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UNPUBLISHED OPINION. CHECK COURT
 RULES BEFORE CITING.

Court of Chancery of Delaware.
 Charles LILLIS, Gary Ames, Richard Post, Frank
 Eichler, Robert Crandall, Lou
 Simpson, Pierson Grieve, Richard McCormick, Janice
 Peters, Pearre Williams,
 Roger Christensen, Doug Holmes, Steven Boyd, Patti
 Klinge, Connie Campbell,
 Sharon O'Leary, Jim Taucher, Bud Wonsiewicz And
 Daniel Yohannes, Plaintiffs,
 v.
 AT & T CORP. and AT & T Wireless Services, Inc.,
 Defendants.
C.A. No. 717-N.

Submitted: March 6, 2007.

Decided: July 20, 2007.

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MEMORANDUM OPINION AND ORDER

[LAMB](#), Vice Chancellor.

*1 This is a dispute about the terms of certain employee stock options acquired by former officers and directors of a telecommunications company as the result of a series of adjustments made to those options following a 1999 merger in which that company was acquired. At issue is a 2004 cash merger involving one of the corporations in which the former officers and directors held adjusted options. According to the terms of the merger agreement governing that transaction, all employee stock options (including those held by the plaintiffs) were adjusted into the right to receive the cash

merger price minus the strike price of the option regardless of the duration remaining on the option contract. Thus, "out-of-the-money" options having years remaining but with a strike price equal to or higher than the merger price were rendered worthless. Similarly, "in-the-money" options with a remaining duration were stripped of any fair value in excess of their "intrinsic" value, i.e., the difference between the strike price and the merger consideration.

The question presented is whether the terms of the plan governing these options, that required an appropriate adjustment to preserve each plan participant's economic position with respect to the options, prohibited this treatment and, instead, required that the former officers and directors be compensated for the full fair value of their options as of the date of the 2004 merger. The court recognizes that, as a general rule, the value of a derivative instrument, such as a stock option, is tied to the value of the security into which it is exercisable. If, as the result of a transaction, the underlying security is converted into the right to receive a fixed sum of cash, the value of the option will ordinarily also be measured by reference to that same amount of cash. This general rule, however, is not invariable and can be altered by contract. After trial in this case, the court concludes that the option plan at issue is properly interpreted as being at variance with this general rule and further concludes that the terms of that plan were breached by the adjustment made to the options held by the former employees. As damages, the court will award the plaintiffs a sum of money equal to the full economic value of the options less the consideration received by them in the merger.

I.

A. The Parties

The plaintiffs are the former officers and directors of MediaOne Group, Inc., a broadband telecommunications company acquired in 2000 in a merger with AT & T Corporation. [\[FN1\]](#) As a result of that former employment and the terms of the agreement governing that merger, the plaintiffs held employee stock options issued by AT & T Wireless Services, Inc. at the time it was acquired by Cingular Wireless LLC. In this suit, they claim to have been improperly and illegally deprived of part of the value of those options by the terms of the merger.

[FN1](#). The plaintiffs are Charles Lillis, the former chairman and CEO of MediaOne; Gary Ames; Richard Post, the former CFO of MediaOne; Frank Eicher; Robert Crandall; Lou Simpson; Pierson Grieve; Richard McCormick; Janice Peters; Pearre Williams; Roger Christensen; Doug Holmes; Steve Boyd; Patti Klinge, the former Senior Vice President for Human Resources for MediaOne; Connie Campbell; Sharon O'Leary, the Assistant Secretary for U S WEST; Jim Taucher; Bud Wonsiewicz; and Daniel Yohannes.

The defendants are AT & T Corp. ("AT & T") and AT & T Wireless Services, Inc. ("Wireless"). At the time the complaint was filed in 2004, AT & T was a publicly owned corporation organized and existing under the laws of the State of New York, having its principal place of business in Bedminster, New Jersey. It was an international provider of local, long distance, internet and transaction-based voice and data services for consumers and businesses. AT & T was acquired in 2005 by SBC Corporation, which then changed its name to AT & T, Inc. Shortly thereafter, the newly combined entity bought BellSouth Corp.

*2 When the complaint was filed, Wireless was a publicly owned corporation organized and existing under the laws of the State of Delaware, having its principal place of business in Redmond, Washington. Wireless was an international provider of wireless voice and data services for consumers and businesses. As part of the transaction at issue in this suit, Wireless was acquired by Cingular in a cash merger. At that time, Cingular was a joint venture owned by SBC (60%) and BellSouth (40%). As a result of the various transactions just described, Cingular (renamed AT & T Mobility) is now a wholly owned subsidiary of AT & T, Inc.

B. History Of The MediaOne Option Grants

Before MediaOne was split-off from its parent corporation, U S WEST, many of the plaintiffs were participants in U S WEST's stock option plan. After the split-off, the MediaOne board of directors authorized a broad employee stock options grant program in which nearly all MediaOne employees received stock option awards.

1. The 1994 Plan

The MediaOne stock options were all issued under a 1994 options grant plan (the "1994 Plan"). All the plaintiffs signed the MediaOne 1994 Plan. The key provision of the 1994 Plan at issue in this case is the adjustment clause in paragraph XVIII.A, which provides that, in the event of certain transformative transactions:

the number or kinds of shares or interests subject to an Award and the per share price or value thereof shall be appropriately adjusted ... at the time of such event, provided that each Participant's economic position with respect to the Award shall not, as a result of such adjustment, be worse than it had been immediately prior to such event.

As will be discussed later in this opinion, the parties hotly dispute the proper interpretation of this paragraph.

2. The 1994 Plan And The AT & T-MediaOne Merger

MediaOne and AT & T signed a merger agreement on May 6, 1999. That merger did not close until 2000. The treatment of the MediaOne options was a heavily negotiated deal term in the AT & T-MediaOne merger. AT & T's initial proposal was for the options to be cut short of their full exercise period and cashed out. MediaOne demanded that all MediaOne options be adjusted into AT & T options, remain outstanding for their original exercise period, and continue to be governed by the 1994 Plan. [FN2](#) In the end, after much negotiation, AT & T acceded to MediaOne's demands and the 1994 Plan continued to govern the plaintiffs' options, even after those options were adjusted into options to purchase AT & T stock. In this connection, AT & T specifically agreed to "take such actions as are necessary for the assumption of the MediaOne Stock Options." [FN3](#) More generally, AT & T also agreed to cause its subsidiaries to honor the terms of all MediaOne employee benefit plans. [FN4](#)

[FN2](#). The 1994 Plan provides that it can only be amended by consent of the option holders.

[FN3](#). Ex. 9 at § 3.4(h).

[FN4](#). See Ex. 9 at § § 7.5, 11.4.

The 1994 Plan was amended in connection with the AT & T-MediaOne merger to provide that the options would remain fully vested and exercisable for their full grant terms. Even though the amendments were presumably beneficial to the option holders,

MediaOne obtained written approval from each option holder pursuant to the terms of the 1994 Plan requiring holder approval for any amendment. AT & T agreed to the amendments in a letter dated March 21, 2000. [\[FN5\]](#) In this letter, AT & T expressly stated that the options would continue to be governed by the 1994 Plan. AT & T also agreed that no changes to the 1994 Plan would be made without the written consent of the option holders unless otherwise expressly permitted by its terms.

[FN5](#). Ex. 14.

*3 Thus, when the AT & T-MediaOne merger closed, the plaintiffs and other 1994 Plan option holders received AT & T stock options. The adjustment to the MediaOne options was made by reference to the "intrinsic value" of the options being adjusted, without regard to differences in volatility between the two underlying securities. In this process, for example, a previous number and strike price of MediaOne options were converted into an equivalent number and strike price of AT & T options by reference to the deal price and the price of the AT & T stock. While not based on the well known Black-Scholes methodology, [\[FN6\]](#) this process did, if imprecisely, preserve both the intrinsic value and the option value of the MediaOne options. [\[FN7\]](#)

[FN6](#). This commonly accepted method for valuing options is discussed in a later part of this opinion.

[FN7](#). Options have two components of value: time value and intrinsic value. The time value is the chance that the underlying security will appreciate before the option expires such that the market price is more than the strike price. The intrinsic value is the difference between the strike price and the market price now. While the previous adjustments made to the plaintiffs' options did not take into account any differences in volatility between the old options and the new options, they did preserve both the time value and intrinsic value of the options because the new options had both components of value.

3. *The Wireless Split-off*

Between the time the AT & T-MediaOne merger agreement was signed and the 2000 closing, AT & T sought and secured MediaOne's approval for the

planned issuance of a tracking stock [\[FN8\]](#) to reflect the performance of its business unit, AT & T Wireless. The objective was to realize a higher combined market value for the company by separating its wireless assets from the rest of the entity.

[FN8](#). Ex. 12.

In April 2001, the 1994 Plan option holders received a letter from AT & T regarding their options. This letter, addressed to "all AT & T Stock Option Participants," announced that Wireless would be split-off from AT & T and that their AT & T options would be adjusted into options to acquire both AT & T stock ("T" options") and Wireless stock ("AWE options"). [\[FN9\]](#) The letter further stated, in pertinent part, that the "stock option grant for AWE will become immediately vested and exercisable under the terms applicable to your termination." [\[FN10\]](#) The letter did not mention the 1994 Plan or MediaOne. Two more letters were received by the plaintiffs. In June 2001, AT & T notified them of a blackout period. [\[FN11\]](#) The final letter, dated August 2001, was sent by both AT & T and Wireless and announced the completion of the split-off, stating that "all option accounts have been adjusted in accordance with the methodologies communicated in April 2001." [\[FN12\]](#) This same letter (that only one plaintiff has a record of having received) informed plan participants that a "new long-term plan document adopted by AT & T Wireless Services, Inc. is now in effect for all adjusted stock option grants for 'AWE' as of July 9, 2001," and that this "new plan document does not change any of your terms and conditions" with immaterial exceptions. [\[FN13\]](#) The letter specifically states that for "T" option grants "the long-term plan documents and the stock option agreement provided with your original stock option grant, either under an AT & T long-term incentive program or a pre-merger program such as ... MediaOne ... continue to govern...." [\[FN14\]](#)

[FN9](#). Ex. 19.

[FN10](#). Ex. 19.

[FN11](#). Ex. 26.

[FN12](#). Ex. 30 at 1.

[FN13](#). *Id.* at 7.

[FN14](#). *Id.*

Upon the split-off, the plaintiffs' AT & T stock options, including the out-of-the-money options, were converted into adjusted AT & T and new Wireless options pursuant to a formula that preserved both the positive and negative intrinsic value of each option as well as the remaining time period and other characteristics.

C. The AT & T Wireless Employee Benefits Agreement And The Wireless Adjustment Plan

*4 A series of agreements and other documents exist that govern various aspects of the split-off. Of particular interest among these is the Employee Benefits Agreement by and between AT & T Corp. and AT & T Wireless Services, Inc. dated as of June 7, 2001, [\[FN15\]](#) and the AT & T Wireless Services Inc. Adjustment Plan ("Wireless Adjustment Plan"). [\[FN16\]](#) The former agreement divided all of the employee benefits obligations between AT & T and Wireless. Section 5.3 deals with the obligations of the parties with respect to the adjustment of options issued under any AT & T Long Term Incentive Plan, a term defined to include the 1994 Plan. According to section 5.3(a)(i), all AT & T options were to "be adjusted into adjusted AT & T Options ... under the applicable AT & T Long Term Incentive Plan and Wireless Options under the Wireless [] Adjustment Plan..." [\[FN17\]](#) Similarly, section 5.3(b) provides that "[e]ach AWE Option outstanding under any AT & T Long Term Incentive Plan ... shall be converted ... into Wireless Options ('converted Wireless Options') under the Wireless [] Adjustment Plan ." [\[FN18\]](#)

[\[FN15\]](#). Ex. 20.

[\[FN16\]](#). Ex. 29.

[\[FN17\]](#). Ex. 20.

[\[FN18\]](#). *Id.* When AT & T created the AWE tracking stock, it also created and issued to certain persons AWE tracking stock options. The court understands the provisions of section 5.3(b) quoted in the text to refer to the adjustment of those tracking stock options into options to acquire the common shares of AWE post split-off. The court is uncertain from the record, including the detailed pretrial stipulation, whether any of the plaintiffs ever held AWE tracking stock options.

Unlike paragraph XVIII.A of the 1994 Plan, the

Wireless Adjustment Plan does not include a provision that is protective of a participant's "economic position" in the event of an adjustment. Instead, section 4(c) of that plan provides in the case of a merger or similar transaction for "such adjustment and other substitutions ... as the Committee, in its sole discretion, deems equitable or appropriate." [\[FN19\]](#) AT & T did not obtain the consent of the plaintiffs to any amendment to the 1994 Plan or any related documents in connection with the split-off.

[\[FN19\]](#). Ex. 29 at 4.

D. The Cingular-Wireless Merger

On February 17, 2004, Wireless announced that it had signed an agreement to merge with Cingular. Cingular, a privately held limited liability company, agreed to purchase all of Wireless's outstanding shares in a cash merger at \$15 per share. The agreement provided that all Wireless options with a strike price above \$15 would be "cancelled." [\[FN20\]](#) The plaintiffs, upset at what they considered a breach of the 1994 Plan, called Wireless and complained. Once it became clear through a review of the merger agreement that all options were to be cancelled, the plaintiffs' counsel objected in writing to both AT & T and Wireless. [\[FN21\]](#) AT & T's counsel responded, agreeing with the plaintiffs' position but claiming that AT & T had done and was doing all it could to rectify the situation.

[\[FN20\]](#). Ex. 54.

[\[FN21\]](#). Ex. 57.

On September 2, 2004, the Wireless compensation committee met and, upon the advice of Cingular's lawyers, purported to undo the cancellation of the plaintiffs' options. [\[FN22\]](#) The amendment had no effect on the plaintiffs' economic position, since the options were later adjusted into the right to receive \$15 in cash upon exercise. Thus, while they remained "outstanding" after the closing of the merger, the plaintiffs' out-of-the-money options became worthless and the value of the in-the-money options was fixed at the spread between the exercise price and \$15.

[\[FN22\]](#). Ex. 65.

E. The Plaintiffs Bring Suit

*5 After receiving no reassurance from Wireless

about the treatment of their options in the merger, the plaintiffs brought this action on September 24, 2004, the very day the Wireless compensation committee met to "uncancel" the options. The complaint states four claims for relief. The first claim, for breach of contract by Wireless, [\[FN23\]](#) seeks damages from Wireless for the "unilateral cancellation of their Options without compensation and/or adequate compensation." This claim alleges that "[t]he 1994 Plan obligates Wireless to preserve the economic value of the Options by delivering to Plaintiffs a security that is equivalent to the value of the Options prior to any merger or change in control." [\[FN24\]](#) This obligation, in the plaintiffs' view, could have been satisfied by "cashing out the Options for their full value." [\[FN25\]](#) While this claim was initially brought only against Wireless, the plaintiffs' portion of the pretrial stipulation asserts this claim against Wireless and AT & T jointly and severally. [\[FN26\]](#) Moreover, the plaintiffs' have moved to conform the pleadings to the evidence showing that, in the absence of a novation, AT & T remains liable directly under paragraph XVIII.A of the 1994 Plan.

[\[FN23\]](#). Compl. ¶¶ 42-47.

[\[FN24\]](#). *Id.* at ¶¶ 45, 47.

[\[FN25\]](#). *Id.* at ¶ 46.

[\[FN26\]](#). *See* Pretrial Stip. IV. A. 2. ("Whether AT & T, in the absence of a novation, is jointly and severally liable for Wireless's breach of the 1994 Plan. ¶ 18.").

The second claim for relief pleads, in the alternative, that if the court finds Wireless is not bound by the 1994 Plan [\[FN27\]](#) both AT & T and Wireless are in breach of that contract for failing "to ensure the continued efficacy of the 1994 Plan following the split-off from AT & T in July 2001." [\[FN28\]](#) This claim (as it relates to Wireless) is based on the plaintiffs' belief that the 1994 Plan was binding on Wireless and that the defendants informed the plaintiffs that the 1994 Plan did, in fact, continue to govern their options. It also states the plaintiffs' belief that the 1994 Plan could not be amended without notice and written consent, "the very terms that AT & T contractually agreed to uphold." [\[FN29\]](#)

[\[FN27\]](#). Compl. ¶ 51.

[\[FN28\]](#). *Id.* at ¶¶ 48-51.

[\[FN29\]](#). *Id.* at ¶ 50.

The third claim for relief, negligent misrepresentation by AT & T and Wireless, [\[FN30\]](#) relies on the representations made by AT & T that the plaintiffs' AWE options "would be governed by the 1994 Plan." [\[FN31\]](#) The claim also states that "AT & T has acknowledged that Plaintiffs are entitled to have the value of their economic rights protected in any Wireless merger." [\[FN32\]](#) This claim is stated as an alternative "[t]o the extent that Defendants repudiate Plaintiffs' contractual rights." [\[FN33\]](#)

[\[FN30\]](#). *Id.* at ¶¶ 52-56.

[\[FN31\]](#). *Id.* at ¶ 54.

[\[FN32\]](#). *Id.* at ¶ 55. Indeed, AT & T admitted as much in the April 9 letter from its counsel to the plaintiffs and in its original answer.

[\[FN33\]](#). *Id.* at ¶ 56.

The fourth claim seeks advancement of legal fees and expenses. [\[FN34\]](#) This court granted summary judgment in favor of the plaintiffs in a previous opinion. [\[FN35\]](#)

[\[FN34\]](#). *Id.* at ¶¶ 57-63.

[\[FN35\]](#). *Lillis v. AT & T Corp.*, 904 A.2d 325 (Del. Ch.2006).

AT & T answered the complaint on December 8, 2004, admitted all of the principal allegations, and expressly agreed with the plaintiffs' characterization of the terms of the 1994 Plan. [\[FN36\]](#) AT & T's only defensive position was that it was Wireless, not AT & T, that was liable to the plaintiffs. In contrast to AT & T, Wireless's answer admitted nothing of substance. AT & T's admissions confirmed the position taken in a letter from AT & T's counsel to plaintiffs' counsel dated April 9, 2004. [\[FN37\]](#)

[\[FN36\]](#). Ex. 73. AT & T broadly admitted many of the allegations contained in the complaint that "AT & T expressly promised to preserve the value of the Options, including in connection with future mergers or changes in control, in connection with its acquisition of MediaOne," that "cancellation of the Options would leave the option holder in a worse off position," that "[b]oth AT & T and Wireless assured Plaintiffs that the new Wireless Options would continue to be governed by the 1994 Plan and the

Individual Agreements," that "Wireless (i) had an obligation to preserve the value of the options it had granted if Wireless chose to pursue any merger or other extraordinary transaction and (ii) Wireless took action that affected the value of the Plaintiffs' options," and that "Defendants believed that Plaintiffs' Options-even Plaintiffs' out-of-the-money Options-had significant value." See Lillis v. AT & T Corp., 896 A.2d 871, 874-75 (Del. Ch.2005).

FN37. Ex. 58.

*6 AT & T's position was also consistent with its position in a \$200 million arbitration it initiated against Wireless with respect to the treatment in the merger of the AWE options held by AT & T's current and former employees, issued under plans other than the 1994 Plan. In the arbitration, AT & T argued that Wireless was required, by the terms of the Wireless Adjustment Plan, to preserve the value of out-of-the-money options in the merger. AT & T maintained its position in the arbitration and before this court even after it entered into a merger agreement with SBC in January 2005. SBC, as the 60% owner of Cingular, had an obvious adverse interest in the outcome of both the arbitration and this case.

On May 23, 2005, the arbitral tribunal issued its decision, entirely rejecting AT & T's arguments and holding that Wireless was not required to preserve the value of any of those options that were underwater at the time of the CingularWireless merger. FN38 Shortly thereafter, presumably at the urging of SBC, AT & T performed a volte-face in this litigation. In June 2005, in connection with the hearing on the plaintiffs' motion for judgment on the pleadings, AT & T moved to amend its answer (and to overhaul its briefs) in order to withdraw all of its damaging admissions about the meaning of the 1994 Plan and to interpose the same defenses advanced by Wireless (by then controlled by SBC, through Cingular). FN39 The court reluctantly allowed AT & T to abruptly change position, even though that change appeared to be driven purely by the loss of the arbitration and the emergence of SBC as the common controlling party. FN40 The court conditioned its order on AT & T's payment of substantial attorneys' fees and costs to the plaintiffs for all the work done in reliance on AT & T's earlier admissions.

FN38. The arbitration panel, consisting of three former federal judges, found that there

was a good faith adjustment in the option holders' plans by converting their options into the right to receive \$15 in cash upon payment of the strike price. The plan differs in many significant respects from the 1994 Plan. Most notably the powers of the compensation committee were much greater under the Wireless Adjustment Plan. See text, *supra*, at n. 19.

FN39. AT & T later amended its answer again to assert a statute of limitations defense to the plaintiffs' negligent misrepresentation claim, further distancing itself from the admissions in its original answer. AT & T abandoned its statute of limitations defense at trial.

FN40. The purely tactical nature of AT & T's change of position is now entirely evident since AT & T made no attempt at trial (or at any other time during the course of this litigation) to explain the good faith basis for the withdrawal of its admissions. Rather than explain its change of position, AT & T simply replaced its counsel with the same set of lawyers who represented Cingular in the merger and who advised the Wireless compensation committee on September 24, 2004.

F. The Trial

The trial took place January 16 through 19, 2007, with fourteen witnesses testifying in person, by video deposition, or by deposition designation. FN41 The plaintiffs who testified emphasized the unusually large role stock options played in the MediaOne compensation scheme. Not only did every single employee receive options, senior executives' options represented as much as 50% to 70% of total compensation. According to the plaintiffs who testified, the terms of the 1994 Plan were uniquely protective of the rights of employees in order to protect the exceptionally large interest of the employees in the value of those options. Thus, each witness who testified expressed a belief that the 1994 Plan required that he or she receive the full economic value, both intrinsic and time value, for his or her options in the Cingular-Wireless merger, either in cash or in options to purchase securities of another entity.

FN41. The witnesses were: Charles Lillis, Richard Post, Marilyn Wasser, Hal

Burlingame, Mirian Graddick-Weir, Patti Klinge, Sharon O'Leary, Edward Rock, Daniel Ryterband, Ralph Larson, Gregg Jarrell, Jane Marvin, Daniel Somers, and Andrew Carron.

The first two witnesses, Charles Lillis and Richard Post, testified that they were personally involved in the negotiation of the AT & T-MediaOne merger agreement and that the 1994 Plan was a negotiated deal point. [\[FN42\]](#) Sharon O'Leary testified that she was involved in drafting the agreement. [\[FN43\]](#) Marilyn Wasser, AT & T's Associate General Counsel; [\[FN44\]](#) Daniel Somers, AT & T's CFO; and Harold Burlingame, AT & T's Executive Vice President/ Human Resources negotiated the agreement for AT & T. Lillis and Post testified at trial that AT & T wanted to cancel the MediaOne options in connection with the merger, but was met with resolute opposition from the MediaOne team. At first, AT & T proposed a full cancellation, then 90 days for employees and up to three years for executives, and finally relented and agreed the options would remain outstanding for their full grant terms and would continue to be governed by the 1994 Plan. As discussed earlier, this agreement was implemented in the AT & T-MediaOne merger agreement and related documentation.

[FN42](#). Tr. 17, 93.

[FN43](#). Tr. 266. O'Leary testified that the merger agreement was drafted to create a third-party beneficiary right to the option holders to enforce the agreement and was specifically crafted to bind AT & T and its subsidiaries to the 1994 Plan.

[FN44](#). Wasser was also involved in the negotiations of the Cingular-Wireless merger. Her trial testimony was largely uninformative, although she did confirm that Cingular took a non-negotiable position on the subject of the underwater options. Other potentially relevant testimony about conversations she had with Cingular immediately after the announcement of the merger was blocked by the assertion of a joint defense privilege, even though no joint defense agreement was ever produced and there is nothing to suggest that any joint defense activities were undertaken for months after the date of those conversations.

*7 The trial yielded little or no testimony about the

treatment of the 1994 Plan options in the 2001 split-off. Thus, the record is sparse on the question of whether the plaintiffs' AWE options are governed by the 1994 Plan or by the Wireless Adjustment Plan. The plaintiffs played no role in those negotiations and had no useful testimony on this subject. Burlingame, did testify helpfully to the plaintiffs that he believed the 1994 Plan governed the terms of the plaintiffs' Wireless options, but his testimony does not explain the significance of that fact. Other than this, the court is left with (i) the documentary record of the Employee Benefits Agreement and the Wireless Adjustment Plan discussed *supra*, (ii) the April and June 2001 communications from AT & T to its plan participants, including the plaintiffs, suggesting that the terms of the replacement options would be the same as those being replaced, (iii) the August 2001 joint letter from AT & T and Wireless to plan participants stating that the terms of the options were unchanged but also suggesting that all AWE options were being issued under the Wireless Adjustment Plan, and (iv) AT & T's extensive (although later withdrawn) admissions in its first answer in this litigation.

There is also little evidence that anyone at Wireless ever reviewed or considered the 1994 Plan in connection with the negotiation of the Cingular-Wireless merger. Wireless certainly reviewed the Wireless Adjustment Plan in connection with that negotiation. Notably, Daniel Ryterband, the president of Wireless's compensation consulting firm, Frederic W. Cook, advised Wireless that none of the AWE options (including the underwater options) could be cancelled in a merger. [\[FN45\]](#) As an example, on January 27, 2004, Ryterband wrote to Burlingame, Wasser, and others as follows: "[I]n my experience it would be unusual to simply terminate these awards since the grants represent contractual agreements between participant and company. Generally, they are either converted into newco awards of equivalent value or bought out for consideration, with participant consent." [\[FN46\]](#) In his deposition testimony, however, Ryterband made clear that this advice was not based on any review of the 1994 Plan. [\[FN47\]](#)

[FN45](#). Exs. 46-50.

[FN46](#). Ex. 46.

[FN47](#). Tr. 429. Ryterband was scheduled to testify live at trial, but on the morning he was scheduled to testify, the defendants chose not to call him and, instead, introduce

his deposition into evidence.

The evidence suggests that it was Cingular's flat refusal to replace or pay for any out-of-the-money options that caused the Wireless compensation committee to give up on getting any value for them and, instead, insist that Cingular agree to bear the litigation risk and to indemnify Wireless and its directors against claims from option holders. [\[FN48\]](#) Thus, when Post called Wasser on February 25, 2004, to complain about the proposed treatment of the 1994 Plan options in the merger, Wasser told him, incorrectly, that teams of experts had reviewed all of the relevant documents, including the 1994 Plan, and had concluded that the options could be cancelled. When Post protested further, Wasser told him to go south of the Mason-Dixon line (referring to SBC and Cingular), since it was no longer her problem. [\[FN49\]](#)

[\[FN48\]](#). Ex. 51 ("buyer will own the lawsuit").

[\[FN49\]](#). Tr. 129-30.

*8 The testimony at trial showed that it would have been possible to adjust the plaintiffs' options in the Cingular-Wireless merger into other comparably valued options. This could easily have been achieved using options in Cingular's publicly traded parent companies, or even (although improbably) using options, or similar stock appreciation rights, in the privately held Cingular entity. Of course, the merger agreement could have cashed out the plaintiffs' options at their full economic value, not just their intrinsic value. Indeed, the testimony at trial showed that Black-Scholes value was used to cash out Wireless options held by Wireless directors, including Ralph Larson, the chairman of Wireless's compensation committee who agreed to Cingular's demand to eliminate out-of-the-money options.

II.

The plaintiffs argue that the 1994 Plan governs their AWE options and that the plan protects the "economic position" of their options in a merger such as the Cingular-Wireless merger. [\[FN50\]](#) They argue that in this context "economic position" means the full economic value of their options, and not just the intrinsic value. Thus, they argue that the defendants breached the 1994 Plan because the Cingular-Wireless merger agreement did not make provision either to issue them replacement options or to pay them in cash the full economic value of their options. The plaintiffs also argue that if the court finds the

1994 Plan is ambiguous, both the extrinsic evidence and the course of conduct of the parties support their interpretation. In this connection, they further point out that the 1994 Plan could not be amended without the written consent of the option holders and there is no evidence that such consent was ever given.

[\[FN50\]](#). In addition to the 1994 Plan, the plaintiffs contend that the Wireless options are governed by the plaintiffs' individual MediaOne Group, Inc. Non-Qualified Stock Option Agreements, the Agreement and Plan of Merger between MediaOne and AT & T, dated May 6, 1999, and certain of the plaintiffs' individual Change of Control Agreements with MediaOne.

The plaintiffs contend that both AT & T and Wireless are liable for the improper treatment of their options in the Cingular-Wireless merger. AT & T's liability is in the alternative. If, as plaintiffs contend, their AWE options are governed by the 1994 Plan, AT & T is directly liable for breach of contract since it remained liable for the performance of the 1994 Plan. [\[FN51\]](#) If, alternatively, the 1994 Plan does not govern the plaintiffs' AWE options, AT & T is liable for having breached its contractual duty to cause those options to be subject to the 1994 Plan. Wireless's liability is predicated on the argument that it succeeded to AT & T's obligations under the 1994 Plan when the AT & T options were adjusted into Wireless options in connection with the 2001 split-off. This liability, they argue, was plainly within AT & T's power to impose at the time and is found in the agreements that divided the employee benefits obligations between AT & T and Wireless. [\[FN52\]](#) Both AT & T and Wireless are also sued, in the alternative, for negligent misrepresentation based on their various communications with the plaintiffs in 2001.

[\[FN51\]](#). The plaintiffs request that the court conform the pleadings to the evidence produced at trial on this issue. *See* Ch. Ct. R. 15(b) and text *infra*.

[\[FN52\]](#). Ex. 20.

The plaintiffs further contend that the proper measure of damages is the Black-Scholes value of their options. In calculating this valuation, the plaintiffs argue the court should use the price of the stock at the time the merger was consummated, \$15. Finally, the plaintiffs assert that the court should employ historical volatility of Wireless for 2003 as

the volatility assumption in the Black-Scholes model. The court will discuss the expert testimony on this subject, *infra*.

*9 In its defense, Wireless maintains that it never agreed to be bound by the 1994 Plan and that the plaintiffs' AWE options were governed by the Wireless Adjustment Plan, which is not even alleged to have been breached in the Cingular-Wireless merger. For its part, AT & T argues that it should not be found liable for breach of the 1994 Plan for two reasons: first, because the 1994 Plan does not govern the plaintiffs' AWE options; and, second, because it had no contractual obligation to bind Wireless to the 1994 Plan once Wireless ceased to be an AT & T subsidiary. The defendants also argue that the Economic Loss Doctrine bars the plaintiffs' claim against it for negligent representation.

The defendants also take issue with the plaintiffs' reading of the 1994 Plan, making a series of construction-based arguments as to the meaning of the phrase "economic position" as found therein. First, they argue that the plaintiffs' economic position "immediately prior" to the merger was no worse than after, as the value of the options evaporated because the options would only be worth \$15 in cash. In essence, this argument focuses on the term "immediately prior" as it modifies "economic position." The defendants maintain that "immediately prior" to the merger, the out-of-the-money options were worthless or nearly worthless because the market would have priced in the fact that the merger was going to take place and the underlying stock would be replaced with a right to \$15 in cash.

Next, the defendants argue that the plaintiffs' economic position was not made worse "as a result of [the] adjustment." They contend that the event, and not the adjustment, made the plaintiffs' economic position worse. The adjustment did nothing to affect the plaintiffs' options. It was the underlying event--the conversion of Wireless stock into a right to receive the \$15 of merger consideration--that negatively affected the value of the plaintiffs' options.

The defendants also presented expert testimony contradicting the plaintiffs' Black-Scholes model for measuring damages. First, the defendants assert that the volatility factor should be calculated "immediately prior" to the merger, either one day or several hours, which leads to a very low volatility and valuation. In the alternative, the defendants maintain that the proper measure of damages should be the value of the options "immediately prior" to the

announcement of the merger. Using this assumption, the defendants contend, the amount the plaintiffs received in the merger for their in-the-money options was greater than the total fair value of all their options measured before the announcement. Finally, the defendants assert that implied volatility, rather than historical volatility, should be used to compute damages.

III.

Before turning to the contract interpretation issues presented, the court will first examine the possible sources of the defendants' liability to the plaintiffs.

A. AT & T Is Liable Under The 1994 Plan

*10 If the 1994 Plan governs the plaintiffs' AWE options, AT & T will be subject to liability if the court concludes that the terms of the Cingular-Wireless merger violated the 1994 Plan, since the plaintiffs never agreed to an assignment of AT & T's performance obligations or to a novation releasing AT & T from its duties under the 1994 Plan. If, however, the court concludes that Wireless did not issue the plaintiffs' AWE options under the Wireless Adjustment Plan, AT & T could still be liable under the 1994 Plan since the plaintiffs' never consented to the elimination of that plan as the governing plan. Alternatively, in that case, AT & T could also be found liable for breach of contract since it had a contractual duty to ensure that the 1994 Plan did govern those options. [\[FN53\]](#)

[FN53.](#) The court notes that there are no temporal obstacles to the assertion of a claim against AT & T for breach of contract in connection with the 2001 spin-off. AT & T abandoned its statute of limitations defense in post-trial briefing after it was confronted with powerful testimony from the plaintiffs about their diligent inquiry and their reasonable reliance on AT & T's affirmative representations that the terms of the AWE options were the same as the old "T" options. The trial testimony of Patti Klinge and Sharon O'Leary most clearly showed the diligence pursued by the plaintiffs to protect their interests and the reasonable reliance they placed on statements made by AT & T regarding the continued effect of the 1994 Plan. It was not until the announcement of the Cingular-Wireless merger in February 2004 (only seven months before the complaint was filed) that the plaintiffs had any reason to

question these representations.

The plaintiffs originally pleaded a contract claim against AT & T only in the alternative, i.e., if Wireless is not bound by the 1994 Plan and is not liable for the breach in 2004. The evidence developed during discovery and presented at trial, however, was directed at both AT & T and Wireless. In these circumstances the court conforms the pleadings to the evidence presented since there plainly is no prejudice to AT & T in doing so. [FN54](#) The defendants are represented by the same counsel, are now owned by the same parent entity, and counsel put forth a vigorous defense on the plaintiffs' breach of contract claim. In addition, the issue of AT & T's direct liability under the 1994 Plan was an issue underlying this litigation from the start.

[FN54](#). See Ch. Ct. R. 15(b) ("When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues."); [Norberg v. Security Storage Co.](#), 2000 WL 1375868, at *5 (Del. Ch. Sept. 19, 2000) ("It is within my discretion to allow the pleadings to be amended to reflect any new issues not asserted in the pleadings so long as the responding party is not prejudiced by its admission."); [Cantor Fitzgerald, L.P. v. Cantor](#), 1999 WL 413394, at *2 (Del. Ch. June 15, 1999) (Rule 15(b) "allows this Court to deem a complaint amended to conform to the evidence in the absence of prejudice."); [Nufarm v. RAM Research, et al.](#), C.A. No. 16179, Steele, V.C. (Del. Ch. Sept. 15, 1998), Ltr. Op. at 9.

Turning to the contract analysis, the court notes that, before this action even began, AT & T admitted that the treatment of the plaintiffs' options in the merger violated the 1994 Plan, but pointed the finger at Wireless as the responsible party. AT & T's attorneys advised the plaintiffs' counsel on April 9, 2004, that in the 2001 split-off, "AT & T took all reasonable steps ... to ensure that all Adjustment Options, as compared to the 'T' options they replaced, ... (iii) were governed by the same terms and conditions, and

(iv) were not subject to cancellation prior to the expiration of their original term." [FN55](#) Similar but more detailed admissions are found in AT & T's first answer filed in this action on December 8, 2004. In this document, AT & T conceded its obligation to cause Wireless to assume its duties under the 1994 Plan, but claimed that it had fully discharged that obligation. After AT & T fell under the control of SBC and lost the arbitration, it radically changed its litigation position and now asserts that neither it nor Wireless is liable. AT & T's new theory is that the 1994 Plan does not govern the plaintiffs' AWE options and that AT & T was not required, in connection with the 2001 split-off, to cause Wireless to assume its duties under the 1994 Plan since Wireless ceased being its subsidiary in connection with that transaction.

[FN55](#). Ex. 58, 4/9/2004 letter from Robert D. Owen, Esq. of Fulbright & Jaworski to Miranda S. Schiller, Esq. of Weil, Gotshal & Manges, LLP.

The court will address later the questions of whether or not the AWE options are governed by the 1994 Plan and whether Wireless has any liability under that plan merely by virtue of the fact that it was, at one time, a subsidiary of AT & T. The answers to those questions do not, however, bear on the issue of AT & T's liability to the plaintiffs. AT & T bound itself pursuant to section 3.4 of the AT & T-MediaOne merger agreement to perform the 1994 Plan. In doing so, it agreed that any replacement options for the "T" options issued in the AT & T-MediaOne merger would be governed by the 1994 Plan. When AT & T decided to split-off Wireless and to adjust the "T" options into new "T" options and AWE options, AT & T undoubtedly possessed both the duty and the power to cause Wireless to agree that the 1994 Plan would govern the terms of the plaintiffs' AWE options. [FN56](#) AT & T repeatedly recognized this fact itself until it came under the control of SBC, which by that time, controlled Cingular and Wireless.

[FN56](#). [Anadarko Petroleum Corp. v. Panhandle Eastern Corp.](#), 545 A. 2d 1171, 1174-77 (Del.1988) (in preparing contracts between itself and a wholly owned subsidiary in anticipation of a spin-off, a corporate parent owes no fiduciary duty to the subsidiary).

*11 It is a well known rule of contract law that the original signatory remains liable on a contract unless

the other party consents to an assignment or there has been a novation. [\[FN57\]](#) There is no dispute that AT & T assumed MediaOne's liabilities under the 1994 Plan. [\[FN58\]](#) The defendants do not seriously argue that there was a novation of the original 1994 Plan because the 1994 Plan specifically requires that every amendment to it be approved by the option holders, and there is no evidence that any amendment ever occurred.

[FN57.](#) See *Schwartz v. Centennial Ins. Co.*, 1980 WL 77940, at *3 (Del. Ch. Jan. 16, 1980) (restating that a novation requires "the consent of all parties to the novation transaction").

[FN58.](#) Ex. 9, § 3.4 ("AT & T shall take such actions as are necessary for the assumption of the MediaOne Stock Options.").

Thus, after the split-off, AT & T remained primarily liable to the plaintiffs under the 1994 Plan with respect to the AWE options that it caused Wireless to issue in connection with that transaction. When the Cingular-Wireless merger occurred, AT & T remained liable on the 1994 Plan and was obligated to adjust the plaintiffs' options in accordance with paragraph XVIII.A of that plan when Wireless failed to do so. Additionally, the court concludes that, if the 1994 Plan does not govern the plaintiffs' options, AT & T's failure to ensure that it did was itself a breach of contract, although AT & T's continued primary liability under the 1994 Plan will likely mean that there are no separate damages for this breach.

B. *Wireless's Liability*

The plaintiffs have a series of less convincing arguments to support a finding that Wireless breached the 1994 Plan. They first point to the fact that, in the section of the AT & T-MediaOne merger agreement entitled "Employee Matters" (section 7.5), AT & T agreed that it, and its subsidiaries, would "honor the terms of all ... MediaOne Benefit Arrangements," defined broadly to include plans like the 1994 Plan. This fact does little to support their position, however, since Wireless did not even exist as a separate corporate entity at the time of the AT & T-MediaOne merger. As importantly, despite the generality of language used and the breadth of definition, the merger agreement plainly does not contemplate any performance under the 1994 Plan by any AT & T subsidiary. On the contrary, in the section of that agreement dealing expressly with stock options (section 3.4) only AT & T, not any of

its subsidiaries, agreed to "take such actions as are necessary for the assumption" of the 1994 Plan. In both the performance of the merger and, in the years that followed, when action needed to be taken under the 1994 Plan, it was taken by AT & T. This is hardly surprising, since AT & T was the SEC registrant and the only issuer of stock or options.

The plaintiffs also contend that Wireless became bound to the 1994 Plan at the time of the split-off. They point to AT & T's obligation to make the replacement options subject to the 1994 Plan and to the fact that, in the split-off, AT & T credited Wireless with over \$200 million of additional value to ensure that Wireless would honor AT & T's obligation to all option holders. Despite these facts, the record is far from clear that the AWE replacement options are, in fact, governed by the 1994 Plan or that Wireless ever agreed to perform AT & T's obligations under that plan. The fact that AT & T should have bound Wireless to the 1994 Plan does not mean that AT & T did so as to render Wireless liable. Similarly, there is no evidence tying the \$200 million in consideration to the treatment of the MediaOne option holders. On the contrary, AT & T's principal concern was the treatment of the thousands of its current and former employees or directors who were going to get AWE options in the split-off.

*12 For other evidentiary support, the plaintiffs point to the 2001 letters from AT & T giving them some assurance that the new options would be subject to the same terms. In addition, Burlingame, who was a senior executive at both AT & T and Wireless, testified to his view that the plaintiffs' AWE options are governed by the 1994 Plan, although that testimony did not address paragraph XVIII.A directly.

These thin reeds of evidence do not overcome the other evidence showing with reasonable clarity that Wireless agreed to issue the AWE replacement options under the Wireless Adjustment Plan, not the 1994 Plan. This is particularly clear from the language used in the Employee Benefits Agreement that contrasts the treatment of "T" replacement options, that are specifically made subject to the 1994 Plan, to the treatment of AWE options that are made subject to the Wireless Adjustment Plan. This same dichotomy of treatment is described in the August 2001 joint communication to all plan participants. A reasonable reading of that language leaves the impression that the "T" options, but not the AWE options, would be governed by the 1994 Plan.

For the foregoing reasons, the court concludes that Wireless is not contractually bound to perform the 1994 Plan. This conclusion means that Wireless cannot be found liable to the plaintiffs. Because the court reached the opposite conclusion about AT & T, the court will now turn to the language of the contract to examine whether the treatment of the plaintiffs' options in the Cingular-Wireless merger was permitted under the terms of the 1994 Plan.

C. *The History Of Option Anti-destruction Clauses*

As a general rule, anti-destruction provisions like paragraph XVIII.A of the 1994 Plan are interpreted to tie the interests of option holders to the interests of the holders of the securities into which they are exercisable. [FN59] Before the advent of anti-destruction clauses, options were rendered worthless if the company engaged in a transaction that destroyed the underlying security, even if that underlying security was thereby converted into the right to receive something else of value. It is for this reason that anti-destruction clauses are included in option agreements--to prevent opportunistic behavior by corporations that benefits stockholders at the expense of option holders. Further, it is generally the case that, when a corporation enters into a cash merger, in which all of its common stock is converted into the right to receive only a fixed amount of cash, option plans permit the adjustment of options into the right to receive the difference between the merger consideration and the exercise price of the option. Where that is the case, underwater options are cancelled for no consideration. The most obvious example of this rule is seen in the treatment in the Cingular-Wireless merger of the AWE options governed solely by the Wireless Adjustment Plan.

[FN59. See *Continental Airlines Corp. v. Am. Gen. Corp.*, 575 A.2d 1160, 1162 (Del.1990) ("American General was found to be entitled to the same options granted to the Continental employee-stockholders in the merger.... We agree and, accordingly, affirm."); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1352 (Del.1985) (" 'Anti-destruction' clauses generally ensure holders of certain securities of the protection of their right of conversion in the event of a merger by giving them the right to convert their securities into whatever securities are to replace the stock of the company."); *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 939 (Del.1979) (Anti-destruction clauses may be triggered by "events that will not

merely dilute the conversion privilege by altering the number of shares of common but, rather, may destroy the conversion privilege by eliminating the stock into which a [security] is convertible."); *Aspen Advisors LLC v. United Artists Theatre Co.*, 843 A.2d 697, 706 (Del. Ch.2004) (finding a change in structure of the company "left the plaintiffs in the same position as they were in before").

Notwithstanding these general observations, option agreements like the 1994 Plan and the related option grant agreements are no more or less than contracts that must be construed in accordance with normal rules of contract interpretation. Thus, there is no hard and fast rule to prevent an agreement such as the 1994 Plan from containing an anti-destruction provision that does more than tie the fate of an option to the fate of the stock into which it is convertible. Two decisions from outside this state finding that options can survive in mergers illustrate this point. [FN60] Those decisions provide some support for the plaintiffs' argument that their options could not be adjusted into the right to receive only the cash amount paid per share in a cash merger.

[FN60. *R.A. Mackie & Co., L.P. v. Petrocorp Inc.*, 329 F.Supp.2d 477 (S.D.N.Y.2004); *Hilton Hotels Corp. v. Dunnet*, 275 F.Supp.2d 954 (W.D.Tenn.2002).

*13 In *R.A. Mackie & Co., L.P. v. Petrocorp Inc.*, [FN61] the defendant corporation replaced the plaintiffs' perpetual stock warrants in connection with a merger. [FN62] Under the terms of the merger, the warrant holders could either exchange their warrants for stock in the new corporation or could receive, in cash, the difference between the stock price of the merging entity and the exercise price of their warrants. The plaintiffs' sued for the estimated value of the warrants at the time of the merger, if the warrants had been converted into warrants of the acquiring corporation. The U.S. District Court for the Southern District of New York held that the defendant could not call the warrants or exchange them for common stock. [FN63] The court required the defendant to pay the plaintiffs damages equal to the value of the warrants had they been converted into warrants in the acquiring entity. [FN64]

[FN61. 329 F.Supp.2d at 477.

[FN62. *Id.* at 480.

[FN63. *Id.* at 514.](#)

[FN64. *Id.* at 514-15.](#)

While the *R.A. Mackie* opinion includes a useful discussion of the effect of anti-dilution and anti-destruction clauses and their effects on warrants, [\[FN65\]](#) it is distinguishable from this case for several reasons. As a threshold matter, *R.A. Mackie* is a case about an issuance of "perpetual warrants," not incentive stock options, and discusses very different contract language from that found in the 1994 Plan. Additionally, the merger at issue in *R.A. Mackie* was stock-for-stock, and it was possible, and indeed simple, for the defendant there to adjust the warrants at issue into warrants in the new entity. Here, the merger was for cash and the acquiring entity (Cingular) was privately held, creating a different issue with respect to replacement options.

[FN65. *Id.* at 504.](#)

The plaintiffs also cite to *Hilton Hotels Corp. v. Dunnet*, [\[FN66\]](#) where Hilton sought a declaratory judgment allowing it to cancel the underwater options of the former employees of its acquisition target, Doubletree Corporation. [\[FN67\]](#) The U.S. District Court for the Western District of Tennessee denied Hilton's motion for summary judgment. The facts in *Hilton Hotels* are quite similar to those here. Doubletree was acquired by Promus in 1997. [\[FN68\]](#) Promus, in turn, was acquired by Hilton in 1999. [\[FN69\]](#) As part of the Hilton-Promus merger, Hilton required that Promus cash out all outstanding options while agreeing to assume the legal consequences of that act. [\[FN70\]](#) The out-of-the-money options became worthless while the in-the-money options were exchanged for the difference between the exercise price and the \$38.50 merger consideration. [\[FN71\]](#) The parties disputed the legality of Hilton's treatment of the options.

[FN66. 275 F.Supp.2d 954 \(W.D.Tenn.2002\).](#)

[FN67. *Id.* at 956.](#)

[FN68. *Id.*](#)

[FN69. *Id.* at 957.](#)

[FN70. *Id.*](#)

[FN71. *Id.* at 957, n. 2.](#)

In denying the motion for summary judgment, the *Hilton Hotels* court addressed many of the same issues as are present here. In *Hilton Hotels*, a 1998 resolution extended and guaranteed the options for a three-year period. [\[FN72\]](#) The court found the 1998 resolution, like the agreement to guarantee the options for the full ten-year period in connection with the AT & T-MediaOne merger, manifested the parties' understanding that the options were valuable. [\[FN73\]](#) Also, the options were a negotiated deal point in the merger, with Promus taking the position that Hilton should assume the options. [\[FN74\]](#) Only at the last minute did Promus agree to cancel them and did so only if Hilton assumed liability for that action. [\[FN75\]](#) The option agreement in *Hilton Hotels*, which is similar in structure and principle to the 1994 Plan, contains a provision that prevents any non-consensual amendment from "impair [ing] any rights or obligations under any Options." [\[FN76\]](#) The court found in denying summary judgment to Hilton that the option holders' interpretation of the plan that it prevented their options from being cashed out "appears to be ... the more reasonable one." [\[FN77\]](#)

[FN72. *Id.* at 959.](#)

[FN73. *Id.*](#)

[FN74. *Id.* at 961.](#)

[FN75. *Id.*](#)

[FN76. *Id.* at 962.](#)

[FN77. *Id.* at 963.](#)

D. *The Text Of The 1994 Plan*

*14 The court turns now to the plain language of the 1994 Plan. Paragraph XVIII.A of the plan states:

In the event there is any change in the Common Stock by reason of any consolidation, combination, liquidation, reorganization, recapitalization, stock dividend, stock split, split-up, split-off, spinoff, combination of shares, exchange of shares or other like change in capital structure of the Company, the number or kind of shares or interests subject to an Award and the per share price or value thereof shall be appropriately adjusted by the Committee at the time of such event, provided that each Participant's economic position with respect to the Award shall not, as a result of such adjustment, be worse than it had been immediately prior to such event.

The plaintiffs say this language clearly requires that

the full economic value of their options be maintained. The defendants make a litany of arguments to counter the plaintiffs' position.

First, the defendants point out that the provision contemplates, among other things, a liquidation and argue that in a liquidation there would be no resultant or surviving security into which to adjust options. Thus, in their view, there could be no value in out-of-the-money options. From this, they argue by analogy, in the case of a cash merger in which the stock is converted into the right to receive a fixed sum of money, options to purchase the stock should likewise be valued by reference to that same fixed sum of money, i.e., their intrinsic value. The difficulty with this argument is found in its premise that, in a liquidation, there would be no opportunity for option holders to realize the remaining option value of their contract. That would depend entirely on the terms of the option agreement and the circumstances of the liquidation. All that can be said in the abstract is that liquidations were included in paragraph XVIII.A to protect the option holders from opportunistic behavior by the corporation.

Next, the defendants focus on the phrase that follows the economic position language: "[E]ach Participant's economic position with respect to the Award shall not, *as a result of such adjustment*, be worse than it had been *immediately prior* to such event" (emphasis added). The defendants make two arguments based on this language: first, that it was the "event" not the "adjustment" that resulted in the plaintiffs' economic position being made worse; and, second, that, following the adjustment, the plaintiffs' economic position was not worse than "immediately prior" to the event.

The defendants' first argument overlooks the earlier provision that mandates the options "shall be appropriately adjusted." The correct reading of the paragraph is that, when there is a triggering event, the plaintiffs' options must be adjusted to maintain their economic position. This mandatory adjustment provision is in contrast to other option agreements produced at trial, many of which left the adjustment to the discretion of the committee by using the term "may" rather than the term "shall." When viewed in this context, the terms "event" and "adjustment" are tied together. If there is an event, there must be an adjustment, and that adjustment must preserve the options' economic position.

*15 This reading is supported by the fact that in all circumstances it will be the event that precipitates the

need for an adjustment. To adopt the defendants' reading of the section would eviscerate the meaning of the entire provision. For example, a stock split would dilute the options. The adjustment to the options is required to avoid this dilution. Likewise, in all of the other events listed, the event triggers the need for the adjustment--which is mandatory--and the adjustment is made to preserve the economic position of the option holders. This is consistent with the purpose of this paragraph of the 1994 Plan, which requires an adjustment to prevent the worsening of the option holders' "economic position." The clause is best read as a belt-and-suspenders provision, included to insure that the adjustment would *fully* preserve the economic position of the options. Without the clause, a plausible, though incorrect, reading would be that an adjustment must be made, but it would not have to completely preserve the economic position of the options.

The defendants' second argument suffers from the same overly technical readings of paragraph XVIII.A, overlooking the significance of the mandatory adjustment provision. The defendants focus on the phrase "immediately prior." In essence, the defendants maintain that immediately prior to the merger, the plaintiffs' out-of-the-money options had little or no value and, therefore, the plaintiffs' economic position was not worsened by adjusting those options into the right to receive \$15 in cash upon payment of the exercise price. The plaintiffs' options, defendants' argue, had little or no value because they were options to buy a security that was itself about to be converted into the right to receive \$15 cash. The only value the out-of-the-money options had, according to the defendants, was the chance that the merger would not go through and the stock price would appreciate above the strike price before the expiration of the options.

The provision must be read in the context of the rest of the paragraph. In that context, it is clear that the adjustment must be made to compensate the option holders commensurate with their economic position, "immediately prior" to the event, rather than at some other time. When taken in the context of a transaction such as the Cingular-Wireless merger, where there is a run-up in the stock after the announcement of the event, but before the event occurs, this interpretation makes perfect sense. If the adjustment is made in connection with the announcement of the event, the plaintiffs are deprived of the run-up enjoyed by the stockholders. To preserve the economic position of the options, the adjustment must be made in connection with the event itself. Any other reading

would defeat the purpose of the paragraph. For example, in a combination where the stock was not to survive, the out-of-the-money options would be nearly worthless "immediately prior" to the event. In light of the highly protective nature of paragraph XVIII.A, this interpretation of "immediately prior" is the only reasonable one.

E. The Meaning Of Economic Position In The 1994 Plan Is Ambiguous

*16 Contracts must be construed as a whole, to give effect to the intentions of the parties. [\[FN78\]](#) Where the contract language is clear and unambiguous, the parties' intent is ascertained by giving the language its ordinary and usual meaning. [\[FN79\]](#) The fact that the parties disagree on the meaning of a term or the contract's proper construction does not render that term ambiguous. [\[FN80\]](#) "Rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings." [\[FN81\]](#)

[FN78. *E.I. duPont de Nemours & Co. v. Shell Oil Co.*, 498 A.2d 1108, 1113 \(Del.1985\).](#)

[FN79. *Northwestern Nat'l Ins. Co. v. Esmark, Inc.*, 672 A.2d 41, 43 \(Del.1996\); *Rhone-Poulenc Basic Chemicals Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1195 \(Del.1992\).](#)

[FN80. *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 343 \(Del.1983\).](#)

[FN81. *Rhone-Poulenc*, 616 A.2d at 1196.](#)

While most of the provisions focused on by the parties can be interpreted based on the plain language of paragraph XVIII.A, there is an ambiguity as to the meaning of "economic position." This ambiguity renders the entire paragraph ambiguous as "economic position" is the operative term in it. Evidence at trial, including searches of SEC filings databases, showed that neither side could find another agreement that used the term "economic position." [\[FN82\]](#) "Economic position" is not a defined term and has no special trade meaning. In short, the 1994 Plan may be *sui generis* in the use of the term "economic position," rendering the entire meaning of paragraph XVIII.A ambiguous. The court is left to infer the meaning of "economic position" from extrinsic evidence.

[FN82.](#) The predecessor agreement to the MediaOne 1994 Plan from U S WEST is substantially similar and also uses the term "economic position."

The court will consider extrinsic evidence to interpret the agreement only if there is an ambiguity in the contract. [\[FN83\]](#) If the instrument is clear and unambiguous on its face, parole evidence may not be used "to interpret it or search for the parties' intent." [\[FN84\]](#) Where, as here, "there is uncertainty in the meaning and application of the terms of the contract" the court "will consider testimony pertaining to antecedent agreements, communications and other factors which bear on the proper interpretation of the contract." [\[FN85\]](#)

[FN83. *Pellaton v. Bank of New York*, 592 A.2d 473, 478 \(Del.1991\).](#)

[FN84. *Hibbert*, 457 A.2d at 343; *Cleveland Trust Co. v. Wilmington Trust Co.*, 258 A.2d 58, 65 \(Del.1969\).](#)

[FN85. *Pellaton*, 592 A.2d at 478 \(citing *Klair v. Reese*, 531 A.2d 219, 223 \(Del.1987\)\).](#)

F. Extrinsic Evidence Supports The Plaintiffs' Interpretation Of The 1994 Plan

1. Other Adjustments Maintained The Full Economic Value Of Plaintiffs' Options

Some understanding of the meaning of the phrase "economic position" is gained by looking at how other adjustments were made under the 1994 Plan. On a number of other occasions, the plaintiffs' options were converted into new options with an equivalent or higher full economic value. The first such adjustment was made in connection with the AT & T-MediaOne merger itself, when AT & T exchanged the MediaOne options for new options in AT & T. [\[FN86\]](#) When the split-off occurred in 2001, the plaintiffs received both new AT & T options and Wireless options. On another occasion, when AT & T sold cable assets to Comcast, the plaintiffs received adjusted Comcast options. Eventually, when AT & T was acquired by SBC, the plaintiffs' AT & T options were adjusted into SBC options. All of these adjustments were made in the same way: the existing options were replaced with options in the new entity based on the positive or negative intrinsic value of the old options and new options. The only changes

were to strike price and the number of options to account for the differences in price between the old and new stock. In this process, even out-of-the-money options, with negative intrinsic value, were replaced with new out-of-the-money options having equivalent negative intrinsic value, thus maintaining the time value of those options and, therefore, the plaintiffs' economic position.

[FN86](#). In the AT & T-MediaOne merger, both stockholders and option holders elected whether to receive cash, new securities, or a combination. The discussion here focuses on the adjustment calculated for those persons who elected to receive adjusted AT & T options.

*17 The defendants argue that this process maintained only the intrinsic value of the options and not the full economic value. This argument misses the point of the adjustment into new options. While the adjustments did not take into account differences in volatility between the old shares and the new shares, they did preserve both the time value and intrinsic value of the options because the new options had both components of value. Moreover, testimony at trial demonstrated that the volatility of the replacement options was substantially the same as the original options in all these adjustments. Therefore, the full economic value of the options was maintained in all these adjustments. In contrast, an adjustment into cash (such as in the Cingular-Wireless merger) measured by the intrinsic value of in-the-money options fails to maintain the options' full economic value.

2. Options Were A Large Portion Of The Compensation For MediaOne Employees

It is of some importance to recognize that the plaintiffs' stock options represented a significant portion of their compensation from MediaOne. Unlike many option plans that are designed as an incentive bonus for management alone, the MediaOne options were conceived as a material portion of compensation for all employees, in addition to being a very large portion of compensation for the company's executives. [\[FN87\]](#) While these facts alone do not require any particular construction of paragraph XVIII.A, they do make it more likely that the terms of the 1994 Plan and the related agreements were designed to be more than usually protective of the economic interests of the option holders. The court will bear that in mind in construing the phrase "economic position."

[FN87](#). Tr. 195. For example in 1999, options represented 65% of Post's total compensation. Tr. 84.

3. The Understanding Of The Parties Involved Supports The Plaintiffs' Interpretation Of The 1994 Plan

The testimony at trial from the plaintiffs, not surprisingly, universally supported the conclusion that the 1994 Plan was intended to preserve the full economic value of the plaintiffs' options in a transaction such as the Cingular-Wireless merger. The intent of the parties is paramount in determining the meaning of an ambiguous contract. [\[FN88\]](#) Here, not only are the plaintiffs the ones intended to receive the benefits of the option grants, they were also the principal executives responsible for drafting and implementing the plan. Their interpretation, along with that of MediaOne's in-house attorney, supports a reading of the 1994 Plan that would preserve the full value of the plaintiffs' options until the grants expired.

[FN88](#). *Northwestern Nat'l Ins. Co. v. Esmark, Inc.*, 672 A.2d 41, 43 (Del.1996).

More significant, however, in resolving the ambiguity in the phrase "economic position" is the fact that AT & T, the entity contractually bound to perform the 1994 Plan, wholeheartedly agreed with the plaintiffs' interpretation. That agreement is evidenced both in the April 9, 2004 letter from Fulbright & Jaworski to Weil Gotshal & Manges, and in AT & T's December 8, 2004 answer to the complaint in this action. While AT & T is not strictly bound by the positions taken in the later withdrawn answer, the court is entitled to consider both the letter and that answer and to give them great weight in reaching a decision. [\[FN89\]](#) In this case, where AT & T made no effort to explain the change in its earlier statements and admissions, the court is left to conclude that AT & T fully believed its statements to be true at the time they were made, and later moved to withdraw its answer only because it was, by then, in the process of being acquired by SBC.

[FN89](#). This is a long established principle of law. See, e.g., *Sayre v. Mohnney*, 56 P. 526, 528 (Or.1899) (" 'Admissions made in pleadings will bind the party in the suit in which they are filed, though such pleadings have been stricken out or withdrawn.' Upon principle, such pleading must be admissible

in evidence, for, if a party makes an oral declaration against his interest, it will be received in evidence, as tending to defeat a right which he attempts to assert in an action or suit in which the admission becomes material; and, such being the case, an original pleading, when verified, as in the case at bar, must, when superseded by an amendment, also be admissible for like reasons." (quoting 1 Am. & Eng. Enc. Law (2d ed.) 719).

4. "Economic Position" Means Full Economic Value

*18 After considering the plain language of the 1994 Plan and all the extrinsic evidence, the court concludes that the phrase "economic position" must refer to the full economic value of the options. The term "economic position" may well be unique in option grant agreements. At a minimum, the parties and their expert witnesses were unable to identify another employee option plan with the same language. The use of this distinctive term implies that the drafters of the 1994 Plan intended it to have an unusual meaning—one broader than intrinsic value. The only other plausible argument by the defendants to the contrary is that "economic position" refers to the option holders' position relative to the stockholders. [\[FN90\]](#) However, this interpretation finds no textual support in the 1994 Plan.

[FN90.](#) The defendants' argument is that the option holders are protected in that they were entitled to receive only what the stockholders receive. Thus, the option holders' "economic position" must only be the same as the stockholders. This argument finds no support in the 1994 Plan as the 1994 Plan does not tie the consideration the option holders receive to the consideration paid to the stockholders. While such an interpretation would be consistent with the general rule on how options function, here that general rule is modified by the 1994 Plan.

G. The Terms Of The Cingular-Wireless Merger Violated the 1994 Plan

The Cingular-Wireless merger agreement initially contemplated that all AWE options would be extinguished as of the effective date of the merger and would, as of that time, be adjusted into the right to receive \$15 in cash in exchange for the exercise price. The holders of in-the-money-options would

simply be paid the difference or spread between the exercise price and the cash amount. The holders of out-of-the-money options would receive nothing. As a result of the threat of litigation, the Wireless compensation committee, acting with the consent of Cingular and on the advice of Cingular's counsel, amended the merger agreement to "undo" the plan to extinguish all options at the effective time. This change had no real practical consequence, however, as the revived options were still adjusted as planned. Thus, the plaintiffs were paid the intrinsic value of their in-the-money options and received no compensation for their out-of-the-money options.

Plainly, this adjustment process was not undertaken with a view to preserving each "Participant's economic position with respect to the Award," as contemplated by the 1994 Plan. Thus, the court will now turn to the question of whether and, if so, to what extent the plaintiffs were damaged by the adjustment made to their options in connection with the merger.

IV.

A. Damages And Volatility In Options Valuation

The court heard from two damages witnesses, Professor Gregg A. Jarrell, who testified for the plaintiffs, and Dr. Andrew S. Carron, who testified for the defendants. Jarrell is a tenured professor of economics and finance at the William E. Simon Graduate School of Business Administration of the University of Rochester. Carron, who holds a Ph.D. in Economics, is the President of NERA Economic Consulting, a national economics consulting firm.

Although they disagree on other things, the two experts agree that use of the Black-Scholes option pricing model is an appropriate way to value the plaintiffs' options. [\[FN91\]](#) Black-Scholes uses five inputs to value a stock option: (1) the current price of the underlying asset (in this case, the value of the stock); (2) the exercise price; (3) the time to the expiration date; (4) the variance in the price of the underlying asset, often referred to as volatility; and (5) the risk-free interest rate. [\[FN92\]](#) The only one of these inputs that is not known is volatility. [\[FN93\]](#)

[FN91.](#) See Fischer Black & Myron Scholes, THE PRICING OF OPTIONS AND CORPORATE LIABILITIES, 81 J. POL. ECON. 637 (1973). The testimony at trial indicated that Black-Scholes was the most common method, but that another model, the lattice model, could be more appropriate for

employee stock options. As both experts employed Black-Scholes in measuring damages and testified that it was an appropriate method, the court adopts that method.

[FN92](#). There is a sixth factor, the payment of dividends, that is not relevant in this case.

[FN93](#). *C.F. T.C. v. Risk Capital Trading Group, Inc.*, 452 F.Supp.2d 1229, 1260 (N.D.Ga.2006) ("The more volatile a market is, the more likely it is that a price change may eventually make the option worthwhile to exercise. Thus, the option's time value, and therefore premiums, are generally higher in volatile markets. Volatility, mathematically expressed, is the standard deviation of price movements of some period of time. However, as you can see, volatility is the "soft" number of the three factors [time to expiration, strike price, and volatility] discussed here; in other words, the other two factors are objective values, only volatility is subjective. As a consequence, there are many ways of calculating and interpreting volatility.").

1. Jarrell's Damages Calculation

*19 Jarrell computed the investment value of the options on two dates: February 19, 2004, which he refers to as the cancellation notice, and October 26, 2004, the merger closing date. In both cases, he assumes that Wireless hypothetically exchanges the plaintiffs' options for Cingular options that have the same characteristics as the AWE options "so as to preserve their economic value in the merger with Cingular." [\[FN94\]](#) He uses, in both valuations, the \$15 cash merger price as the "current market price" since "both valuations are relevant only if the Cingular/AT & T Wireless merger actually takes place." [\[FN95\]](#) Jarrell also derived both a historical volatility for Wireless (63%) and an implied volatility for Wireless (42%). Using these inputs, together with the characteristics of each of the plaintiffs' option grants (i.e., exercise price and remaining period) and the risk-free interest rate, Jarrell calculated the investment value of the plaintiffs' options to be between \$12.9 million and \$17.7 million as of February 19, 2004, and between \$12 million and \$16.5 million as of October 26, 2004. The lower values in these ranges result from using the lower implied volatility, and the higher values result from using historical volatility.

[FN94](#), Ex. 97 at 2.

[FN95](#), *Id.* at 3.

As damages, the plaintiffs seek the difference between Jarrell's \$16.5 million October 25, 2004 valuation and the \$5,193,014 received by them in the merger as payment for the intrinsic value of their in-the-money options, or \$11,306,986. They seek the higher amount because, based on Jarrell's testimony, they argue that historical volatility more closely approximates the expected future volatility of the combined Cingular-Wireless enterprise.

2. Carron's Opinions

Carron's initial expert report contained a series of opinions that are framed to support the defendants' legal arguments about the proper construction of paragraph XVIII.A. This report does not provide any expert damages opinions. Carron's first opinion is that "because the value of MediaOne options was unaffected by the change in the common stock that resulted from the Cingular Merger, the economic position of holders of MediaOne options was unaffected by the adjustment of the options that occurred upon the closing of the Cingular Merger." [\[FN96\]](#) As he recognizes, this opinion is consistent with the result reached by the tribunal in the arbitration brought by AT & T under the Wireless Adjustment Plan. It is not, however, consistent with this court's conclusion that the 1994 Plan requires a different treatment of the plaintiffs' options. Carron's second opinion is that the treatment afforded the plaintiffs' options in the merger was consistent with "the manner in which the options were created in the first place, the concurrent treatment of publicly traded options by the [Options Clearing Corporation] and the professional accounting guidance for the valuation of options of non-public companies." [\[FN97\]](#) This again is an opinion addressing the merits of the liability case and does not relate to the question of the plaintiffs' damages. The final two opinions in Carron's report are to a similar effect. For example, his fourth conclusion is that it is consistent with market practices in cash acquisitions of public companies by private companies to pay only the intrinsic value of options, as measured by the deal price. That is, of course, exactly what happened in the Cingular-Wireless merger.

[FN96](#), Ex. 508 at 6.

[FN97](#), *Id.* at 9.

*20 Carron's rebuttal report consists of a series of mild criticisms of Jarrell's work. Carron's principal criticism is that Jarrell improperly paired a \$15 stock price with a volatility input measured at a time when the Wireless stock was trading at much lower, pre-announcement, prices. To "correct" this error (in his view), Carron performed two Black-Scholes analyses, one using the December 31, 2003 book value as the stock price, and the second using the November 11, 2003 stock price of \$6.77. These analyses yield values drastically lower than the intrinsic value paid in the merger. Having said that, neither the year end 2003 book value nor the stock price on November 11, 2003 has any relevance to the proper measure of damages in this case. They appear to have been prepared and advanced simply to show that the actual terms of the merger provided a windfall to the plaintiffs.

Carron's third and final report purports to value the options at the end of the trading day preceding the close of the transaction. In this calculation, Carron used the stock trading price near the deal price (\$14.92) but used a 6.48% implied volatility figure that was reported in the financial press based on that same day's trading in Wireless standardized call options. This analysis yielded a damages figure of no more than \$550,249. The relevance of this analysis to a damages calculation depends to a large extent on the validity of using such a low measure of volatility.

Carron is correct that the volatility of standardized options was low immediately before the merger; however, the plaintiffs' economic position is not reflected in this volatility measure since standardized options are extinguished by an event such as a merger. Thus, in the days leading up to the effective time of a merger, the volatility of such options will naturally tend toward zero. Moreover, to use a price other than the deal price would not fully maintain the plaintiffs' "economic position," within the meaning of the 1994 Plan since that plan required that the adjustment, like all prior adjustments made to account for earlier transactions, be based on the full value of the deal.

Thus, the court is led to conclude that all of Carron's expert opinions as to the value of the options are based on premises inconsistent with the requirements of the 1994 Plan. Specifically, as discussed above, the 1994 Plan mandates an adjustment in the plaintiffs' options at the time of the merger to fully preserve the plaintiffs' economic position. To adopt Carron's valuations using extraordinarily low

volatility or to use a price other than the merger price is simply inconsistent with the 1994 Plan. For these reasons, the court will base its damages calculation on Jarrell's work.

3. *Calculating Volatility*

The last remaining issue, one purely of valuation rather than legal interpretation, is whether this court should employ implied or historical volatility and what exact measure of volatility should be employed in calculating the plaintiffs' damages with the Black-Scholes formula. After weighing the experts' testimony, the court makes the following findings. The Black-Scholes valuation in this case depends substantially on what volatility assumption is used. There are two accepted methods for assigning a volatility assumption: historical volatility and implied volatility. [FN98] Implied volatility uses the trading price of standardized options to imply a volatility figure for non-publicly traded options. Since the market price is known for publicly traded options, the Black-Scholes formula is designed to solve for volatility rather than price. This volatility is then used to compute the price or value of other non-publicly traded options. Historical volatility uses the past movements of the stock price to calculate actual volatility over a prior period of time. Both methods are considered acceptable in different situations. Theoretically, implied volatility and historical volatility should be similar for the same company. Often, as here, they are not.

[FN98. See *In re Ashanti Goldfields Sec. Litig.*, 184 F.Supp.2d 247, 265 n. 17 \(E.D.N.Y.2002\)](#) (" 'Historical' volatility is derived from observed fluctuations in the market value of a financial instrument. 'Implied' volatility is derived from the option prices of the instrument. As historical volatility measures past market action, it is not considered to be as an accurate indicator of future volatility.") (citing Kimberly D. Krawiec, [More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives](#), 23 J. Corp. L. 1, 19 (Fall 1997)).

*21 Volatility is a measure of the rates of change in the value of the underlying asset. [FN99] Implied volatility has certain theoretical advantages in valuing options as it is based on the trading prices of other options, not the underlying stock. Thus, it can value non-traded options consistently with the market values of other comparable options. Implied volatility

also is forward-looking because the option prices from which implied volatility is derived reflect the market's view of the future volatility of the underlying stock.

[FN99](#). Kimberly D. Krawiec, [More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives, 23 J. Corp. L. 1, 19 \(Fall 1997\)](#) ("Volatility is measured by vega. Vega is usually expressed as a dollar amount per one percent change in volatility. An option with a vega of two dollars thus increases (decreases) in value two dollars for every one percent increase (decrease) in volatility.").

Implied volatility also has some disadvantages. Publicly traded options are often short term and have strike prices that are close to the current trading price of the underlying asset. The typical publicly traded option is for 90 or 120 days. Thus, implied volatility derived from publicly traded options reflects the market's opinion of the short-term prospects of the company rather than the long-term volatility prospects. In contrast, employee stock options are often for several years or more. Also, unlike the employee stock options here, publicly traded options do not have an anti-destruction provision. If the underlying security is destroyed by a merger, the option becomes worthless if not exercised. As a result, rational market participants account for this take-out risk by reducing the value they place on options. While implied volatility is the more pure economic means to calculate volatility, it must be used with caution when dealing with long-term options with anti-destruction clauses, or when operating in the context of an announced merger affecting the underlying stock.

Historical volatility measures past market action by calculating the actual volatility of the stock over time. Generally, when historical volatility is used, the historical period is matched to the remaining time left to exercise the option. Historical volatility is also not without flaws. As a purely historical measure, it may not be an accurate indicator of future volatility. This is most likely to be the case where the company has changed its risk profile, resulting in a different level of volatility going forward than in the past. Historical volatility also does not take into account a prediction of the general volatility of the market or the general market trend of the stock.

Volatility is a vitally important measure not only because implied volatility (measured by the price of

an option) often changes to reflect changing views as to future volatility, but because volatility has a large affect on the value of an option, especially an out-of-the-money option with a long duration until maturity. In circumstances such as this where the court is assessing damages based on an option valuation, the court should consider all factors before choosing a volatility assumption.

B. Factors Here Mandate The Use Of Historical Volatility

While implied volatility is the generally preferred method of valuing options, here historical volatility is the more appropriate measure of volatility for calculating damages. There are several reasons for this. First, the publicly traded options were of a much shorter duration than the plaintiffs' options. While this is typically a problem with using implied volatility to measure employee stock options, the problem here is particularly acute due to the changes in the telecom market. Second, and most important, the implied volatility of Wireless clearly shows that the market priced the options to include a significant take-out risk based on merger speculation. [\[FN100\]](#)

[FN100](#). See Exs. 128, 130.

*22 Implied volatility for Wireless from 2002 until December 2003 averaged in the 60% range. There was a sharp drop in implied volatility leading up to the merger announcement. The 42% implied volatility used by both experts was measured after this significant change. When Jerrell was asked to explain the sharp drop in implied volatility prior to the merger, he responded that the options would become worthless if the underlying stock was destroyed by way of a merger. The market clearly priced this risk into the options. The cellular industry was undergoing heavy consolidation and there was speculation Wireless was a merger target. Thus, implied volatility, even if used immediately before the merger announcement or first direct rumor of the merger, underprices the value of the plaintiffs' options because of the take-out risk priced into the publicly traded options. Therefore, the court adopts historical volatility as the proper measure of damages.

C. Damages Conclusion

The plaintiffs request damages based on a historical volatility of 63%, the same volatility used by Wireless to value its employee stock options in 2003. [\[FN101\]](#) The court finds this is a reasonable estimate

for the volatility of the plaintiffs' options. [\[FN102\]](#)
Based on Jarrell's valuation analysis as of October 25, 2004, the total value of the plaintiffs' options at the time of the merger was \$16.5 million. Because the plaintiffs received a total of \$5,193,014 in payment for their options in the merger, their damages amount to \$11,306,986. They are also entitled to prejudgment interest on this amount at the legal rate.

[FN101.](#) Ex. 81.

[FN102.](#) While the plaintiffs selected a fixed measure of volatility, the better metric would be to use historical volatilities that are commensurate with the time remaining to exercise the option. For example, under this calculation an option with three years remaining would have a volatility based on the last three years of historical volatility. In this case, historical volatility would be adjusted to exclude the period of market speculation prior to the merger. The court, after estimating the value of the options using the formula that employs historical volatilities adjusted for the time remaining to exercise the options, concludes that the valuation using that methods is sufficiently similar to the level of damages plaintiffs request and would likely result in a slightly higher value.

V.

For all the foregoing reasons, judgment will be entered in favor of the plaintiffs and against defendant AT & T in the amounts described in this opinion. Judgment will also be entered in favor of defendant Wireless. Counsel for the plaintiffs are directed to submit an order and final judgment in conformity with this opinion on or before July 31, 2007. IT IS SO ORDERED.

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