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Dismissals Loom Over Backdating Derivative Suits

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Tuesday, May 29, 2007 --- With the all-too-palpable threat of dismissal looming in derivative shareholder complaints filed over the alleged backdating of stock options, plaintiffs attorneys are already strategizing for the next stage and preparing their amended complaints.

A number of options backdating derivative shareholder suits filed in 2005 and 2006 have been dismissed in recent months because, the judges have ruled, the plaintiffs failed to adequately show demand futility. As the plaintiffs in these cases regroup and prepare to refile amended complaints, other cases may face a similar fate.

Suits against Bed Bath & Beyond, Computer Sciences Corp., and CNET Networks Inc. have all been dismissed in the last few months by federal and state court judges for failing to sufficiently plead demand futility.

Since derivative suits like these are ostensibly filed on behalf of the corporation against directors and executives, plaintiffs are required to first ask the board of directors to pursue claims before filing a suit themselves. If plaintiffs don't seek approval from the board, they must prove that it would have been futile to do so.

Plaintiffs can prove futility if they show specific evidence proving that the board was interested in the litigation. This requires the plaintiffs to implicate a majority of the board in the alleged options backdating activities.

Given the strict requirements of demand futility, the recent dismissals have come as no surprise to many securities attorneys.

Filing a motion to dismiss based on a failure to show demand futility is one of the first weapons in a defense attorney's arsenal, said Scott Meyers, a partner and chair of the litigation practice group at Levenfeld Pearlstein LLC. When faced with any derivative shareholder suit, defense attorneys will attack the complaint at basic levels, arguing that pleading standards were not met.

"The first round of complaints are usually not the best," Meyers said. "The first complaints usually have thin allegations and there is not a lot of case law instructing the plaintiffs as to what the courts will demand. So, some judges are being aggressive in viewing these complaints."

In options backdating derivative suits, if a judge finds that the complaint failed

to show that a majority of the board played a role in the alleged scandal, he or she can dismiss the suit.

“The judges in these cases are asking whether or not the board was conflicted,” Meyers explained. “They are looking for the complaints to specify which board members were involved in the alleged scandal, who received options, when they received it, and who approved it. The dismissals show that some judges have been taking their jobs as gatekeepers seriously.”

John D. Pernick, a partner at Bingham McCutchen LLP, recently co-authored a securities litigation alert focused on CNET and CSC’s dismissals. He agreed that judges are scrutinizing the particularity presented in the options backdating derivative suits’ complaints.

“Particularity means particularity as to the options grants at issue and the specific procedures of the corporations,” Pernick said. “Plaintiffs have to allege facts. They can’t just claim that someone had a role in the backdating. What these courts seem to be asking is, 'what did the defendant actually do?'”

Securities attorneys are preparing for more dismissals in similar cases in the near future. Dismissals will follow because defense attorneys are most likely going to present recent court decisions to judges mulling over similar cases in other jurisdictions.

“I expect to see more dismissals,” Meyers said. “Once a body of law starts to develop, a momentum starts to build.”

Jordan D. Hershman, co-chair of the securities litigation group at Bingham McCutchen, concurred.

“While each of these cases will be analyzed in a very fact-specific way, this is likely the beginning of a trend,” Hershman said. “The rationale in these recent cases is quite persuasive, and other courts are likely to follow those well-reasoned opinions.”

On the other hand, however, some motions to dismiss have been denied by courts. The Delaware Court of Chancery has denied two such motions in recent months. And according to Bruce G. Vanyo, the co-chair of the securities litigation practice at Katten Muchin Rosenman LLP, the dismissals are nothing more than a blip.

“I think recent dismissals might be misleading,” Vanyo said. “Dismissals are the first wave of resolutions you see. After that the settlements start to flow in from the unsuccessful dismissals or the cases where dismissals were not pursued.”

Now that judges are starting to issue decisions about dismissal motions, it's the ideal time for plaintiffs and corporations to reevaluate their cases and begin settlement talks in earnest, Vanyo said.

"There are some options backdating derivative suits that are very close to being settled. In a few months we'll see some settlements trickling in," Vanyo added.

The settlements, which may range from hundreds of thousands to millions of dollars, will most likely include disgorgement from individuals who profited backdated stock options as well as the plaintiffs attorneys' fees.

"Historically derivative actions have been a mechanism for the plaintiffs bar to extort legal fees from corporations," Meyers said.

But even if a judge denies a motion to dismiss, don't expect corporations to rush to settle. The next wave of developments in options backdating derivative suits may be dismissals based on actions already taken by the corporations to curb backdating.

"Even in instances where the defendants' motion to dismiss is denied, an options-related case may be rendered moot as a consequence of remedial actions that the corporation may have voluntarily undertaken," Hershman said. "The recent Bed, Bath & Beyond case raised that issue, and defendants are likely to press that issue in other cases going forward."

After the SEC began investigating alleged backdating at certain corporations, a number of companies commenced their own internal investigations. Typically, companies established committees to investigate alleged backdating and make recommendations about how to remedy any problems that were discovered.

Public companies are required to disclose their investigative committees' findings in reports filed with the SEC, which is both good and bad for plaintiffs in options backdating derivative suits. Although plaintiffs can learn which directors were involved in specific instances of options backdating through such reports, the public reports also outline what steps the companies have taken to make up for past indiscretions and prevent them from happening in the future.

If remedial actions have already been taken by a company involved in a derivative suit, there is not much more to dispute. The companies can ask the court to dismiss the complaint in light of their actions.

"It's hard to articulate the damage to the company caused by backdating," Pernick said. "In cases where companies have taken remedial actions it's going to be difficult for the plaintiffs to prove that there are any other remedial measures that could be taken. Where there's no damage there is no claim."

And even if a number of these suits get dismissed in the coming months, many will continue to languish in various courts around the country. A new scandal might crop up to catch the attention of the plaintiffs bar, but options backdating derivative suits will take a few more years to make their way

through the court system.

“The plaintiffs bar rarely gives up,” Meyers said. “The recent dismissals will show the plaintiffs’ attorneys what evidence they have to present when they file an amended complaint.”