HANDLING THE STOCK OPTIONS CASE FROM A PLAINTIFF'S PERSPECTIVE

by
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I. **The basics definitions for stock options cases.** See Exhibit A, a simple timeline identifying some of the terms contained in these definitions.

a. "**Black-Scholes**" model — the Black-Scholes model for estimating the value of stock options is a widely-accepted method of valuing options developed by two professors at the University of Chicago. Its primary component is the "spread" between the exercise price and the current market value of the stock (see definition below), but it also takes into consideration the value of the option, given the volatility of the stock at issue, and the length of time the purchaser has to exercise the option. Literally, the formula is as follows:

$C = SN(d_1) - Ke^{(-rt)}N(d_2)$
C = Theoretical call premium
S = Current Stock price
t = time until option expiration
K = option striking price
r = risk-free interest rate
N = Cumulative standard normal distribution
e = exponential term (2.7183)

$$d_1 = \frac{1n(S / K) + (r + s^2/_2)t}{s\sqrt{t}}$$

$d_2 = d_1 - s\sqrt{t}$
s = standard deviation of stock returns
1n = natural logarithm

Black & Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973). Most option cases do not involve substantial disputes over the method of calculating option value under the Black-Scholes model.

b. **Cash exercise** — when an individual uses cash to exercise the option.

c. **Cashless exercise** — if an employee stock option plan permits a "cashless" exercise, the option holder "borrows" money from a brokerage or the employer at no or minimal cost and purchases all shares commensurate with the tendered options. A portion of the shares is then sold, with the proceeds used to repay the loan.

d. **Exercise date** — this is the date that the holder of the option notifies the issuer of securities that he has elected to exercise the option — tender funds in exchange for shares of stock.

e. **Grant date** — the date upon which options are awarded, usually by an employee stock option plan, employment agreement or consulting agreement.

f. **Incentive stock option** — these are options granted to employees, usually based on performance. They are given preferable tax treatment under certain exercise and holding conditions.

g. **Non-qualified option** — an option that, unlike an incentive option, is not eligible for favorable tax treatment.

h. **Option term** — the period of time, usually commencing with the grant date, in which the option holder may exercise his options. Frequently, the option term is ten years.

i. **Registration rights** — the right to acquire stock by use of an option does not necessarily entail the right to acquire "publicly traded" stock. The party set to acquire stock via stock options may therefore insist upon "registration rights." These rights often consist of the right to insist that the issuer will undertake to register the stock to be transferred pursuant to the stock option grant at some set time or place. The parties may agree to a “piggyback” registration in which the option holder’s stock will be registered along with stock of others. The parties might also agree that the party exercising the option has the automatic right to obtain “free trading and fully registered’ stock for which a previous registration has occurred.

j. **Spread** — the difference between the option’s “strike price” and the value of the stock on the day of the exercise of the option.

k. **Strike price** — the price at which the owner of the option has the contractual right to make a purchase of stock.

l. “**Underwater**” versus **“in the money**” — an option is said to be “underwater” when the exercise price of the option is higher than its current trading price. An option with a strike price below the current market price is said to be “in the money.”

m. **Unvested/vested** — companies often grant options subject to a vesting schedule, where the options may vest at the rate of, say, one-third per year over three years following the grant of the options. These graduated vesting periods are designed to encourage the employee to remain at the granting firm for a longer period of time. Typically, when options “vest,” it means the employee is contractually entitled to them regardless of later events (with narrow exceptions) and that the employee’s rights in the options may not be diminished absent his consent.

n. **Vesting schedule** — a vesting schedule is a statement of the rate at which options already granted become vested in the owner.

II. The source of stock options and focal points of litigation.

a. **The source of stock option grants.** Most stock options are granted to mid- to high-level managerial employees as benefits derived from their employment with a corporation. There are, however, other means by which a party may come to own an option. He may have received it as part of a divorce settlement, or as payment for consulting services undertaken for a corporation, or even as part of a merger.

b. **Stock option litigation focal points.** Litigation over stock options in Texas tends to break down into several distinct "camps." The following appear to be the principal areas of contention:

i. **Basic entitlement.** Consultant claims that he is entitled to 200,000 options to purchase the stock in newly-minted public corporation in exchange for work done to establish the company's contracts on a pre-IPO basis. *Robert E. Chamberlain, Jr. v. Telscape International, Inc., et al.*; Cause No. 97-53582, 270th Judicial District Court, Harris County, Texas.

ii. **Divorce/valuation disputes.** Because stock options are an increasingly common method of corporate compensation, they often come into play during divorce proceedings, where the value of the options and the steps required under the decree to preserve them are the issue.

iii. **Term disputes.** Where the party granting options concedes that options were granted but disputes the number, term, vesting provisions or exercise rights of the option holders to exercise.

iv. **"Disentitlement" disputes.** These disputes arise when options were granted and their total and terms are known, but something has occurred in the period following the grant of the option that causes the issuer to claim that the owner has lost the option — either the termination of employment for cause, de-listing of the company's shares or some other condition stated in the grant documents. *Thomas K. Grundman v. Key Energy Services, Inc.*; Civil Action No. 4:05-CV-01955, United States District Court, Southern District of Texas, Houston Division.

v. **Valuation as components of other litigation.** Frequently, understanding and evaluating options are necessary to the resolution of officer and/or director breach-of-fiduciary-duty cases, particularly where it is alleged that officers or directors of a publicly-traded company have breached their fiduciary duty to shareholders or creditors in order to obtain more favorably priced options. *Jeff B. Prostok, et al. v. Peter C. Browning, et al.*; No. 05-99-0826-CV, Fifth District Court of Appeals, Dallas, Texas (reversed on other grounds). In such cases, the value of the options, the date of their issuance and timing are evidentiary of some other claim in the case — in *Prostok*, the alleged breach of fiduciary duty by officers in a company emerging from bankruptcy.

III. Preparing and trying the liability case.

a. **Essential preparation.** Essentially, the trial of a stock option case is the trial of a contract claim with overlays of fraud and potentially of conversion thrown in for good measure. If the debate is one of contractual entitlement, the liability case will devolve into proof that the plaintiff has satisfied contractual performance requirements and that the contract provides for a defined number of options on specified terms. Frequently, disputes arise over the meaning of contracts granting options, and in these cases, the preparation and trial of the case is no different than in any other standard contract case — whether the contract has one of two disputed meanings and whether, under the plaintiff's preferred meaning, the defendant has complied. Finally, in what we have identified here as "disentitlement" cases, where options are granted and then claimed to be lost, the trial of the case will again develop into a dispute over the facts relating to the underlying termination of employment or eligibility and whether the issuing defendant is entitled to restrict, withdraw or eliminate option rights.

b. **Understanding the "base" documents.**

i. **Employee incentive plans.** Most current stock options are granted to employees or executives through stock option plans. Because the nature and scope of these plans are virtually always material to a company's GAAP accounting, the plans are disclosed in publicly-filed documents. In addition, both the issuance of options to highly-placed managerial officials and treatment of those officials upon the development of disputes with the company are also on record. Stock option plans contain a number of common elements:

1. **They are usually administered by a specific committee separate from management.** Because virtually all levels of management are eligible for stock options, an agency of the board of directors is usually established to determine the number and terms of stock option grants for any given year.

2. **Exercise price.** Typically, the options granted to employees are priced as of the stock's closing share price on the day of the grant. The general notion here is that all members of management ought to be attempting to increase the value of the enterprise. As a result, exercise prices are set on a "current" basis so that management will profit only if their efforts result in an increased share price for shareholders.

3. **Cap on total options permitted under the plan.** In virtually every case we have encountered, stock option or "incentive" plans contain an absolute cap on the number of "qualified" options that may be granted to management. Typically, these caps may be expanded only with shareholder approval.

4. **Common forms.** Most corporations maintain as part of their stock option programs a standard set of forms for the grant of the options, their vesting schedule and their exercise. Often, the forms contain exculpatory language, or language designed to limit the rights contained in the initial grant.

5. **Common and potentially critical language.** In preparation for this speech, I reviewed a number of employee stock option plans easily retrievable on the internet. The 1993 stock option plan of Halliburton Company was fairly typical of its kind.

a. **"Vesting."** The 1993 Halliburton Company Stock Option plan is typical of employee stock option plans and provides that each grant made by the Compensation Committee is to be made in accordance with a three-year vesting schedule. Apr. 18, 2006 Proxy Statement, Halliburton at 27.

b. **Exculpation.** As with many of its peers, the Halliburton 1993 Stock Option Plan provides for limited exculpation of the Compensation Committee in making awards, terminating them, and in interpreting or modifying plan language.

c. **Exclusivity of decision making/absence of entitlement.** Virtually every plan contains a provision dictating that no employee is entitled to any pre-set award of options or benefits and that the right to make a determination of the number and terms of option issue resides with the compensation committee.

d. **Termination/loss of benefits.** It is a universal precondition of ESOP plans that the beneficiaries consist only of management and employees of the company. Non-plan options are granted, if applicable, outside the provisions of the plan because specialized arrangements come into play when options are used to compensate consultants and other non-employee providers.

c. **Understanding the contract law applicable to the liability case.**

i. **"Common law" contract rules govern.** Stock options are not governed by any special rules of construction, such as those that govern the formation and interpretation of contracts for the sale of goods under the Uniform Commercial Code. Instead, the issue of whether a contract has been formed and the meaning of the contract will be governed by common law concepts. Frequently, however, the plan will choose the law of the state of the issuer's incorporation (often Delaware) as governing, leaving the issues to be determined by the law of a foreign state. Texas courts can take judicial notice of this law with no special proof. TEX. R. EVID. 202. It is not necessary for a party to plead the law of another state to apply it, but the party must equip the court with "sufficient information" to determine both the applicability of the law and its meaning. *Daughtery v. Southern P.T. Co.,* 772 S.W.2d 81, 83 (Tex. 1989).

ii. **Sloppy documentation is not uncommon.** In "non-plan" settings, the parties are often sloppy in their documentation. Contracts providing for the transfer of stock options to consultants, merger partners or financiers of start-up companies are often sloppily drafted and take the form of simple but incomplete letter agreements. Frequently, neither the consultant nor the company has processes in place, or the cash, to call upon counsel for professional assistance. As a result, contracts may be poorly drafted or based upon either party's "last deal." In such situations, the common law rules relating to contract formation will come into play. *Dewitt County Elec. Coop. Ass'n v. Parks*, 1 S.W.3d 96, 100 (Tex. 1999) (meaning of an unambiguous contract a matter of law for the court, but ambiguous contract an issue for the jury); *United Concrete Pipe Corp. v. Spin-Line Co.*, 430 S.W.2d 360, 364 (Tex. 1968) (an "acceptance" which is equivocal or which varies from the offer is a counter-offer); *Harris v. Balderas*, 27 S.W.3d 71, 77 (Tex. App. — San Antonio 2000, pet. denied) (to form an enforceable contract, there must be an offer, acceptance, meeting of the minds, and an expression of the terms with sufficient certainty so that there will be no doubts as to what the parties expected).

iii. **"Implied contract in fact" principles are commonly applied in these matters.** In some cases, employees are made beneficiaries of stock option plans but are not required to execute documentation accepting the options or agreeing to limitations upon their exercise. In such situations, the employee may advance one of two arguments: (1) the existence of a contract in fact or (2) promissory estoppel. An implied-in-fact contract arises when the intentions of the parties are not fully expressed in writing, but an obligation is implied from the parties' acts or conduct. *Preston Farm & Ranch Supply, Inc. v. Bio-Zyme Enters.,* 625 S.W.2d 295, 298 (Tex. 1981). An implied-in-fact contract must arise from the conduct of the parties demonstrating that there was a meeting of the minds on the terms of the contract. *Williford Energy Co. v. Submergible Cable Servs., Inc.,* 895 S.W.2d 379, 384 (Tex. App. — Amarillo 1994, no writ). The finding of a contract in fact based upon the publication of plan documents, issuance of the options, issuance of notices of vesting, the carrying of the employee's options on the books and records all support findings of an implied contract in fact. *See, e.g., Ishin Speed Sport Inc. v. Rutherford*, 933 S.W.2d 343, 348 (Tex. App. — Fort Worth 1996, no writ). The second option of promissory estoppel is less appealing because the damage measure is likely lower. In the promissory estoppel case, damages will consist of the employee's "reliance damages," such as out-of-pocket expenses incurred or opportunities foregone by virtue of the employee's reliance upon the promise of an option grant. *See, e.g., COC Servs., Ltd. v. CompUSA, Inc.,* 150 S.W.3d 654, 661 (Tex. App. — Dallas 2004, no writ).

iv. **Statutes of fraud are unlikely to apply.**

1. **TBCC Section 8.319 has been abolished.** Until 1995, the defendant facing a breach-of-contract case relating to the provision of stock options would face statutes-of-fraud challenges. Texas' version of the Uniform Commercial Code, Section 8.319, provided that an agreement "relating to the sale of securities" was unenforceable unless in writing. That statute was repealed effective 1995 and is

unlikely to come into play in any current stock options dispute. *See* Act of May 25, 1967, 60th Leg., R.S., ch. 785, § 1, 1967 Tex. Gen. Laws 2343, 2512, *repealed by* Act of May 27, 1995, 74th Leg., R.S., ch. 962, § 1, 1995 Tex. Gen. Laws 4760, 4767 (appearing at TEX. BUS. & COM. CODE ANN. § 8.113 (Vernon 2002)). Even so, previous authorities interpreting the Act precluded its application to "stock for employment" cases. *See Bowers Steel, Inc. v. DeBrooke,* 557 S.W.2d 369, 373-74 (Tex. Civ. App. — San Antonio 1977, no writ) (holding that former Section 8.319 does not prohibit enforcement of oral employment contract for which consideration is corporate stock).

2. **Option contracts are "potentially" performable within a year.** Texas' Business and Commerce Code, Section 26.01(b)(6), provides that to be enforceable, an agreement must be in writing if it is "an agreement which is not to be performed within one year from the date of making the agreement." TEX. BUS. & COMM. CODE § 26.01(b)(6). For the statute to be implicated, however, performance must be such that it *must* occur, if at all, in more than one year from the date of the agreement. *Miller v. Riata Cadillac Co.,* 517 S.W.2d 773, 775 (Tex. 1974)*; Iacono v. Lyons,* 16 S.W.3d 92, 95 (Tex. App — Houston [1st Dist.] 2000, no pet.) ("If performance within a year is a possibility that is consistent with the provisions of the agreement, the fact that performance within one year is not required or expected does not bring the contract within the statute of frauds."). Since the option holder's rights typically accrue immediately and may be exercised immediately, the one-year statute of limitations is unlikely to come into play.

v. **Fiduciary duty claims may be undermined by the "mere expectancy" rule.** Virtually all of us are familiar with direct or derivative claims that shareholders may assert against management for the breach of fiduciary duty. Texas has yet to decide whether officers and directors owe option holders in the companies they manage a fiduciary duty, though one case indicates that they are likely to reach this result. In *Willis v. Donnelly,* 118 S.W.3d 10, 30 (Tex. App. — Houston [14th Dist.] 2003, no writ), the court held that a majority shareholder who had promised to transfer but in fact had never transferred a 25% interest in a closely-held corporation was guilty of a breach of fiduciary duty arising out of the minority "shareholder's" putative interest. Surprisingly, even though options are frequently vested rights with clear economic value, and those values can be impacted enormously by the activities of management, most courts have treated options as "mere expectancies" that are undeserving of protection. The courts typically reason that for fiduciary duty to exist, one must hold the property of another for the benefit of another. *See Simons v. Cogan,* 549 A.2d 300 (Del.1988) ("Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist."). Under Delaware law, "a mere expectancy interest does not create a fiduciary relationship … [because] [b]efore a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist." *Simons,* 549 A.2d at 303-04 (addressing whether fiduciary duties are owed to owners of convertible debentures). Holders of unexercised stock options merely have a contractual right to purchase an equitable interest in a corporation at some later date. *See Starkman v. Warner Comm., Inc.,* 671 F. Supp. 297, 304 (S.D.N.Y. 1987) ("The [option] instrument stands alone, claiming no equity in the corporation, entitled to no vote, and with no fiduciary obligation of the management to the option holder's interest."), *cited in Powers v. British Vita, P.L.C.,* 969 F. Supp. 4, 5 (S.D.N.Y. 1997). Stock options, therefore, "do not qualify for the protections that flow from a fiduciary duty." *See Glinert v. Wickes Co.,* No. 10407, 1990 WL 34703, at *9 (Del. Ch. Mar. 27, 1990), *aff'd,* 586 A.2d 1201, 1990 WL 254353 (Del. 1990). These rules were first adopted at a time when options contracts were far less commonplace than they are today and their value less reliably established. Today, option contracts in the tens of millions are written daily, and it seems apparent that they are every bit as much "property of another" as the share certificates that document the very intangible rights of shareholders.

vi. **Federal securities statutes are, however, clearly and directly applicable to option disputes.** When an individual "commits herself to employment by a corporation in return for stock or the promise of stock," she will be considered an investor worthy of protection under the federal securities laws. *See Yoder v. Orthomolecular Nutrition Inst., Inc.,* 751 F.2d 555, 560 (2d Cir. 1985). Similarly, in *Rudinger v. Insurance Data Processing, Inc.,* the plaintiff bargained for and received an employment contract wherein he was to receive a certain number of stock options in addition to an annual salary of $100,000. 778 F. Supp. 1334, 1338-39 (E.D. Pa. 1991). The court declared "[a]n agreement exchanging a plaintiff's services for a defendant corporation's stock constitutes a 'sale' under the terms of the Securities Exchange Act." *Id.; see also, e.g., Campbell v. National Media Corp.,* No. 94-4590, 1994 WL 612807 (E.D. Pa. Nov. 3, 1994) (finding that grant of options to purchase 50,000 shares in executive's employment agreement was a purchase of securities); *Collins v. Rukin,* 342 F. Supp. 1282, 1289 (D. Mass. 1972) (finding that stock options were a "quid pro quo offered to induce plaintiff to enter into the employ of [the issuer]").

vii. **It is uncertain whether a stock option can be the subject of common-law conversion.** What happens if your client's stock options have been converted, *i.e.*, if the options were cancelled and given to another employee — or even the very management that took them? A stock certificate may be a piece of property, itself negotiable, and subject to civil theft or misappropriation, but the rule with respect to an option, which consists of the contractual right to obtain that written indicia of ownership, is less clear. Decisions in the Fifth Circuit Court of Appeals both hold that a mere name cannot be converted but that the plaintiff is instead limited to his rights under the copyright and trademark laws for misuse of a copyright or trademark. *Ciccorp v. Aimtech*, 32 F. Supp. 2d 425, 442 (S.D. Tex. 1998); *Neles-Jamesbury Inc. v. Bill's Valves,* 974 F. Supp. 979 (S.D. Tex. 1997). These results, however, appear to stem both from the general rule that an intangible item of property cannot be converted and from the fact that a federal regulatory and statutory overlay governing name usage exists. *See, e.g., Neles-Jamesbury Inc.* at 984. A number of Texas courts have held that when the owner of an intangible item of property right has a tangible exemplification of the right, then conversion is appropriate. *OXY v. Southwestern Energy Prod. Co.*, 161 S.W.3d 277 (Tex. App. — Corpus Christi 2005, no writ) (Texas law recognizes the conversion of intangible property where the underlying intangible right has been merged into a document and that document has been converted). In *Monsanto Co. v. Boustany*, 73 S.W.3d 225 (Tex. 2002), the court reversed contract findings based upon the conclusion that the sale of a wholly-owned subsidiary constituted a "termination of employment" under a stock option plan but remanded for a determination of whether plan administrators could be sued for conversion for the loss of benefits caused by the sale. Presumably, the court would not have remanded the case had it believed that conversion of stock options was not possible.

viii. **Examples of the application of these contractual principles in Texas**. A number of cases in Texas have applied basic contract and tort principles in the context of stock option claims. These are but a few examples (divided by Supreme Court and Court of Appeals decisions), but they serve to illustrate how contract law and stock option rights tend to interact.

1. ***Monsanto Co. v. Boustany***, 73 S.W.3d 225 (Tex. 2002). In *Boustany*, the plaintiffs, a group of 110 stock option holders sued for fraud, conversion and breach of contract when Monsanto sold the subsidiary for which they worked, and its compensation committee determined that such sale constituted a "termination of employment" with Monsanto triggering their obligation to exercise stock options within three months of termination. Since the options could not be exercised within a year of the time they had been granted and the sale took place within that year, the plaintiffs' options were effectively wiped out. The trial court granted the defendant's motion for summary judgment, in effect ruling that provisions relating to termination were conditions subsequent to the grant and because they were not met, the grant disappeared. The Court of Appeals reversed, ruling that had Monsanto meant to put a "change of control of subsidiary" provision in the agreement, it should have done so. The Texas Supreme Court reversed the decision of the appellate court and reinstated the summary judgment, remanding the case on conversion and fraud claims. The court first ruled that Delaware law controlled the issue, since the plan chose Delaware substantive law. 73 S.W.3d at 229. The court then ruled that Delaware followed the same "headwaters" determination that Texas courts followed, namely whether the contract was ambiguous. The option holders' rights turned on whether their employment with Monsanto had terminated. The plan defined termination of employment as "the discontinuance of employment of a Participant *for any reason* other than a transfer." 73 S.W.3d at 230 (emphasis added). Since sale of the subsidiary resulted in the severance of the relationship between the participants and the company, the employment relationship had been terminated and the stock options lost. The employees' argument that the

more liberal terms of the stock option certificates prevailed was rejected because the certificates recited that they were "issued pursuant to and subject to" the terms of the plan. The court did not reach Monsanto's alternative grounds that the Compensation Committee had the exclusive authority to interpret plan provisions. 73 S.W.3d at 232. *Boustany* highlights the importance of choice-of-law provisions. Since so many entities are incorporated in Delaware, it is not at all unlikely that the plan may choose Delaware law. What is not addressed in *Boustany* or in any subsequent decisions interpreting it is what happens when the terms of an ancillary agreement, such as an employment contract, vary or conflict with plan terms.

2. ***Siemens v. Bartek***, ___ S.W.3d ___, 2006 WL 1126219 (Tex. App. — Austin Apr. 28, 2006, no writ) (where representations were made to employees of newly-acquired Austin-based subsidiary regarding the existence and scope of a stock option plan for them, action on claims related to the representations had proper venue in Travis County).

3. ***Pearson v. Visual Innovations***, ___ S.W.3d ___, 2006 WL 903736 (Tex. App. — Austin Apr. 6, 2006, no writ) (promise of eligibility and grant of stock options was sufficient consideration for execution of a non-compete agreement).

4. ***Ledig v. Duke Energy Corp.***, ___ S.W.3d ___, 2006 WL 727712 (Tex. App. — Houston [1st Dist.] Mar. 23, 2006) (in the absence of fraud, employee who definitively selected to exchange 50% of his bonus compensation for stock options could not reverse his decision because falling stock prices made the choice less profitable).

5. ***McCranie v. Chaimberlain, Hrdlicka, White, Williams & Martin, P.C.***, ___ S.W.3d ___, 2006 WL 278276 (Tex. App. — Houston [14th Dist.] Feb. 7, 2006) (cause of action for legal malpractice relating to failure of stock options to become valuable or to vest accrued at the time the law firm warned of this potentiality before closing).

6. ***Carlson Mfg. Inc. v. Smith***, 179 S.W. 3d 688 (Tex. App. — Beaumont 2005, no writ) (grant of stock options by parent corporation to employee of subsidiary was insufficient evidence of alter ego).

7. ***Donaldson v. Digital Gen. Sys.***, 168 S.W.3d 909 (Tex. App. — Dallas 2005, no writ) (evidence was sufficient to support trial court's determination that 30-day exercise period post-termination found in plan was binding).

8. ***Farone v. Bag 'N Baggage***, 165 S.W.3d 795 (Tex. App. — Eastland 2005, no writ) (president lacked documentation of sufficient terms to create an enforceable contract for the provision of stock options in corporation).

9. ***Boyd v. Koons Fuller et al.***, ___ S.W.3d ___, 2005 WL 23374 (Tex. App. — Waco Jan. 5, 2005) (firm sued by displeased husband who wanted divorce decree finalized before he received options purportedly worth $8,000,000).

10. ***Shirvanian v. Defrates***, 161 S.W.3d 102 (Tex. App. — Houston [14th Dist.] 2004, no writ) (largest shareholder and option holder in Waste Management Inc.'s claim for fraud was a derivative claim and resolved by prior derivative action in which he had participated).

11. ***American Med. Techs., Inc. v. Miller***, 149 S.W.3d 265 (Tex. App. — Houston [14th Dist.] 2004, no writ) (Dispute under a stock option plan that contained arbitration clause was governed by the Federal

Arbitration Act due to fact that resulting stock granted from plan would be sold on a national exchange. As a result, mandamus was the appropriate mechanism for relief — but employer must properly prove up the arbitration provision in order to enforce it).

12. ***Creel v. Houston Indus.***, 124 S.W.3d 742 (Tex. App. — Houston [1st Dist.] 2003, no writ) ("incentive pay" guaranteed to executives of firm did not include incentive stock options under agreement to assume their contracts).

13. ***Agillon Inc. v. Oliver***, 114 S.W.3d 86 (Tex. App. — Austin 2003, no writ) (executive who upon severance accepted settlement package with two annual installments totaling $1,000,000 entered into an accord and satisfaction on claim that employer would "make good" the value of her stock options from prior employer).

IV. **Understanding and making the right decisions with respect to the damage case.** Because the shares to which option rights are attached change in value, the damage measure used by the trial court, as well as the "date of breach," may be outcome-critical. Exhibit A sets out a hypothetical claim in light of the fluctuations in the value of Halliburton stock over the previous five years.

Let's make the following assumptions: an employee earns 10,000 options at a strike price of $40 per share with a grant date of March 30, 2001 and a term of 10 years. The employee continues to work for Halliburton for the three years necessary for his options to vest before a dispute develops in the first quarter of 2005, causing the Company to take the position that all 10,000 options have been lost.

The employee's damage claims will vary enormously, depending upon the causes of action he asserts and the elections he makes while asserting the causes of action.

A. ***Miga v. Jensen***, 96 S.W.3d 207 (Tex. 2002) — the starting point for analysis of contractual damage claims.

In *Miga v. Jensen*, the plaintiff worked for a small, privately-owned telephone company for a number of years, acquiring an option to purchase 4.8% of shares in a newly-acquired subsidiary of his employer for the sum of $40,800, or about $77 per share. 96 S.W.3d at 209. In December of 1994, Miga gave notice of his resignation and that he wished to "settle his account" with Jensen. When Jensen replied without mentioning the option to purchase 4.8% of the subsidiary for the set price, Miga tried to exercise the option. Jensen refused. By 1996, however, the subsidiary had engaged in a 940-to-1 stock split and made an initial public offering. The stock opened at $12 per share, peaked at $45.75 per share and was worth $35.75 at the time of the parties' 1997 trial. *Id.*

The jury found for the plaintiff, awarding $1,034,000, consisting of the difference between the option price and the value of the subsidiary's stock in December of 1994 when Miga first attempted to exercise his options. It then also awarded damages of $17,775,686 for what the trial court called "lost profits" — the increase in value of the stock from December of 1994 to its value at the time of trial. 96 S.W.3d at 210. The question on appeal was whether the plaintiff could recover the massive increase in value that occurred between the date of the attempted exercise and the date of trial. It ruled that *given the elections made by the plaintiff*, any such award would be speculative and inappropriate.

The court began its analysis by recounting the plaintiff's testimony and pointing out that there was no clear evidence on the issue of when the plaintiff might have sold his stock once he acquired it. This left to speculation the key issue determining stock value — the date of its disposition. 96 S.W.3d 213. The court distinguished *Randon v. Barton*, 4 Tex. 289 (1849), and *Calvit v. McFadden*, 13 Tex. 324 (1855). Although the buyer of "land certificates" in *Randon* and the purchaser of cattle in *Calvit* were permitted to recover the "highest intermediate value" of the item between the date of breach and trial, the court attributed the result to the fact that "the purchase price was paid in advance,"[1] whereas, presumably, the option-holder has not paid all consideration "in advance." 96 S.W.3d 214.

The holding in *Miga* was the subject of a lengthy dissent by Justices O'Neill, Schneider and Hankinson, who noted that by fixing the value of the option on the date the issuer refused to honor it, the court: (1) abbreviated the contractual exercise period and (2) permitted the issuer to choose the time of repudiation so as to minimize the option holder's damage claim. 96 S.W.3d at 218. It appears that the concerns of the dissenters are misplaced because of the very narrow scope of the majority's ruling.

The majority was careful to note that the plaintiff dictated the outcome of the case by choosing to attempt to exercise his options in December of 1994. 96 S.W.3d at 215. "Because Jensen breached the contract on the same day Miga attempted to exercise his option, the correct measure of damages for Jensen's failure to perform on his promise is the traditional one: 'the difference between the price contracted to be paid and the value of the article at the time when it should [have been] delivered….'" *Id.* Thus, according to the majority, the plaintiff is the captain of his own destiny: while acknowledging that the calculation of the value of the remaining term of an option is a "complicated enterprise, requiring the application of finance models to determine the present value of the right to purchase stock…at some future time," "when, as here, breach occurs when the option holder seeks to exercise the option, the option becomes a straightforward contract to sell a certain amount of

[1] Frankly, the payment of the purchase price in advance is no basis for distinguishing the results in *Randon* and *Calvit* from the result obtained in the trial court. In both instances, the purchaser had paid his "consideration" in advance of coming into possession of the item for which value he sued. Perhaps the notion was that since the option holder had not actually tendered the price of the option, he had not "paid the purchase price in advance." If this was, in fact, the reasoning of the court, it runs contrary to the general principle that the law will not require parties to engage in a vain act. Since the stockholder refused to recognize the existence of the option agreement, little could have been gained by a formal tender of the funds. A more principled and direct distinction evolves from the option holder's date of election to exercise, and the court itself seems to recognize this in a subsequent part of its discussion. 96 S.W.3d at 215.

stock at a certain price at the time chosen by the holder. When Miga attempted to exercise his option in December 1994, the time for delivery was set…." 96 S.W.3d at 216.

B. ***Mackie v. Petrocorp Inc.***, 329 F. Supp. 2d 477 (S.D.N.Y. 2004).

Mackie v. Petrocorp extensively commented upon and interpreted *Miga* in a dispute involving the sale and subsequent extinguishment of "perpetual warrants" whose terms were governed by Texas law. The plaintiffs had purchased several hundred thousand "perpetual warrants" issued by Southern Mineral Corp. The warrants were acquired for an initial face value of $0.50 per warrant but were perpetual in their grant and gave to the holder the right to convert the warrant into stock of the issuer upon certain preconditions. One of those triggers was the merger of the issuer into another entity. In a fairly standard provision, warrant-holders were protected in that they became entitled to receive the same consideration on a pro-rata basis that all shareholders received as of the date of the merger — roughly $4.71.

The trial court concluded that the warrant agreement had been breached on June 5, 2001 — the date of the merger between Southern Mineral and Petrocorp when the company attempted to convert the instruments into warrants that could be redeemed for their initial purchase price alone. The court was forced to decide between two opposing damage theories. Plaintiffs contended that the proper method for assessing damages was an award of the Black-Scholes value of the warrants as of the day of the merger. Petrocorp reasoned that because the warrants were publicly traded, their value was known and consisted of the market price of the warrants the day preceding the merger. Since the average daily closing price in the months in which the warrants were traded was $0.6473, Petrocorp reasoned that the plaintiffs' damages were only $0.1473 per warrant. Plaintiffs, on the other hand, believed their warrants would have been worth $2.34 per warrant — one-half the value of Petrocorp's stock, had Petrocorp honored them. 329 F. Supp. 2d at 511-12.

The court adopted the plaintiffs' proposed measure of damages, interpreting *Miga* as establishing a damage rule only for option (or in this case warrant) holders who have elected to exercise their option prior to the time of trial. 329 F. Supp. 2d at 512. The court then relied upon Black-Scholes calculations provided by the plaintiffs and by their outside consultant supporting the $2.34 per warrant valuation, and rejected the "actual market" defense, reasoning that because merger documents were widely circulated more than eight months in advance of the merger and clearly foretold the impending destruction of the warrants, the market price of the warrants was "artificially depressed." 329 F. Supp. 2d at 512-13.

C. ***Hurst v. Forsythe***, 584 S.W.2d 314 (Tex. Civ. App. — Texarkana 1979, writ ref'd n.r.e.), and the "highest intermediate value" rule.

Texas cases involving the loss of stock, as opposed to the loss of stock options, fall into two camps. Cases such as *Hurst v. Forsythe*, which was favorably cited by *Miga*, relate to situations in which consultants or employees are promised a transfer of stock, usually in a small, closely-held corporation, in exchange for their agreement to work for the promissor. A virtually uniform distinction had developed in claims of this kind: where the claim is a simple breach-of-contract claim for the non-delivery of stock on the date of termination, courts hold that the value of the stock on that day constitutes the measure of loss. *Hurst v. Forsythe*, 584 S.W.2d at 317. One critical distinction for advocates of stock option claims is that the stock option contract, unlike the promise to transfer a stock certificate, has a distinct time component in which the promissee has the right to exercise the option for a set period — say, ten years. This "optionality" is not present in the standard failure-to-deliver-stock case, and it indicates a contrary result as envisioned in *Miga*. The primary reason announced by courts in failing to apply a "highest intermediate value" measure of damages is their unwillingness to grant to the plaintiff the benefit of hindsight. *See, e.g., Scully v. WATS, Inc.*, 238 F.3d 497, 508 (3d Cir. 2001).

When the cause of action is for fraud or conversion, then the measure of loss in Texas and elsewhere will be the "highest intermediate value" of the stock between the time of breach and the time of trial. *See, e.g., Patterson v. Wizowaty*, 505 S.W.2d 425 (Tex. Civ. App. — Houston [14th Dist.] 1974, no writ); *Ligon v. E.F. Hutton & Co.,* 428 S.W.2d 434 (Tex. Civ. App. — Dallas 1968, writ ref'd n.r.e.). In these cases, the intentional nature of the injury places the defendant in a different position — the defendant in effect becomes responsible for the worst possible outcome from his actions, including all actual losses that may be encountered by the plaintiff due to the defendant's actions.

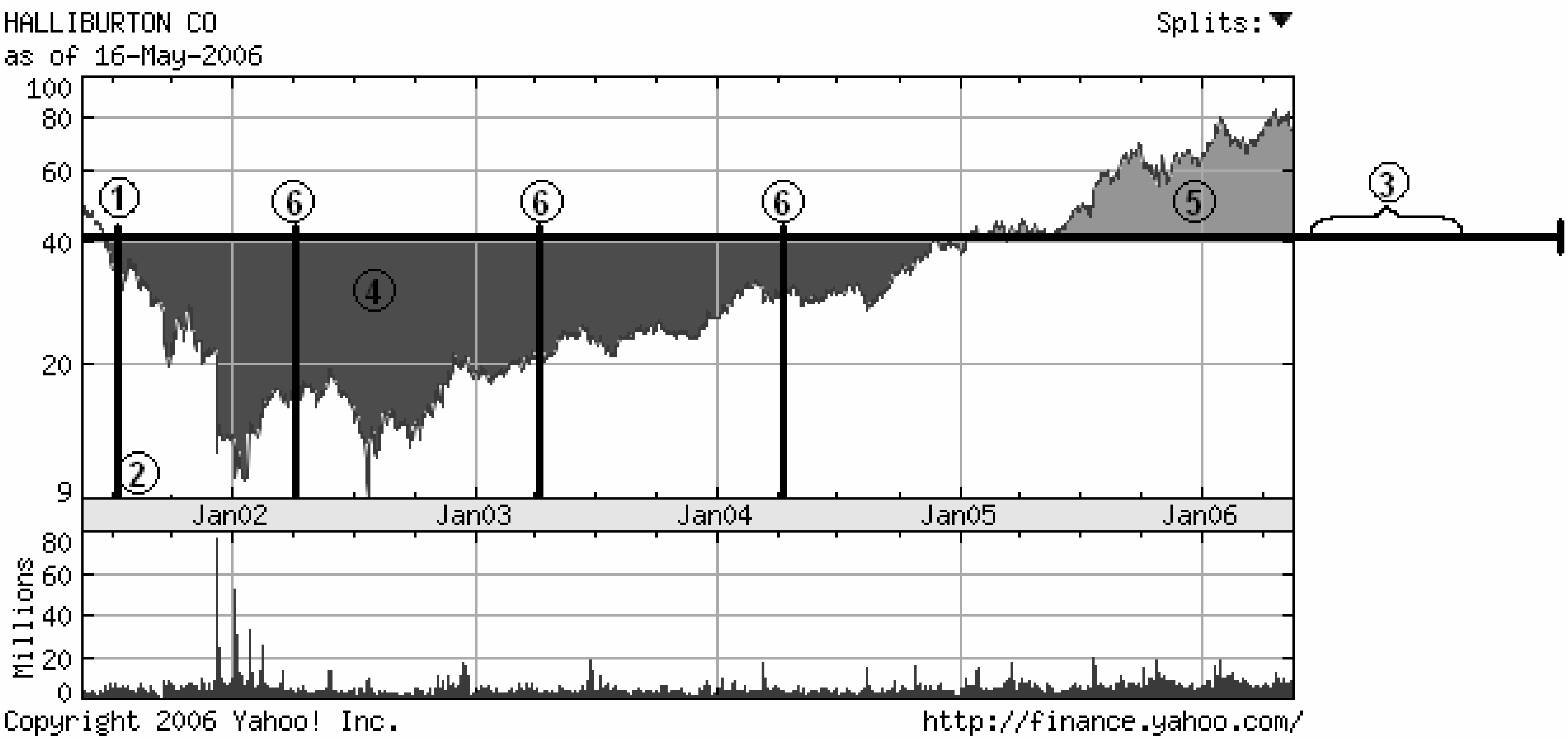
D. *Walden v. Affiliated Computer Sys. Inc.*, 97 S.W.3d 303 (Tex. App. — Houston 2003, rev. denied).

Walden v. Affiliated Computer Sys. Inc. presents a wrinkle not envisioned in *Miga*. In *Walden*, the plaintiffs attempted to exercise stock options in a savings and loan at a time it was under an Office of Thrift Supervision order prohibiting the entity from issuing stock. The court ruled that the merger entitled the option holders to exercise their options for shares in the successor corporation and that the OTS blackout on stock transfers did not "frustrate the purpose" of the underlying contract — but instead merely delayed its implementation. In addressing the issue of damages, the court held that although the plaintiffs had all attempted to exercise their options during the OTS blackout period, the damages would be established as of the date the issuer could first lawfully issue stock. 97 S.W.3d at 329 ("… to compensate Butler for his actual losses resulting from ACS's breach of the Original Agreement, Butler's damages should be calculated based on the value of ACS stock on September 29, 1997, the first date after ACS's breach on which he actually could have taken delivery of the stock.").

I hope you find this compilation helpful. If you are involved in a stock-option case and have questions, feel free to give me a call. I may not have the answer but may be able to steer you in the right direction.

EXHIBIT A

Hypothetical Stock Option in Halliburton Company



1 = exercise of "strike" price — $40
2 = grant date
3 = option term

4 = "underwater" period
5 = "in the money" period
6 = vesting period anniversaries