in *Chiarella* that a duty to disclose arising from a specific relationship between the parties must exist before there can be a Rule 10b-5 violation.<sup>126</sup> Dirks worked with a firm specializing in the investment analysis of insurance companies.<sup>127</sup> Secrist, a former officer of Equity Funding of America ("Equity Funding"), a corporation that sold life insurance and mutual funds, alleged to Dirks that the company was fraudulently booking assets.<sup>128</sup> While investigating these allegations, Dirks disclosed the information to numerous investors, some of whom then liquidated their Equity Funding holdings.<sup>129</sup> *The Wall Street Journal* ultimately exposed the fraud publicly,<sup>130</sup> and Equity Funding went into receivership.<sup>131</sup> The SEC censured Dirks for aiding and abetting violations of Rule 10b-5 by repeating the allegations of fraud made to him to members of the investment community who sold their Equity Funding stock.<sup>132</sup>

The D.C. Circuit Court of Appeals affirmed the censure, but the Supreme Court reversed.<sup>133</sup> The Supreme Court held that Dirks did

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120. *Id.* at 226-27 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)).

121. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

122. *In re Cady*, 40 S.E.C. at 912.

123. *Id.*

124. *Chiarella*, 445 U.S. at 228.

125. 463 U.S. 646 (1983).

126. *Id.* at 654, 657-58.

127. *Id.* at 648.

128. *Id.* at 649.

129. *Id.*

130. William E. Blundell, *A Scandal Unfolds; Some Assets Missing, Insurance Called Bogus at Equity Funding Life*, WALL ST. J., Apr. 2, 1973, at 1.

131. *Dirks*, 463 U.S. at 650.

132. *Id.* at 650-51.

133. *Id.* at 652, 657.

not have a relationship with the stockholders of Equity Funding that gave rise to a duty to disclose or abstain. Even if Dirks, as a tippee, was deemed to inherit his tipper's fiduciary duties, there could be no violation because Secrist did not personally benefit from revealing the corporation's fraudulent activities. To the contrary, he was motivated by a desire to expose the fraud.<sup>134</sup> Absent the requisite fiduciary relationship, Dirks was not subject to the disclose or abstain rule.<sup>135</sup>

Taken together, *Chiarella* and *Dirks* make it clear that insiders, because of their special relationship of trust and confidence with shareholders, must disclose material inside information before trading or abstain from trading and thus avoid making "secret profits."<sup>136</sup> *Dirks* went on, however, to note that not all breaches of fiduciary duty in connection with a securities transaction implicate Rule 10b-5.<sup>137</sup> *Dirks* followed *Santa Fe Industries, Inc. v. Green*<sup>138</sup> in requiring that some manipulation or deception be effected by the breach to support a violation.<sup>139</sup> In *Santa Fe*, the Supreme Court stated that a claim of fiduciary breach creates Rule 10b-5 liability "only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of [Section 10(b)]."<sup>140</sup>

Unfortunately, the foregoing formulation is ill-suited to handling the propriety of timing the grant of stock options prior to the release of favorable inside information. First, it fails to specify the source—state or federal—of an insider's underlying fiduciary duty obligation. Second, it does not identify important details needed to assess whether a trade is deceptive. As discussed below, these gaps present the possibility that board knowledge of inside information at the time of the grant—a factor often present when grants are awarded—can insulate the grant from either constituting a breach of fiduciary duty or being deceptive.

Professor Stephen Bainbridge has argued that the fiduciary duty that must be breached before there can be a Rule 10b-5 violation is

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134. *Id.* at 666–67.

135. *Id.*

136. *Id.* at 654.

137. *Id.*

138. 430 U.S. 462 (1977).

139. According to the *Dirks* Court, "[i]n an inside-trading case this fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'" *Dirks*, 463 U.S. at 654 (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

140. See *Santa Fe*, 430 U.S. at 473–74 (emphasis added).

the duty to refrain from self-dealing in nonpublic information.<sup>141</sup> Under this view, insiders are obligated to use their access to confidential information solely for corporate purposes.<sup>142</sup> The Delaware Supreme Court described this duty in *Guth v. Loft, Inc.*,<sup>143</sup> stating that:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.<sup>144</sup>

As Professor Bainbridge pointed out, however, even if we conclude that the fiduciary duty relevant to insider trading liability is that against self-dealing, the source of that duty still needs to be ascertained.<sup>145</sup> Specifically, it must be determined whether the federal prohibition incorporates state law fiduciary duty concepts or creates a unique rule of federal common law that applies uniformly across all states. The source of the fiduciary duty informs its substance, including to whom the duty is owed and how it can be discharged.

*Chiarella* and *Dirks* and, more recently, *United States v. O'Hagan*,<sup>146</sup> suggest a federal source underlying the federal insider trading prohibition. For example, *Chiarella* refers to a relationship that “*the Commission recognized . . . of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position within that corporation.*”<sup>147</sup> Similarly, *Dirks* noted that *In re Cady*

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141. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1200 (1995).

142. *Id.*

143. 5 A.2d 503, 510 (Del. 1939).

144. *Id.*

145. Bainbridge, *supra* note 141, at 1201–02.

146. 521 U.S. 642 (1997).

147. *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (emphasis added); *see also* Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships As a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 473–74 (2002) (arguing that the *Chiarella* Court created a uniform fiduciary duty for insiders under Rule 10b-5 when it described an insider’s fiduciary duty to disclose or abstain from selling stock to persons who previously may not have been stockholders in the corporation, despite the absence of

recognized that the common law in only “some” jurisdictions imposed a duty of disclosure on corporate insiders when trading securities but went on to hold that a breach of that duty established the elements of a Rule 10b-5 violation.<sup>148</sup> In reaffirming *Chiarella* and *Dirks*, *O’Hagan* also referred to a duty to disclose or abstain from trading by corporate insiders without reference to any state law duty.<sup>149</sup>

Nevertheless, the notion that federal law should supply the substance of the fiduciary duty requirement of insider trading law is inconsistent with the Supreme Court’s decision in *Santa Fe Industries, Inc. v. Green*. In *Santa Fe*, the Court cautioned against using Rule 10b-5 to create a federal common law fiduciary duty.<sup>150</sup> The concern articulated in *Santa Fe* was that application of a federal fiduciary rule against self-dealing would bring a wide variety of corporate conduct traditionally left to state regulation within Rule 10b-5.<sup>151</sup> The Court was wary about using Rule 10b-5 to federalize state corporate law absent a clear indication of congressional intent.<sup>152</sup> While the *O’Hagan* Court claimed its decision was consistent with *Santa Fe*, its discussion of the matter fails to address the portion of *Santa Fe* dealing with the Court’s reluctance to displace state corporate law through Rule 10b-5.<sup>153</sup> Thus, although *O’Hagan* suggests that there exists a federal common law fiduciary duty requiring corporate insiders to abstain from self-dealing in their companies’ securities while in possession of material nonpublic information, the issue is not free from doubt.<sup>154</sup> Accordingly, this Part addresses the substance of the fiduciary duty preventing insiders from self-dealing in their corporations’ securities under both state and federal law and the implications of each for favorably timed option grants.

### 1. State Law Fiduciary Duties

When the SEC decided *In re Cady*, only some states required insiders to disclose material nonpublic information before trading.<sup>155</sup> Under what has been referred to as the “majority rule,”<sup>156</sup> insiders

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state law authority for this proposition).

148. *Dirks v. SEC.*, 463 U.S. 646, 653 (1983).

149. *O’Hagan*, 521 U.S. at 652.

150. *Santa Fe Indus., Inc., v. Green*, 430 U.S. 462, 478–79 (1977).

151. *See id.*

152. *See id.* at 479.

153. *See O’Hagan*, 521 U.S. at 655–56.

154. *See BAINBRIDGE*, *supra* note 79, at 556–61.

155. *In re Cady*, 40 S.E.C. 907, 911 n.13 (1961).

156. *See WILLIAM K.S. WANG & MARC I. STEINBERG*, INSIDER TRADING § 16.2.2 (1996 & Supp. 2002) (describing the “majority rule”); Barbara A. Ash, *State Regulation of*

owed no duty to disclose any information in their private dealings with shareholders. The so-called "majority rule" receded in importance, however, as an increasing number of courts adopted the "special facts" doctrine, announced by the Supreme Court in *Strong v. Repide*.<sup>157</sup> Under the special facts doctrine, in a face-to-face transaction, as opposed to a transaction conducted on an impersonal exchange, special circumstances can render nondisclosure by an insider unconscionable.<sup>158</sup> In addition to application of the special facts doctrine, some states required disclosure of nonpublic information to shareholders in all face-to-face transactions, even in the absence of special circumstances.<sup>159</sup>

Thus, at the time of the SEC's ruling in *In re Cady*, state law provided only limited remedies to a shareholder of a corporation whose officers or directors engaged in insider trading. First, not all states recognized an insider's duty to disclose material nonpublic information before trading.<sup>160</sup> Second, in those states that did impose such a duty, the duty arose only in face-to-face transactions.<sup>161</sup> Finally, in most of the cases in which shareholders prevailed against insiders, the insiders had gone beyond failing to disclose material nonpublic information and had actively misled shareholders.<sup>162</sup>

Since *In re Cady* was decided, the most important development in state insider trading law has been the decision of the New York Court of Appeals in *Diamond v. Oreamuno*.<sup>163</sup> There, insiders possessing unfavorable, undisclosed information sold their shares in market transactions. Though no specific harm to the corporation was alleged, the court permitted a derivative action on behalf of the corporation, suggesting it may have suffered harm to its reputation.<sup>164</sup> It also suggested its holding could be justified in part by the then-inadequate federal remedies for insider trading.<sup>165</sup> When, however,

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*Insider Trading—A Timely Resurgence?*, 49 OHIO ST. L.J. 393, 399 (1988) ("Under what has been referred to as the 'majority rule,' an officer or director owed no duty to disclose any information even when the trading transaction was with an existing shareholder.").

157. 213 U.S. 419 (1909).

158. *Id.* at 431-33.

159. *See, e.g.*, *Oliver v. Oliver*, 45 S.E. 232 (Ga. 1903) (holding that a director, when purchasing stock from a shareholder, is under the same disclosure obligations as a fiduciary).

160. *See* Bainbridge, *supra* note 141, at 1221.

161. *See* Ash, *supra* note 156, at 402 & n.72; WANG & STEINBERG, *supra* note 156, § 16.2.3.1.

162. *See* Ash, *supra* note 156, at 399-400 & n.55.

163. 248 N.E.2d 910 (N.Y. 1969).

164. *Id.* at 912-13.

165. *Id.* at 915.



the perceived gap in federal law was filled by *Texas Gulf Sulphur* and its progeny, the evolution of state common law regulation of insider trading was effectively aborted.<sup>166</sup>

Given that state insider trading law is both non-uniform and only partially developed, an insider's duty of disclosure in the context of a stock option award is more readily analyzed under general state common law principles of fiduciary duty. As already described, the state common law duty of loyalty prohibits unfair self-dealing by corporate officers and directors and thus proscribes them from using their privileged positions to advance their personal interests at shareholder expense.<sup>167</sup> The key to upholding an interested transaction under state law is its approval by a neutral decision-making body—namely, independent directors, shareholders, or the courts.<sup>168</sup> State statutes, such as section 144(a) of the Delaware General Corporation Law,<sup>169</sup> provide a safe harbor for corporate officers and directors to prevent conflicts of interest from voiding corporate actions. Under section 144(a), a transaction between a corporation and its officers or directors will not be void or voidable solely because it is a self-dealing transaction if the transaction is ratified by a majority of disinterested directors of the board or committee charged with authorizing the transaction or by the shareholders.<sup>170</sup> Such ratification is valid, however, only if the material facts as to the relationship or interest and as to the transaction have been disclosed or are known by the ratifying party.<sup>171</sup> In the absence of such disclosure, the transaction can be rendered non-voidable only if it was fair to the corporation as of the time it was authorized.<sup>172</sup>

Common law rules and state statutes such as section 144(a) thus permit approval by a majority of informed and disinterested directors to remove the taint from a self-dealing transaction.<sup>173</sup> Accordingly,

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166. See Ash, *supra* note 156, at 403.

167. See *supra* note 141–43 and accompanying text.

168. See, e.g., *In re Walt Disney Co.*, 731 A.2d 342, 367 (Del. Ch. 1998) (noting that shareholders may in certain circumstances be served notwithstanding the fact that the deal might be characterized as an interested transaction).

169. DEL. CODE ANN. tit. 8, § 144(a) (2001).

170. *Id.*

171. *Id.* § 144(a)(1).

172. *Id.* § 144(a)(3).

173. The precise implications of ratification for an interested transaction is controversial and depends heavily on the nature of the transaction. See generally Mary A. Jacobson, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 DEL. J. CORP. L. 981, 984 (1996) (providing “a critical analysis of Delaware’s current ratification doctrine”); Leo E. Strine, Jr., *The Inescapably Empirical*

courts applying state fiduciary duty law have generally held that where disinterested directors approve a transaction in which an officer or director has a conflict of interest, their action will be reviewed by the courts pursuant to the business judgment rule.<sup>174</sup> In other words, the directors will be presumed to have acted in good faith, on an informed basis, and in the honest belief that their actions are in the best interests of the corporation and its shareholders.<sup>175</sup>

The foregoing principles make clear that, in analyzing a favorably timed stock option grant under state law fiduciary duty principles, knowledge of inside information by the executive receiving the option or the board is relevant. Consider first the executive who: (1) uses his influence over the timing of an option award to obtain an exercise price with respect to the options that does not fully reflect corporate information that he has obtained as a result of his insider status; and (2) does not disclose the information to an otherwise uninformed board prior to the board's grant of the options. The executive cannot be presumed to know how disclosure of the information would affect the board's grant decision. Because the inside information in the optionee's possession would increase the market price of the stock underlying the option if disclosed publicly, and therefore the value of the options, a board possessing the information might choose to grant the executive fewer options, grant the executive the same number of options but reduce another element of his compensation, or simply delay granting the options until after the information is revealed. Thus, by failing to disclose the information to the board, the executive places his own interests above those of the corporation and its shareholders—a breach of the duty of loyalty.

An analogous situation arose in *SEC v. Texas Gulf Sulphur Co.*<sup>176</sup> In that case, certain top Texas Gulf Sulphur Co. ("TGS") executives received stock options while in possession of the nonpublic material information that their company had discovered a valuable mineral

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*Foundation of the Common Law of Corporations*, 17 DEL. J. CORP. L. 499 (2002) (discussing tensions in Delaware law surrounding effects of ratification of interested transactions). Generally, however, compensation transactions with insiders following full disclosure and approval by disinterested directors are reviewed under a business judgment standard. See Melvin A. Eisenberg, *Self-interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1005 (1988).

174. See DENNIS J. BLOCK ET AL., 1 THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 271 (5th ed. 1998 & Supp. 2001) (citing cases).

175. See *id.* at 25.

176. 401 F.2d 833 (2d Cir. 1968).

deposit on land owned by it.<sup>177</sup> Because TGS was seeking to purchase an adjacent portion of the land on which the deposit was discovered, information of the discovery was dispensed only on a “need-to-know” basis, and not even the company’s board or the board’s stock option committee was aware of it at the time of the grant.<sup>178</sup> According to the *Texas Gulf Sulphur* court, in order to comply with Rule 10b-5, the option recipients would have either had to disclose the inside information in their possession to Texas Gulf Sulphur’s stock option committee or reject the options.<sup>179</sup> The executives failed to make the required disclosure, and the court rescinded the option grants.<sup>180</sup>

The *Texas Gulf Sulphur* court did not give any details as to the source—state or federal—of the disclosure requirement it articulated. The court simply stated:

[W]e would hold with the district court that a member of top management . . . is required, before accepting a stock option, to disclose [to the corporation’s stock option committee] material inside information which, if disclosed, might affect the price of the stock during the period when the accepted option could be exercised.<sup>181</sup>

The court’s language implies that had the executives made the required disclosure, they would not have violated Rule 10b-5 because disinterested option committee approval following full disclosure would have negated any violation of fiduciary duty and prevented rescission.

Thus far, this Article has argued only that, assuming full disclosure to, and approval by, a disinterested board or its committee, there is no state law fiduciary duty violation on the part of an executive who receives stock options while in possession of favorable material nonpublic information about his company. This leaves open the question whether, without further disclosure to the company’s shareholders, the board of directors violates its fiduciary duty to shareholders under state law when it grants the stock options. Bear in mind that, as illustrated above, favorable material nonpublic information, if publicly released, would raise a company’s stock price and therefore the value of its stock options.<sup>182</sup> Put another way, were

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177. *Id.* at 839–40.

178. *Id.*

179. *Id.* at 856–57.

180. The options involved had not been exercised by the executives at the time *Texas Gulf Sulphur* was decided. *See id.* at 857 n.24.

181. *Id.*

182. *See* example discussed *supra* pp. 857–58.

such information released before the grant date, the options' exercise price would have been higher and the value of the options correspondingly lower.

There are numerous reasons to believe a board possessing knowledge of material favorable undisclosed information might grant stock options to top managers. As discussed in Part I.A, a board may be influenced by managers to grant favorably timed options. Alternatively, a board may intentionally grant executives options at favorable times, without regard to managerial influence, in the belief that doing so is an efficient means of compensation. For example, section 162(m) of the Internal Revenue Code prevents publicly held corporations from deducting compensation over \$1 million paid to its CEO or its next four highest paid executives unless, among other requirements, the compensation is "performance-based."<sup>183</sup> If a corporation can substitute the value of opportunistically timed option-based compensation for cash compensation exceeding \$1 million, then it may find it beneficial to compensate the CEO and its next four highest paid executives in the form of favorably timed option grants.

A board of directors might also use a favorably timed option grant as a form of "golden parachute"<sup>184</sup> for executives in the event that the company is sold.<sup>185</sup> Executives who might be reluctant to pursue a sale favored by the board of directors for fear of losing their management positions following an acquisition are often induced to support the sale with severance payments, accelerated vesting of options, or similar devices designed to compensate them upon exit.<sup>186</sup> Similarly, a grant of options timed to precede any public

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183. I.R.C. § 162(m)(4)(C) (2000).

184. "The term 'golden parachute' refers generally to agreements between a corporation and its top officers which guarantee those officers continued employment, payment of a lump sum, or other benefits in the event of a change of corporate ownership." *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 3 n.2 (1985).

185. One example of such a payment involved options awarded to top managers of Fore Systems, Inc., a publicly traded Delaware corporation ("Fore"), in the months leading up to Fore's acquisition by General Electric Company, P.L.C. ("GEC") in 1999. *Millioners Inv. Club v. Gen. Elec. Co.*, No. 99-781, 2000 U.S. Dist. LEXIS 4778, at \*3 (W.D. Pa. Feb. 8, 2000). While Fore's board of directors was actively pursuing a possible sale of the Company to GEC, as well as to other potential acquirors, Fore's compensation committee granted a total of 1,300,000 stock options pursuant to the Company's 1998 Stock Option Plan to senior executives at prices ranging from \$14.31 to \$20.56. *Id.* at \*4. Less than three weeks after the latest grant of options, GEC's board offered to pay \$35 per share in cash for Fore, which Fore's board accepted. *Id.* As a result, the managers who had been granted the foregoing options received over \$26 million in profits. *Id.* at \*5.

186. See Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 896-97 (2002).

announcement that the company is considering being acquired will make an eventual sale more attractive to managers by providing them with an incentive to secure the highest possible premium for their companies' stock.<sup>187</sup>

Whether a board that knows of favorable inside information can lawfully grant options to managers before that information is released turns on a director's fiduciary duty of disclosure under applicable state law. Any state law-based duty of disclosure would be a judicially imposed fiduciary duty requiring directors to disclose material information to shareholders under certain circumstances.<sup>188</sup> In its earliest form, the law relating to the fiduciary duty of disclosure arose in the context of transactions between a corporation and interested officers or directors.<sup>189</sup> The board was deemed disabled from supplying the objectivity needed to remove the taint of self-interest from such transactions, and shareholder ratification was required.<sup>190</sup> The fiduciary duty of disclosure required that the board provide shareholders all information material to a transaction when seeking their approval of it.<sup>191</sup> Over time, the courts required directors to inform shareholders fully and fairly of all reasonably available information material to any issue or transaction for which shareholder approval was being sought.<sup>192</sup> In *Malone v. Brincat*,<sup>193</sup> the Supreme Court of Delaware addressed the question of whether a duty of disclosure exists absent any need for shareholder action. *Malone* involved allegations that directors made false statements about corporate earnings, which allegedly caused the company to lose all of its value.<sup>194</sup> The court stated:

Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows *a fortiori* that when directors communicate publicly or directly with shareholders about

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187. *See id.*

188. *See generally* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996) (describing a framework for analyzing a director's fiduciary duty to disclose information to stockholders).

189. *See In re Walt Disney Co.*, 731 A.2d 342, 369 (Del. Ch. 1998).

190. *Id.*

191. *See id.*

192. *Brown v. Perette*, No. 13531, 1999 Del. Ch. LEXIS 92, at \*16 (Del. Ch. May 14, 1999).

193. 722 A.2d 5 (Del. 1998).

194. *Id.* at 8.

corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty.<sup>195</sup>

In other words, "[s]hareholders are entitled to rely upon the truthfulness of all information disseminated to them by the directors they elect to manage the corporate enterprise" even in the absence of a request for shareholder action.<sup>196</sup>

*Malone's* requirement that directors make the disclosure necessary to render their communications to shareholders accurate thus requires board disclosure of material nonpublic information known at the time of an option grant, but only upon the board's communicating to shareholders information relating to the grant. In other words, if and when a corporation, either voluntarily or pursuant to applicable disclosure requirements of the federal securities laws, disseminates information to its shareholders relating to the compensation of its executive officers in general or option awards in particular, it must, in order to comply with its state law duty of disclosure, do so fully and accurately.<sup>197</sup>

To summarize, under state law fiduciary duty principles, a manager who receives stock options while in possession of inside information that will raise the stock price when it is later released discharges her fiduciary duty of loyalty through full disclosure to and ratification by a disinterested board. It is then the board's responsibility, pursuant to its fiduciary duty of disclosure, to inform the corporation's shareholders of the favorable timing of the grant, if it disseminates to them information about the company's executive compensation arrangements. Only a failure on either party's part to make the required disclosure constitutes a breach of fiduciary duty by that party under state law.

Assuming that the executive and the board made the required disclosure, there would be no breach of fiduciary duty under state law to support liability under Rule 10b-5. Consequently, the question of

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195. *Id.* at 10.

196. *Id.* at 10-11.

197. The compensation of directors and key officers and transactions between them and their corporation are matters explicitly covered by securities law disclosure regulations. *See* Schedule 14A, Items 8-11, 17 C.F.R. § 240.14a-101 (2002); Regulation S-K, Item 402, 17 C.F.R. § 229.402; *see also* FAS 123, *supra* note 36 *passim* (establishing financial accounting and reporting standards for stock-based employee compensation plans). These rules are intended, among other things, to provide shareholders with clear and full disclosure of all material information about an Exchange Act reporting company's equity compensation practices. *See* Disclosure of Equity Compensation Plan Information, Securities Act Release No. 8048, Exchange Act Release No. 45189 [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86, 611, at 85, 110 (Dec. 21, 2001).

deception would never be reached. On the other hand, a failure on either the executive's or the board's part to make such disclosure would provide the applicable breach of fiduciary duty. It would then be necessary to show that the breach was manipulative or deceptive within the meaning of section 10(b).<sup>198</sup>

## 2. A Uniform Federal Fiduciary Duty

In lieu of looking to state fiduciary duty law as the basis for a Rule 10b-5 violation, the Supreme Court has suggested its intention to create a uniform federal fiduciary duty against insider trading on material nonpublic information.<sup>199</sup> That duty is the duty of corporate insiders to disclose all material nonpublic information known to them before trading or to abstain from trading.<sup>200</sup> In the context of open market transactions, the Court has made clear that the nature of the information required to be disclosed under the "disclose or abstain" rule is the substantive information to which the insider is privy due to his privileged position within the corporation.<sup>201</sup> With respect to the question of to whom that information must be disclosed, the Court has referred to the fiduciary duty against insider trading as a "duty that insiders owe to the corporation's shareholders,"<sup>202</sup> and has suggested that in some circumstances adequate disclosure requires "more than disclosure to purchasers or sellers"<sup>203</sup> and can be effected only by a public release through the appropriate media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.<sup>204</sup>

Although the foregoing duty to disclose or abstain can be readily applied to open market transactions, it is unclear how it should apply to an intra-corporate transaction, such as an option grant, which does not involve a direct trade with a shareholder. Under these circumstances, a standard different from that of disclosing substantive information to the investing public generally may be appropriate. As

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198. For a discussion of the circumstances in which such a breach might fulfill the deception requirement of Rule 10b-5, see *infra* text accompanying notes 205–12.

199. See *supra* text accompanying notes 146–49.

200. In *WANG & STEINBERG*, *supra* note 156, Professors Wang and Steinberg characterize an insider's fiduciary duties in terms of a "classical special relationship triangle" among the issuer, the insider trader, and the counterparty to the trade. *Id.* at § 5.2.1. The insider's counterparty to an option grant is the issuer. The question central to this Article is the method by which an insider discharges his fiduciary duties to the issuer and its shareholders when transacting with the issuer, i.e., his own corporation.

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

202. *Id.* at 653 n.10.

203. *Id.* at 653 n.12.

204. *Id.* (quoting *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973)).

in the state law analysis, it is again relevant to distinguish between the obligations of the executive receiving the option and the board.

We begin again with an executive who has favorable material inside information about his company upon receiving an option grant. One possibility for the federal disclosure standard applicable to the executive is the one provided by state law. In other words, the executive must disclose the information to a disinterested board before accepting the grant. Without such minimal disclosure, the executive possessing significant favorable inside information about his company who accepts a large option grant from a board that is not privy to such information will enjoy a profit attributable solely to the eventual release of the inside information. In the absence of any reason to believe otherwise, both the board and shareholders will assume that this profit is attributable to the executive's efforts or his good fortune. In either case, they will not seek any countervailing adjustment in his compensation, such as a reduction in the number of options granted, salary, or bonus.

If the account in Part I.A that managers are able to influence the timing of their option grants is correct, then shareholders, protected by Rule 10b-5 when initially purchasing their shares on the open market, would, upon becoming shareholders, be at the mercy of managers' ability to divert firm profits to themselves in the form of favorably timed option grants. Information about such behavior is relevant to shareholders' investment decisions because it affects both the level and composition of managerial pay.<sup>205</sup> Yet, it would never be made available to shareholders.

Requiring executives to disclose inside information to the board when the information is not already in the board's possession, as required under state fiduciary duty principles, achieves some of the policy objectives of section 10(b). It should, for example, give the board the ability to adjust executive compensation in light of the inside information. Such disclosure is unlikely, however, to address adequately section 10(b)'s purposes of protecting investors and promoting market confidence. First, it is well settled that a corporation "in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them."<sup>206</sup> Thus, a corporation cannot trade its own stock based on material nonpublic

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205. See John C. Coffee, *Is Selective Disclosure Now Lawful?*, N.Y. L.J., July 31, 1997, at 5, 6.

206. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994).



information.<sup>207</sup> Allowing a company to time option grants around inside information can be analogized to allowing a company to engage in insider trading in the open market and then use the profits to pay its executives.<sup>208</sup>

Board knowledge alone might also be insufficient to discharge the disclosure duty of section 10(b) because, even if the board were to treat favorable grant timing as executive compensation, periodic disclosure regarding such compensation occurs with a substantial delay.<sup>209</sup> Moreover, in certain cases, it does not occur at all. For example, a company that makes an option grant to executives shortly before being acquired and whose stock ceases to be publicly traded before the filing of its next annual report will generally not be required to disclose compensation information for that year.<sup>210</sup>

Without timely disclosure of favorable option grant timing, investors cannot properly assess the effect of a company's option awards on firm performance. Nor can shareholders exercise any injunctive remedies with respect to such awards available to them under state law.<sup>211</sup> To the contrary, rhetoric claiming that options

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207. See WANG & STEINBERG, *supra* note 156, § 5.2.3.3, at 297–98.

208. Of course, the counterparties to the corporation's trading and consequently the parties suffering the loss from it would be different in each case.

209. Disclosure regarding executive compensation is required to be included in the annual report on Form 10-K of an Exchange Act reporting company. See Securities Exchange Act of 1934, 15 U.S.C. § 78m(a) (2000) (requiring annual reports); 17 C.F.R. §§ 240.13a-1 to -13f-1 (2002) (providing rules on periodic disclosure requirements of Exchange Act registered companies); Form 10-K, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,105 (June 25, 2003) (Item 11) (requiring executive compensation information at Item 11); Regulation S-K, Item 402, 17 C.F.R. § 229.402 (2002). Although corporate insiders are required to report to the SEC an issuer's grant to them of stock options on Form 4 pursuant to section 16(a) of the Exchange Act no later than the end of the second business day following the date of the grant, Form 4 does not call for disclosure of any compensatory element associated with the grant. 15 U.S.C. § 78p(a), as amended by § 403(a) of the Sarbanes-Oxley Act 2002, Pub. L. 107-204, § 403, 15 U.S.C. § 78(p)(a), 116 Stat. 789 (July 30, 2002); Form 4, 5 Fed. Sec. L. Rep. (CCH) ¶ 33,721 (May 21, 2003).

210. If, however, the transaction requires shareholder approval and stock options were granted in connection with the transaction, information relating to the options would need to be disclosed in the proxy statement in which shareholder approval is being sought. Regulation S-K, Item 404, 17 C.F.R. § 229.404.

211. See *Goldberg v. Meridor*, 567 F.2d 209, 218–21 (2d Cir. 1977) (nondisclosure to shareholders as to material facts of transaction held actionable under Rule 10b-5 even though no shareholder action was required with respect to the transaction based on shareholders' potential ability to enjoin transaction). *But see* *Isquith v. Caremark Int'l, Inc.*, 136 F.3d 531, 534 (7th Cir. 1998) (noting that this circuit has rejected *Goldberg*). For an early discussion of basing a Rule 10b-5 action on nondisclosure to shareholders, see generally Ely J. Malkin, Comment, *Santa Fe Industries v. Green Revisited: A Critique of Circuit Court Application of Rule 10b-5 to Breaches of Fiduciary Duty to Minority Shareholders*, 28 UCLA L. REV. 564 (1981).

align managerial and shareholder interests generally accompanies proxy statement proposals seeking shareholder approval of executive stock option plans. For example, the purposes of these plans are often stated as being “to increase incentives,” “encourage share ownership,” and “stimulate the efforts” of key executive officers.<sup>212</sup> The underlying message of these statements is, of course, to persuade shareholders that performance-based compensation encourages executives to promote the shareholders’ long-term interests.

If the award of substantial options to executives is, indeed, perceived to incorporate valuable information about incentivizing executives, then the possibility that such awards were systematically timed to precede the release of material information known by insiders on the grant date would presumably lead investors to question the effectiveness of the option grants in promoting long-term company performance. The reason for this is that it would be virtually impossible under these circumstances to predict the incentive effects of the adoption of an option plan or of individual grants. In other words, investors would be unable to distinguish between the (backward-looking) compensation and (forward-looking) incentive aspects of the options until subsequent disclosure, if any, were made about the inside information in an executive’s possession at the time of the grant.

Even after any such delayed disclosure were made, investors would, knowing that boards were timing options to benefit managers without regard to the company’s future performance, be unable to rely on option awards to reduce agency costs. Loss of this vehicle for aligning managerial and shareholder interests might seriously erode the belief of investors that managers have financial incentives to maximize long-term company performance, thereby damaging their confidence in the market. It may, therefore, be appropriate to require disclosure by executive optionees who are granted options while in possession of inside information similar to that required of insiders in their open market dealings—namely, substantive disclosure of the inside information to shareholders before the grant is made or abstention from accepting the grant.

It might be argued that, under the misappropriation theory of insider trading liability, board knowledge prevents the deception requirement of Rule 10b-5 from being satisfied. The

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212. See, e.g., GENENTECH, INC., PROXY STATEMENT 11 (2002) (describing rationale for option plan) (on file with the North Carolina Law Review); INTEL CORP., PROXY STATEMENT 20 (1989) (same) (on file with the North Carolina Law Review).

misappropriation theory, articulated in the Supreme Court's decision in *United States v. O'Hagan*, provides that a party who trades on material nonpublic information without disclosure to the source of that information violates Rule 10b-5.<sup>213</sup> Under that view, the company's knowledge of the information precludes deception.<sup>214</sup>

Applicability of the misappropriation theory to classical insider trading cases is, however, problematic. In *O'Hagan*, the Supreme Court validated the misappropriation theory as a basis for insider trading liability.<sup>215</sup> The misappropriation theory holds that a person violates Rule 10b-5 when, in breach of a duty she owes to the source of certain information, she uses that information in connection with a securities transaction.<sup>216</sup> The misappropriation theory was upheld by the Court in the context of the following facts. The law firm of Dorsey & Whitney represented Grand Metropolitan PLC ("Grand Met") in connection with its possible tender offer for the common stock of the Pillsbury Company.<sup>217</sup> Although O'Hagan, a partner in the law firm of Dorsey & Whitney, did no work on the matter, he learned of Grand Met's intentions and accumulated call options and shares of Pillsbury stock.<sup>218</sup> When Grand Met eventually announced its tender offer, Pillsbury stock rose and O'Hagan pocketed a substantial profit.<sup>219</sup>

The classical theory of insider trading liability could not support an action against O'Hagan. O'Hagan was a partner in Dorsey & Whitney. He had no fiduciary relationship with the shareholders of Pillsbury. As in *Dirks*, O'Hagan "himself was a stranger to [Pillsbury], with no pre-existing fiduciary duty to its shareholders."<sup>220</sup> Accordingly, he had no specific relationship that could give rise to a

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213. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

214. *Id.* at 655.

215. *Id.* at 653. The misappropriation theory has been alternately praised and criticized. See generally Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999) (stating that the court had made a "hash" of the law when it upheld the misappropriation theory); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998) (questioning whether the misappropriation theory will be a workable instrument for enforcing insider trading); A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 17 (1998) (stating that the misappropriation theory "secures the law of insider trading to firmer foundations"). Irrespective of its merits, however, *O'Hagan* has made the misappropriation theory settled law.

216. *O'Hagan*, 521 U.S. at 652.

217. *Id.* at 647.

218. *Id.* at 647-48.

219. *Id.* at 648.

220. *Dirks v. SEC*, 463 U.S. 646, 665 (1983).

duty to disclose or abstain. O'Hagan's trading could not breach a fiduciary duty where none existed.

The government had therefore not relied on the classical theory of insider trading liability in prosecuting O'Hagan, instead trying the case under the misappropriation theory. O'Hagan was convicted in district court for violation of Rule 10b-5, but the Eighth Circuit Court of Appeals rejected use of the misappropriation theory as a basis for insider trading liability and reversed his conviction.<sup>221</sup> Because a conflict in the circuits existed with respect to the viability of the misappropriation theory, the Supreme Court granted certiorari.<sup>222</sup> The Supreme Court reversed the Eighth Circuit, thereby establishing the misappropriation theory as a distinct theory of liability under Rule 10b-5.<sup>223</sup> According to the Supreme Court, O'Hagan's deception involved "feigning fidelity to the source of information."<sup>224</sup> Thus, had O'Hagan obtained his law firm's consent to trade on the nonpublic information that he acquired by virtue of his position, or had he merely disclosed to his law firm that he planned to trade on it, there would have been no deception and thus no section 10(b) violation.<sup>225</sup>

Professor Saikrishna Prakash has argued that, with minor modifications, *O'Hagan's* discussion of deception could logically be extended beyond misappropriation cases to cases of classical insider trading.<sup>226</sup> Noting that under the classical theory, an insider's fiduciary duty runs to the company's shareholders, Prakash posits that an insider's disclosure merely of an intent to trade using material nonpublic information (as opposed to the substantive information itself) eliminates any possible deception of shareholders should the insider subsequently execute her trading plans.<sup>227</sup> Alternatively, Prakash suggests that a company's authorization of insider trading by its executives precludes deception.<sup>228</sup>

Although applying *O'Hagan's* treatment of deception to the

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221. *United States v. O'Hagan*, 92 F.3d 612, 613-14 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

222. *O'Hagan*, 521 U.S. at 649.

223. *See id.* at 650 (holding that liability under section 10(b) may be predicated on the misappropriation theory).

224. *Id.* at 655.

225. *Id.* at 660.

226. *See* WANG & STEINBERG, *supra* note 156, § 5.4.3; Coffee, *supra* note 205, at 5; Painter et al., *supra* note 215, at 180 n.116; Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1516 (1999).

227. Prakash, *supra* note 226, at 1515.

228. *Id.*

classical theory is intriguing, there are good reasons to confine it to trading by “outsiders” (i.e., traders, such as O’Hagan, who owe a fiduciary duty not to the shareholders of the companies in whose stock they trade but, rather, to the source of the information). First, there is the express language of *O’Hagan*: “[t]he misappropriation theory is . . . designed to ‘protec[t] the integrity of the securities markets against abuses by ‘outsiders’ to a corporation who have access to confidential information that will affect th[e] corporation’s security price when revealed, but who owe no fiduciary or other duty to that corporation’s shareholders.’ ”<sup>229</sup> Like the classical theory, the misappropriation theory requires a relationship of trust or confidence.<sup>230</sup> In the misappropriation theory context, however, the operative relationship is not that between “the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”<sup>231</sup> Instead, it is the relationship between a corporate “outsider”—one with no relationship to the shareholders of the corporation in whose securities he trades—and the source of the information.

Second, extending *O’Hagan* to classical insider trading cases presents the possibility that a corporate board could decide that inside information is a corporate perquisite that managers should be authorized to use to gain a strategic advantage in trading the company’s shares. In other words, boards could adopt a corporate policy allowing insider trading by managers. While some scholars have argued that such private contracting is efficient,<sup>232</sup> its application in the classical disclose or abstain arena undermines the interests of investors that section 10(b) was designed to protect.<sup>233</sup>

Under the classical theory, the operative fiduciary relationship is between the insider and the party on the other side of the transaction. To the extent shareholders are intended to be protected from insiders’ use of their privileged positions to gain an unfair trading advantage, disclosure of no more than an insider’s trading plans

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229. *O’Hagan*, 521 U.S. at 653 (quoting Brief for Petitioner at 14, *United States v. O’Hagan*, 521 U.S. 642 (1997) (No. 86-242)).

230. Rule 10b5(2) provides a non-exclusive list of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory. See SEC Rule 10b-5(2), 17 C.F.R. § 240.10b-5(2) (2002).

231. *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

232. See, e.g., Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 39–47 (1984) (arguing that a “subject of contract” test should replace the “pecuniary gain” test).

233. See WANG & STEINBERG, *supra* note 156, § 5.4.1, at 386 & n. 49y (Supp. 2002); Coffee, *supra* note 205, at 5.

would be incomplete. Shareholders would still confront transactions in which their trading disadvantage could not be overcome with research or skill.<sup>234</sup> Nor would such limited disclosure promote confidence in the securities markets. On the contrary, it would be more likely to undermine it by reducing whatever expectations investors had of earning market returns.<sup>235</sup>

In misappropriation cases, however, the interest to be protected is the source's exclusive right to the applicable information. In such a context, board authorization of trading on nonpublic information is well suited to protecting the interests of the source of the information. The information on which the agent wishes to trade is already in the possession of, indeed belongs to, the source of the information. Eliminating any deception of the source under the misappropriation theory thus requires awareness of the fiduciary's intent to use the nonpublic information for personal gain, thereby precluding any feigning of fidelity to the source of the information.<sup>236</sup>

Having concluded that neither knowledge of, nor authorization by, the board negates deception in classical insider trading cases, we are left with the question whether the same can be said in the setting of favorably timed option grants. *Dirks* suggested that it can when it equated a breach of an insider's federal common law fiduciary duty with deception:

Not "all breaches of fiduciary duty in connection with a securities transaction," however, come within the ambit of Rule 10b-5. There must also be "manipulation or deception." In an inside-trading case this fraud derives from the "inherent unfairness involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." Thus, an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes "secret profits."<sup>237</sup>

In other words, an insider's breach of federal fiduciary duty law is deemed inherently deceptive. Thus, an executive who knowingly receives a favorably timed option grant faces potential liability under Rule 10b-5 whenever he fails to satisfy his federal common law obligation to disclose or abstain. As discussed above, that obligation

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234. See *O'Hagan*, 521 U.S. at 658-59; BAINBRIDGE, *supra* note 79, at 548.

235. See BAINBRIDGE, *supra* note 79, at 548-50.

236. *O'Hagan*, 521 U.S. at 655.

237. *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (citations omitted).

requires, at a minimum, that he disclose his knowledge to the board and, possibly, that he disclose it publicly or reject the options.

Because an executive's fiduciary duty of disclosure under federal law may, in the context of an option grant, be limited to disclosure to the board, a knowledgeable board's duty of disclosure to shareholders, if any, must still be addressed. The purposes underlying section 10(b) require a knowledgeable board to avoid making materially misleading statements in connection with a securities transaction.<sup>238</sup> Because shareholders have an interest in knowing both the level and structure of executive pay, information regarding all forms of executive compensation, including that associated with favorably timed option grants, is potentially significant to them. The details of executive compensation arrangements affect not only their investment decisions but also their decisions whether and how to influence executive pay. Although, as noted above, disclosure of favorably timed option grants as a component of executive pay could be accomplished as part of a company's periodic compensation disclosure, the delays associated with such disclosure limit its effectiveness. Nevertheless, such disclosure may be sufficient to bar a Rule 10b-5 claim in the absence of clear evidence that shareholders are harmed by failure to disclose either: (1) the substantive material nonpublic information in their possession before the grant is made; or (2) the compensatory component of a favorably timed grant when the grant is made.

The foregoing conclusions are consistent with the sentiment underlying the 1934 Act that those "charged with the administration of other people's money must not use inside information for their own advantage."<sup>239</sup> Requiring, at a minimum, full disclosure of executive compensation attributable to favorably timed option grants to be included in a company's periodic compensation disclosure would provide shareholders with more accurate information relating to the level and nature of top managers' pay. A rule of disclosure or abstention from accepting the grant would go even further in eliminating insiders' ability to profit on nonpublic information. In either case, the disclosure would generally eliminate the use of option grant timing as a means of awarding executives secret compensation and further the 1934 Act's significant purpose of "eliminat[ing] the idea that use of inside information for personal advantage was a

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238. See *Thel*, *supra* note 114, at 415 (describing the fundamental purpose of the Securities Act as that of full disclosure).

239. H.R. REP. NO. 73-1383, at 13 (1934).

normal emolument of corporate office.”<sup>240</sup>

### B. Purchase or Sale

Rule 10b-5, by its terms, operates only in connection with the “purchase or sale” of a security.<sup>241</sup> The Supreme Court has held that the holders of exchange-traded puts, calls, options, and other contractual rights or duties to purchase or sell securities are “purchasers” or “sellers” under Rule 10b-5.<sup>242</sup> Satisfaction under existing case law of the purchase or sale requirement is not so clear, however, in the context of a company that grants options to its employees.<sup>243</sup>

In addition, in statutory construction cases, the plain language of the statute is of paramount importance.<sup>244</sup> Section 3(a)(14) defines the term “sale” for purposes of the Exchange Act “unless the context otherwise requires” to “include any contract to sell or otherwise dispose of.”<sup>245</sup> There is a parallel definition of the term “purchase.”<sup>246</sup> Although the various meanings of the words “purchase” and “sale” throughout the securities laws is a relevant factor in interpreting their meaning in Rule 10b-5, the Supreme Court has stated that the scope of the words “purchase or sale” in section 10(b) must be determined in the context of that section, regardless of what they or similar words

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240. *Dirks*, 463 U.S. at 653 n.10 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1981)).

241. The United States Justice Department and the SEC have standing under Rule 10b-5 to sue any person who commits fraud in connection with a purchase or sale of a security. In order to bring a private party action under Rule 10b-5, however, the plaintiff must allege that she was an actual purchaser or seller of securities. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–31 (1975).

242. See *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 593–94 (2001); *Blue Chip Stamps*, 421 U.S. at 751.

243. Yablon & Hill, *supra* note 85, at 98 n.59.

244. *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 450 (2002).

245. Securities Exchange Act of 1934 § 3(a)(14), 15 U.S.C. § 78c(a)(14) (2000).

246. *Id.* § 78c(a)(13). The Supreme Court has noted that the definition of “sale” in section 2(3) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(3), differs from that in the Exchange Act in that it requires that the contract of sale or disposition of a security be “for value,” but has not reached the issue whether the word has different meanings under each. *Int’l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 556–57 n.8 (1979). Nevertheless, courts have generally incorporated the “for value” requirement of the Securities Act definition into the Exchange Act definition. See *Lawrence v. SEC*, 398 F.2d 276, 280 (1st Cir. 1968). *But see Rathborne v. Rathborne*, 683 F.2d 914, 919–20 & nn.17–20 (5th Cir. 1982) (focusing not on the “for value” requirement but rather on whether the transaction created fundamental change in the nature of the investment). For purposes of this Article, I assume that a contract to buy or sell securities constitutes a “sale” or “purchase” under the Exchange Act only if the seller receives value for it.



may mean in other provisions of the securities laws.<sup>247</sup>

Thus, in interpreting the "purchase or sale" language of section 10(b), the courts have looked beyond the traditional meanings of those words.<sup>248</sup> In particular, guidance in determining the reach of the words "purchase or sale" under Rule 10b-5 is to be found by looking to whether the conduct in question is the type of behavior that section 10(b) and Rule 10b-5 were intended to prohibit.<sup>249</sup> Also informing the proper interpretation of the language of section 10(b) is the Supreme Court's instruction in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*<sup>250</sup> that section 10(b) must be read "flexibly, not technically and restrictively."<sup>251</sup> This is necessary, as the Court cautioned in that case, because practices "'legitimate for some purposes may be turned to illegitimate and fraudulent means.'"<sup>252</sup> Therefore, the effectiveness of the securities laws requires that the SEC be given broad discretionary power in their application.

The strongest precedent for the proposition that a stock option award satisfies the "purchase or sale" requirement of Rule 10b-5 is *SEC v. Texas Gulf Sulphur Co.*<sup>253</sup> Recall that *Texas Gulf Sulphur* held that executives who received stock options while in possession of the nonpublic material information that their company had discovered an extraordinarily valuable mineral deposit on land owned by it violated Rule 10b-5 by accepting the options without disclosing the information. The issuance of the options was made pursuant to Texas Gulf Sulphur Company's Stock Option Incentive Plan, which was adopted to provide incentives to officers and highly paid employees.<sup>254</sup> Although the court did not elaborate on the point, it must have assumed that the optionees were purchasers under Rule 10b-5 because without the benefit of that assumption, there could have been no fraud "in connection with a purchase or sale," as required by the Rule.

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247. *SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 466 (1969).

248. *See, e.g.*, *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 266 (7th Cir. 1967) (stating that Congress did not intend "purchase" and "sale" to have limited commercial meanings); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 202 n.9 (5th Cir. 1960) (noting that "sale" and "purchase" are both broad).

249. *Nat'l Sec.*, 393 U.S. at 467.

250. 404 U.S. 6 (1971).

251. *Id.* at 12.

252. *Id.* (quoting H.R. REP. NO. 73-1383, at 7 (1934)).

253. 401 F.2d 833 (2d Cir. 1968).

254. *SEC v. Tex. Gulf Sulphur Co.*, 258 F. Supp. 262, 290-91 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 312 F. Supp. 77 (S.D.N.Y. 1970).

Notwithstanding *Texas Gulf Sulphur*, courts have been reluctant to accept the proposition that a stock option grant satisfies the “purchase or sale” requirement of Rule 10b-5.<sup>255</sup> The vast majority of cases addressing the question arise in the context of employees who receive stock option awards that ultimately prove worthless.<sup>256</sup> Typically arguing that they were deceived into believing that the options awarded to them had substantial value, these employees claim that they were “purchasers” of the options and therefore entitled to bring a private party action under Rule 10b-5.<sup>257</sup>

A recent example is *In re Cendant Corporation Securities Litigation*.<sup>258</sup> The case involved a former employee of Cendant Corporation and its predecessor CUC International, Inc. (“CUC”) who received employee stock options under an employee stock option plan.<sup>259</sup> After the options had been granted, Cendant announced that it had discovered accounting irregularities in certain former CUC business units, and its stock promptly fell by forty-seven percent.<sup>260</sup> In rejecting the employee’s claim that she was a “purchaser” of options within the meaning of Rule 10b-5, the court was persuaded that the employee’s receipt of her options by virtue solely of the fact that she qualified for participation under the plan did not “suffice to constitute the type of investment which the Securities Acts were intended to regulate.”<sup>261</sup> In concluding that the employee had not made an affirmative investment decision to acquire her options, the court noted that: (1) participation in the plan was compulsory, so that it was a mere incident of employment and her only choice would have been to forego the receipt of the benefit; and (2) the plan was noncontributory, so that she did not receive her

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255. See, e.g., *Int’l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 566–69 (1979); *In re Cendant Corp. Securities Litigation*, 76 F. Supp. 2d, 539, 544–45 (D.N.J. 1999).

256. See, e.g., *In re Enron Corp. Sec. Derivative & ERISA Litig.*, No. CIV.A.H-01-3913, 2003 WL 22245394, at \*88 (S.D. Tex. Sept. 30, 2003) (where participants in employee stock option plans brought a class action lawsuit after Enron went bankrupt and the options became worthless, the court suggested that “a compulsory, noncontributory program . . . would not be subject to the Securities Act”); *In re Cendant Corp.*, 76 F. Supp. 2d at 541, 545 (indicating that where a former employee brought suit when stock options became worthless after accounting irregularities were discovered, the plaintiff had no standing under Rule 10b-5 because the employee stock option plan was compulsory and noncontributory).

257. See *In re Enron*, 2003 WL 2255392, at \*88; *In re Cendant*, 76 F.Supp.2d at 545.

258. 76 F. Supp. 2d 539 (D.N.J. 1999).

259. *Id.* at 541.

260. *Id.*

261. *Id.* at 544–45 (quoting *Bauman v. Bish*, 571 F. Supp. 1054, 1064 (N.D. W. Va. 1983)).

options as part of a bargained-for exchange.<sup>262</sup>

In contrast, the court in *Yoder v. Orthomolecular Nutrition Institute, Inc.*,<sup>263</sup> stated that a Rule 10b-5 action is available to an individual who promises to work for an employer in return for the latter's promise to issue stock, with or without the payment of a salary.<sup>264</sup> In *Yoder*, the court believed that the plaintiff gave up specific consideration—namely her way of life—in exchange for a contract for the issuance of stock.<sup>265</sup> Having given value for the contract, the plaintiff qualified as an investor to whom section 10(b) was intended to apply.<sup>266</sup>

In the foregoing cases, the courts distinguished between a bargained-for exchange, in which the employee has negotiated with his employer to exchange his labor for a compensation package that include stock options, on the one hand, and an employee's receipt of stock options "as a bonus, granted gratuitously by an employer," on the other hand.<sup>267</sup> Under the former circumstances, which generally involve senior level employees, the courts have concluded that the employees were investors who made an affirmative investment decision to exchange their labor for stock options. Under the latter circumstances, which generally involve the receipt of stock options by rank-and-file employees, the courts have deemed the employees to have received their stock options incidentally to their employment. In other words, the courts have taken the view that the stock option component of these employees' compensation packages was largely irrelevant to their employment decision. As such, the courts have held that these employees are not investors entitled to the protection of section 10(b).<sup>268</sup>

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262. *Id.*; see also *Foltz v. U.S. News & World Report, Inc.*, 627 F. Supp. 1143, 1158 (D.D.C. 1986) (noting the "element of voluntariness"). But see *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1130 (9th Cir. 2002) (holding that an option grant is "a sale under the securities laws because it is a contract to sell a security when the option is exercised" and expressly rejecting the contrary holding of *In re Cendant Corp.*).

263. 751 F.2d 555 (2d Cir. 1985).

264. *Id.* at 561 (noting that, although it did not hold so, it saw "little reason for not holding to that effect"); see also *Rudinger v. Ins. Data Processing, Inc.* 778 F. Supp. 1334, 1338-39 (E.D. Pa. 1991) ("An agreement exchanging a plaintiff's services for a corporation's stock constitutes a 'sale' under the terms of 10b-5."); *Collins v. Rukin*, 342 F. Supp. 1282 (D. Mass. 1972) (distinguishing between a bonus granted gratuitously by an employer which would not support sale treatment and an option that was a quid pro quo offered to induce plaintiff to enter into employment which would).

265. *Yoder*, 751 F.2d at 560.

266. *Id.* at 559-61.

267. *Collins*, 342 F. Supp. at 1289.

268. The express language of section 10(b) provides a basis for this inquiry in giving the SEC rulemaking authority "as necessary or appropriate in the public interest or for the

*Texas Gulf Sulphur* can be read consistently with the foregoing cases, whatever the merits of the distinction those cases make between employees who individually bargain for stock options and those who receive them as an automatic benefit.<sup>269</sup> As discussed above,<sup>270</sup> *Texas Gulf Sulphur* dealt with insiders accepting a grant of stock options while in possession of favorable material nonpublic information. Although the court did not offer an analysis of its holding, it noted that the executives were all members of “top management.”<sup>271</sup> Because these executives likely negotiated for participation in TGS’s option plan as an element of their compensation packages, the Court could easily have concluded that the executives had bargained for the right to receive options. Once a bargained-for-exchange is shown, the case falls within the *Yoder* line of cases, in which the optionee is an investor who qualifies as a purchase under Rule 10b-5.

Perhaps more important than the fact that the outcome in *Texas Gulf Sulphur* can be analyzed in terms of the bargained-for-exchange theory of the *Yoder* line of cases, however, is the observation that most of the cases dealing with whether employee stock option grants are “purchases or sales” focus on the particular set of circumstances in which a recipient of stock options appeals to Rule 10b-5 in connection with a diminution in value of those securities. That context, in which an optionee seeks relief based on his corporation’s fraudulent conduct in granting him options, raises different policy concerns than the context in which existing shareholders are harmed by a grant of options to managers with an exercise price that understates the actual market value of the underlying stock. These differing concerns must be considered because whether a transaction qualifies as a purchase or sale under Rule 10b-5 depends critically on whether the conduct in issue “is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule.”<sup>272</sup>

When grants are fraudulently timed for the secret enrichment of managers, the resulting harm implicates the investor protection

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protection of investors.” Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j(b) (2000) (emphasis added); see Steve Thel, *Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934*, 1988 COLUM. BUS. L. REV. 359, 377 (“Section 10(b) itself states its end—the SEC is to protect investors and the public.”).

269. For a critique of this distinction, see generally Matthew T. Bodie, *Aligning Incentives: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539 (2003).

270. See *supra* notes 176–81 and accompanying text.

271. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 857 (2d Cir. 1968).

272. SEC v. Nat’l Sec., Inc., 393 U.S. 453, 467 (1969).

concerns of section 10(b). As discussed in Part II.B, stock options awards to insiders with an exercise price that does not fully reflect favorable material nonpublic information imposes direct costs on shareholders.<sup>273</sup> The resulting wealth transfer from investors to insiders is the same type of harm as that suffered by investors who sell their shares to an insider where the insider possesses favorable nonpublic information about the issuer of which the investor is ignorant. In both cases, information has been concealed from the shareholder that, if disclosed, would have affected the value of the applicable securities and eliminated the resulting windfall to the insider.

### C. *In Connection with*

To constitute a section 10(b) violation, it is not enough that a fraud have been perpetrated; the fraud must be “in connection with the purchase or sale of any security.”<sup>274</sup> This requirement ensures that there be a meaningful nexus between the fraud perpetrated and a securities transaction, in keeping with the Exchange Act’s aim of preserving the integrity of the securities markets. As the Supreme Court stated in *SEC v. Zandford*,<sup>275</sup> its most recent pronouncement on the “in connection with” requirement, Congress intended section 10(b) neither to provide a broad federal remedy for all fraud nor “to convert every common-law fraud that happens to involve securities into a violation of section 10(b).”<sup>276</sup>

According to the Supreme Court’s interpretation of the “in connection with” requirement, the securities transaction and the fraudulent practices alleged cannot be independent events for a section 10(b) violation to exist. For example, a section 10(b) violation would not exist where a securities broker lawfully consummated a transaction on behalf of a customer and later stole the proceeds.<sup>277</sup> Similarly, the Supreme Court in *United States v. O’Hagan*<sup>278</sup> suggested that there would be no section 10(b) violation where a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds to invest in securities.<sup>279</sup> In the foregoing cases, the fraud perpetrated is sufficiently detached from

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273. *See supra* Part II.B.

274. Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j(b) (2000).

275. 535 U.S. 813 (2002).

276. *Id.* at 820.

277. *See id.*

278. 521 U.S. 642 (1997).

279. *Id.* at 656 (quoting with approval the Government’s Brief on this point).

the subsequent securities transaction that the “in connection requirement” is not met.<sup>280</sup>

In *Zandford*, the Court considered a case in which a father and daughter gave a securities broker discretion to manage an investment account for “safety of principal and income.”<sup>281</sup> Instead of pursuing that objective, the broker sold securities in the account and then made personal use of the proceeds.<sup>282</sup> Some of the transfers involved the broker’s writing checks against a mutual fund in the customers’ names, which required liquidating securities in order to redeem the checks.<sup>283</sup> The Court first noted, as it had in previous cases, that section 10(b) is to be construed flexibly to effectuate its remedial purposes.<sup>284</sup> It then observed that the SEC had consistently adopted a broad reading of the “in connection with” requirement and gave the SEC’s interpretation deference.<sup>285</sup>

Turning to the merits of the case, the Court concluded that the broker’s securities sales were sufficiently related to his fraudulent scheme to convert the proceeds of the sales to his own use to satisfy the “in connection with” requirement.<sup>286</sup> The Court found it relevant that each securities sale of the broker was made for his own benefit, so that the broker’s fraud coincided with the securities sales. As such, the two were not independent because the broker initiated the securities sales in furtherance of his fraudulent purpose. This practice, the Court noted, was especially threatening to investor confidence, which the Exchange Act was intended to promote, because it prevents investors from trusting that their brokers are executing transactions for their benefit and compromises the use of discretionary accounts.

Assume that the grant of an executive stock option qualifies as a “purchase or sale” under section 10(b). If favorable inside information were known to executives when they were granted a stock option award, then the grant and the executive’s knowledge of the inside information must not be independent to meet the “in connection with” requirement. In these circumstances, shareholders are given the false impression that the options are being granted at

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280. *Id.* at 656–57.

281. *Zandford*, 535 U.S. at 822.

282. *Id.* at 820.

283. *Id.* at 821.

284. *Id.* at 819 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

285. *Id.* at 819–20.

286. *Id.* at 825.

their fair market value, when in fact they bear an exercise price that does not fully incorporate inside information known to the executives. Put another way, the options are discount options masquerading as at-the-money options. As in *Zandford*, the fraud coincides with the securities sales. The two events are not independent. In fact, the timing of the option grant is determined to maximize the windfall to the optionee, just as the broker's desire for funds in *Zandford* determined the timing of his securities sales.<sup>287</sup>

#### CONCLUSION

For better or worse, stock options are the principal way that companies in the United States try to motivate managers to act in the best interests of their shareholders. The prevalence of stock options as a component of executive pay creates the possibility for managers to behave opportunistically with respect to the timing of option grants, when an option's exercise price is typically established at the then-current market price of the underlying stock. Specifically, managers can enhance the value of their options by timing the options' award dates to precede the release of favorable corporate information that was known only to insiders at the time of the grant. In fact, several studies have suggested that such opportunistic timing of stock option awards occurs.

On its face, using material nonpublic information as a means of compensating executives would seem to violate the federal insider trading prohibition of Rule 10b-5. After all, the Supreme Court in *Dirks* referred specifically to the use of inside information by corporate insiders to make "secret profits" as a wrong that Rule 10b-5 was intended to prevent. An inquiry into modern insider trading jurisprudence, however, highlights difficulties in applying current doctrine to intra-corporate transactions such as stock option grants. In particular, the source of the fiduciary duty—state or federal—that must be breached as a prerequisite to a federal insider trading violation is not certain. Moreover, the additional requirement that

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287. The fact that the option grant might also involve a legitimate purpose—namely, to motivate the executive—should not remove the transaction from the reach of section 10(b). It was the broker's mandate in *Zandford* to trade securities in his customers' account. Indeed, the broker may well have timed his trades consistently with the stated objectives for the account. What the Court found dispositive in *Zandford* was that the broker's sales were made to further his fraudulent scheme. *Id.* at 820; *see also* *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 597 (2001) (holding that seller's fraud was "in connection with" sale of an option where seller sold option while secretly intending not to permit its exercise).

the breach of fiduciary duty cause some deception of investors does not contain much guidance on who must be deceived or how.

This Article has tried to show that an executive who uses inside information to time option awards for personal gain without, at a minimum, disclosing such information to the board of directors, violates Rule 10b-5. This is true irrespective of whether state or federal law is used to determine the fiduciary duties of managers. The Article further contends that if the board has inside information at the time that it grants an option, it must at least disclose the compensatory element of the grant in its regular executive compensation disclosure. Moreover, if it is federal rather than state law that supplies the substance of the fiduciary duty requirement, then the executive or the board must go further and fully disclose the inside information before the grant is made or avoid the grant. This Article has also analyzed the requirement of an insider trading violation that any fraud be "in connection with the purchase or sale" of a security and concluded that this requirement does not pose a problem for applying Rule 10b-5 to option grants.

Application of Rule 10b-5 to stock option awards need not unduly restrict companies from awarding stock options. For example, stock options granted on a periodic basis should cleanse the grants. Corporate officials could also wait until after the dissemination of earnings or other important information before making option grants. Another appropriate method of granting options while material inside information is pending disclosure is to postpone the establishment of the options' exercise price for a six-month period, by which time material inside information pending at the time of the grant can be assumed to have become public. These sorts of compliance programs are routinely implemented to protect against traditional insider trading violations and could easily be applied to stock option awards.



