LOS ANGELES
Daily Journal
www.dailyjournal.com
TUESDAY, JUNE 28, 2016
PERSPECTIVE

Court clears up admin of stock options

By Marc Boiron

In *CDX Holdings Inc. v. Fox*, the Delaware Supreme Court affirmed the Delaware Court of Chancery's decision that a class of optionholders of a corporation was entitled to damages in the amount of approximately $16.3 million. The court concluded that the actions of certain directors and officers of the corporation in connection with the consummation of a merger resulted in a breach of the corporation's stock incentive plan.

In 2011, Caris Life Sciences, Inc., the parent of three operating businesses, began evaluating strategic alternatives to raise capital and return capital to investors. Caris' board of directors ran a process to sell one of the three businesses. Miraca Holdings Inc. ultimately was the winning bidder with a proposal to purchase the business being sold for $725 million.

To minimize taxes payable in connection with the transaction, Caris structured the transaction so that, first, all of Caris' interests in the two subsidiaries not being sold were transferred to a newly-formed subsidiary and, second, all of the interests of that subsidiary were spun-off to Caris' stockholders, leaving Caris with only the business that Miraca would purchase, which merged with Miraca.

In the merger, each in-the-money option was converted into the right to receive the consideration payable to holders of common stock in the merger holding the number of shares of common stock into which the option was exercisable, less the exercise price payable upon exercise of that option. The holders of common stock were entitled to the purchase price minus, among other things, an amount held in escrow, which would be payable in whole or in part at a later date.

Under Caris' 2007 Stock Incentive Plan, in connection with a merger, each optionholder was entitled to receive, in exchange for each share for which an option was exercisable, the amount by which the fair market value of a share, as determined by Caris' board of directors, exceeded the exercise price of the option, without any deduction for amounts held in escrow.


Shutterstock

In the resolutions approving the spinoff and the merger, Caris' board of directors neither adjusted the number of options outstanding to account for the spinoff nor determined the fair market value of a share of Caris' common stock, both of which were required by the plan. Instead, the board of directors used a fair market value set by Gerard Martino, Caris' chief financial officer, who relied on PricewaterhouseCoopers' intercompany tax transfer analysis that the Delaware Court of Chancery determined was designed to ensure that the spinoff would result in zero corporate level tax for Caris, without regard for the accuracy of certain data used in the valuation. A second valuation by Grant Thornton LLP did not remedy the weakness in PwC's valuation because Grant Thornton admittedly copied the analysis in PwC's valuation.

The plaintiff-optionholder commenced an action alleging that Caris breached the stock incentive plan because (i) the board of directors failed to determine the fair market value of a share of Caris' common stock and to adjust the options to account for the spinoff, (ii) the fair market value of a share of Caris' common stock was not determined in good faith, and (iii) the stock incentive plan did not permit Caris to escrow any of the consideration for cancelled options.

The Delaware Court of Chancery decided that Caris breached the stock incentive plan for the reasons alleged by the plaintiff-optionholder, and the Delaware Supreme Court affirmed the decision. On June 22, the parties entered into a settlement agreement, in which Caris' successor entity agreed to pay damages in the amount of $24 million to the optionholders rather than $16.3 million as determined by in the Delaware Court of Chancery's decision. The settlement resulted from an agreed-upon error in the court's calculation of damages.

The Delaware Supreme Court and Delaware Court of Chancery decisions in *CDX* provide useful insight into drafting equity incentive plans and related agreements and interpreting those plans and agreements. First, the treatment of stock options in a merger must be in accordance with the terms of the plan. Although the merger agreement may set forth the treatment of options in the merger, the terms of the merger agreement are always subject to any existing stock incentive plan and stock option agreement. In addition, parties to a transaction should consider contractual rights that exist outside of the stock incentive plan and stock option agreement, such as employment agreements or change of control agreements, which may provide additional rights to the optionholders. The company must comply with those contractual rights, like those set forth in the stock incentive plan, when consummating a merger.

Second, except in rare circumstances, a stock incentive plan should be drafted to provide the administrator of the plan with the ability to address events that may not be contemplated in the plan, which often arise. In addition, stock option agreements should be drafted to avoid limiting the flexibility provided to the administrator in the plan. If the administrator does not have the right to take a desired action under the stock incentive plan or stock option agreement, then the administrator would be required to obtain the applicable optionholder's consent to amend the plan or agreement in a manner that adversely affects the optionholder. At that point in the transaction, the optionholder likely would not consent to the amendment because he or she has the right to a more favorable treatment in the merger than the amended plan or agreement would provide to him or her. Moreover, the vote of the stockholders of the company may be necessary to amend the equity incentive plan to avoid a similar situation going forward.

Third, directors and officers should expect that Delaware courts will uncover efforts to circumvent an important part of a sales process or a third-party's valuation of the corporation. It is common for the controlling stockholder of a corporation who is also a director or officer of that corporation to attempt to control one or more key aspects of a sales process, which commonly involves limiting the parties approached or permitted to bid in connection with a sale of the corporation or influencing a third-party's valuation of the corporation. If one of the minority stockholders is sophisticated enough to recognize flaws in a sales process or merger agreement and retain legal counsel, then the controlling stockholder's circumvention is highly likely to be discovered. Communications between financial advisors and the stockholder, which are not privileged, will be discoverable and used in the litigation against the stockholder. Those communications often create a record that reveals the true motives and intentions of the advisors and stockholders. Therefore, unless a sales process or valuation is sincere and independent, it is unlikely to provide any protection to the stockholders, directors and officers of the company.

Lastly, the treatment of stock options in *CDX* and as discussed herein applies equally to other equity compensation awards. All restricted stock, restricted stock units, stock appreciation rights, phantom stock, dividend equivalents and other incentive awards granted pursuant to a plan are contractual by nature. Therefore, as with stock options, the administration of those awards and their treatment in a transaction will be subject to terms of the applicable award plan and agreement.


MARC BOIRON
Rutan & Tucker

Marc Boiron *is an associate with Rutan & Tucker LLP. You can reach him at (714) 338-1861 or mboiron@rutan.com.*