

**ALLEGING DEMAND FUTILITY IN NEW YORK STATE COURT
DERIVATIVE ACTIONS ARISING FROM STOCK OPTIONS BACKDATING**

The Appellate Division in New York's First Department recently affirmed the dismissal of a derivative action relating to the backdating of stock options by Bed Bath & Beyond, Inc. The court held that the trial court properly dismissed the derivative action, finding that the complaint failed to allege that demand was excused as futile. This is the first New York appellate court decision affirming the dismissal of an options backdating action for failure adequately to allege demand futility. The court's decision comes just three months after the same court, in an opinion written by the same judge who wrote the Bed Bath & Beyond decision, reversed the dismissal of a derivative action in the high-profile Comverse Technology, Inc. options backdating matter, which was based on similar facts.¹

The Bed Bath & Beyond case, *Wandel v. Eisenberg*, is based on the alleged backdating of stock option grants by Bed Bath & Beyond. The case presented the Appellate Division with the opportunity to consider again the issue of how much knowledge and information a majority of the directors must have regarding the backdating of stock options for the plaintiff to establish demand futility. The Appellate Division held that the complaint "lacks the particularity required to support a finding of demand futility." Distinguishing *Comverse*, the court ruled that the complaint in *Wandel* "fails to allege with sufficient specificity a purposeful and egregious backdating scheme where the directors had significant reason to question or investigate the process of stock option issuance and failed to do so." The court also noted that, unlike in *Comverse*, Bed Bath & Beyond took actions to remedy the backdating "error," including resetting the price of unvested options and adopting a number of new controls.

Background

Similar to other litigation alleging claims arising from the backdating of stock options, *Wandel* had its genesis in publicity disclosing that a number of public companies had backdated stock option grants. In June 2006, securities analyst reports identified Bed Bath & Beyond as a company whose stock option grant dates raised suspicions of backdating. Shortly thereafter, Bed Bath & Beyond's board of directors formed a special committee of two independent directors to conduct an investigation.

¹ *In re Comverse Tech., Inc. Derivative Litig.*, 56 A.D.3d 49 (1st Dep't 2008). See Willkie Farr & Gallagher LLP Client Memorandum, *Special Committees Must Be Fully Independent and Demonstrate a "Vigorous" Commitment to Protecting the Interests of the Corporation* (Oct. 21, 2008) (available at http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2746%5CSpecial_Committees_Must_Be_Independent.pdf).

As a result of its investigation, the special committee, advised by legal counsel: (1) “identified various deficiencies in the process of granting and documenting stock options”; (2) found that “almost all annual grant dates in 1998-2004 likely were selected with some hindsight,” in that grant dates were selected within a few trading days after the recorded date; (3) concluded that the individuals who selected the grant dates did not “appreciate the accounting or disclosure implications of the practices used for selecting those dates”; (4) determined that the people responsible for the accounting and disclosure functions at the company were unaware of any of the improper date selection practices; and (5) concluded that no person involved in the grant process had engaged in willful misconduct, and that the co-chairmen and CEO believed that they were acting in the best interests of the company. In response to the special committee’s findings and conclusions, Bed Bath & Beyond adopted new controls in its stock option awards process, performed a financial analysis of the effect of adjusting for the option misdating and concluded that adjustment of the equity section of its consolidated balance sheet was necessary, and reset the prices of unvested options to the appropriate levels. No employees or officers were terminated.²

Within days of Bed Bath & Beyond’s disclosing the special committee’s findings, the derivative action was filed. The defendants moved to dismiss for failure to plead demand futility, and the lower court dismissed the action. The Appellate Division affirmed.

Demand Futility

Section 626(c) of the New York Business Corporation Law establishes as a prerequisite for a derivative action that the plaintiff allege, with particularity, either that an attempt was made to get the board of directors to initiate the action or that any such attempt would be futile. New York courts recognize three grounds for excusing demand on the board of directors as futile: (1) a majority of the directors are interested in the transaction; (2) the directors failed to inform themselves to a degree reasonably necessary about the transaction; and (3) the directors failed to exercise their business judgment in approving the transaction.³ The Appellate Division concluded that the plaintiff could not satisfy any of these grounds.

- **Majority Of Interested Directors** - Bed Bath & Beyond’s board consisted of ten directors. The complaint alleged that three of the directors (the inside directors) received backdated options, and the court considered them interested. The court, however, rejected the plaintiff’s allegations that the other directors also should be considered interested. First, there was nothing alleged from which to infer that any of the other directors were controlled by the inside directors. Second, a claim that the directors who served on the stock option and compensation committees should be deemed interested because they are “substantially likely to be held liable” is not enough. Finally, the assertion that the directors disregarded or abdicated their responsibilities to manage the stock option plan was not sufficient.

² See Form 8-K filed by Bed Bath & Beyond, Inc. (Oct. 10, 2006).

³ See *Marx v. Akers*, 88 N.Y.2d 189, 198 (1996).

- **Failure To Inform To The Degree Reasonably Necessary** - The court acknowledged that in *Comverse*, it concluded that demand was futile because the complaint adequately alleged that the board and its compensation committee had failed to exercise reasonably appropriate oversight of the stock option granting process. However, the court concluded that the complaint here failed to allege with the required particularity that the Bed Bath & Beyond directors had specific information or reason to inform themselves about the details of the issuance of the stock options and failed to do so. The court held that *Comverse* was distinguishable because there were no allegations here, unlike in *Comverse*, that (a) unanimous consents for grants of stock options were presented to the compensation committee for signature more than a month after the grant date where the stock price had risen dramatically in the intervening period, (b) the compensation committee members orally approved option grants in violation of the company's bylaws, or (c) the list of individuals who received option grants included persons who were not company employees.
- **Failure To Exercise Business Judgment** - The court also noted that in *Comverse*, it concluded that demand was futile because the complaint's allegations established that the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors. Here, however, the complaint failed to allege such a transaction. The court explained that the allegations against Bed Bath & Beyond's board were based on a report "acknowledging backdating but indicating that the misdating was generally by a matter of mere days." In contrast, the allegations in *Comverse* "drew a picture of a backdating process so open and egregious as to preclude the possibility that issuance and approval of those options could constitute an appropriate exercise of business judgment on the part of the board of directors."

Lessons Learned From This Decision

- **Is Backdating Options Egregious Conduct?**

The Appellate Division's decision makes clear that a mere allegation of backdating stock options, without more, is not sufficient to satisfy the demand futility requirement. Rather, the court will examine the specificity of the complaint to determine whether the necessary egregious conduct is alleged with particularity. Unless the specific allegations amount to egregious conduct, the court will be inclined to dismiss the complaint. Thus, the Appellate Division in *Wandel* noted that the complaint "fail[ed] to allege with sufficient specificity a purposeful and egregious backdating scheme where the directors had significant reason to question or investigate the process of stock option issuance and failed to do so." In contrast, in *Comverse*, the court observed that the backdating of stock options was "so egregious that it could not have been the product of the sound business judgment of the directors."⁴

⁴ *Comverse*, 56 A.D.3d at 56 (citing *Ryan v. Gifford*, 918 A.2d 341, 354, 355-56 (Del. Ch. 2007)).

- **The Court’s Analysis Of Remedial Measures**

The Appellate Division’s analysis demonstrates that in assessing whether the plaintiff has satisfied the demand futility requirement, the sufficiency of the remedial measures adopted by the company will be measured in light of the egregiousness of the alleged conduct. In considering the remedial measures adopted by Bed Bath & Beyond, the Appellate Division did not require the termination of any employees. In contrast, in *Comverse*, the termination of the alleged wrongdoers was not deemed sufficient. Thus, in *Wandel*, the Appellate Division noted approvingly that Bed Bath & Beyond had reset the price of unvested options and adopted a number of controls, without criticizing the company for not terminating anyone, while the court observed that Comverse had “failed to take action to correct the damage to it even after the scheme came to light” and criticized the company for not terminating the alleged wrongdoers until after the SEC filed civil charges and the United States Attorney for the Eastern District of New York filed criminal charges against those individuals.

* * * * *

If you have any questions regarding this memorandum, please contact Scott S. Rose (212-728-8502, srose@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

February 3, 2009

Copyright © 2009 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York’s Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.