Northern District of California Dismisses Shareholder Derivative Stock Options Backdating Case: *In re CNET Networks, Inc., Shareholder Derivative Litig.*

KEVIN MUCK, FELIX LEE AND ERIC BALL

In a detailed and thoughtful decision – and one that is certain to be cited frequently in the months ahead – Judge William Alsup has dismissed a shareholder derivative complaint against various officers and directors of CNET Networks, Inc. based on allegations of options "backdating." *In re CNET Networks, Inc. Shareholder Derivative Litigation*, No. 3:06-cv-03817 (N.D. Cal. April 11, 2007). After carefully analyzing the specific grants at issue and allegations relating to individual directors, the Court held that plaintiffs failed to establish that a majority of CNET's board faced a substantial likelihood of personal liability or was otherwise incapable of exercising independent business judgment. As a result, plaintiffs were unable to show that they have standing to sue on the company's behalf.

Based largely on the perceived statistical improbability of CNET's option grant prices, plaintiffs alleged that eight grants to directors and officers had been backdated, which they argued rendered CNET's Board incapable of disinterestedly weighing a shareholder demand to pursue litigation against the defendants. In rejecting plaintiffs' arguments, the Court began by scrutinizing their use of price movements surrounding the option grants to prove their claims of backdating, and noted their "fail[ure] to plead where their method came from, whether it was used by anyone else, or whether it was peer-reviewed or bore other indicia of academic approval." Accordingly, the Court held that without establishing that their allegations were based on "sound analytical methods," an inference of fraud was "more difficult to support."

Relying heavily on guidance provided by the SEC's Chief Accountant on September 19, 2006, the Court also explained that there are a number of non-fraudulent explanations as to how a Company could use the wrong measurement date for an option grant. Consequently, the mere conclusion that an option bore an incorrect measurement date or any resultant restatement of financial statements would be insufficient by itself to demonstrate wrongdoing.

The Court also analyzed the facts surrounding each allegedly improper grant and found in most cases that the plaintiffs failed to plead sufficient facts to support an inference of backdating. In particular, the Court did not find an inference of backdating where:

- The grants were issued pursuant to an overall plan with a pre-scheduled grant date, such as an annual director grant;
- Form 4s were timely filed within two days of the grant;
- The grants were made to new employees as part of a publicly disclosed merger;
- The grant was contemporaneous in time with a public announcement of the new hire who received the grant; or
- The grant was only misdated by "a single day."

The Court ultimately found that plaintiffs adequately alleged that three grants were backdated. In each instance, specific facts suggested that the grant was so fortuitously timed as to raise doubts about its propriety, and defendants were unable to provide a legitimate, judicially-noticeable explanation for the timing.

Nonetheless, the Court made clear that the existence of backdated grants was not sufficient to render the directors incapable of determining whether litigation was in the company's best interest. Instead, the Court evaluated each director's role in the alleged backdating of these options and whether sufficient facts had been pled to call into question their independence and disinterestedness.

In so doing, the Court reaffirmed that "mere membership on a committee or board without specific allegations as to defendants' roles and conduct, is insufficient to support a finding that directors were conflicted." The Court found especially compelling the fact that "plaintiffs [made] no allegation indicating that [the directors] chose the date on which the allegedly backdated options were granted or that they knew the grants' true date." Such facts are even more necessary, the Court explained, in cases where directors delegated their authority regarding the setting of grant dates and prices to company executives. The Court also found that directors who joined the Board or Compensation Committee after the alleged backdating occurred were disinterested and could independently evaluate the Company's option backdating claims.

The Court also noted that once CNET's option problems came to light, the Board appointed a Special Committee to investigate and apply remedial measures. This ultimately resulted in a re-pricing of some options and a restatement of the Company's financials, but the Committee did not find any intentional wrongdoing. In light of this fact, the Court would not infer that fraud occurred "absent other facts" to the contrary.

Because only one director (who received an allegedly backdated grant) was arguably "interested," plaintiffs were not entitled to usurp the Board's authority to decide whether or not to pursue litigation. Although noting that it was inclined to grant defendants' motion to dismiss with prejudice, given plaintiffs' repeated amendments to their complaint, the Court requested additional briefing as to whether the plaintiffs were entitled to limited discovery regarding the Compensation Committee members' possible involvement in alleged backdating.

It is also noteworthy that the Court distinguished the Delaware Chancery Court's recent opinion in *Ryan v. Maxim Integrated Products, Inc.*, No. 221-N (Del. Ch. Feb. 6, 2007), and relied more heavily on Judge Chesney's opinion in *In re Linear Tech. Corp. Deriv. Litig.*, No. C-06-3290 MMC (N.D. Cal. Dec. 7, 2006), which also dismissed a derivative backdating case for failure to plead demand futility.

Kevin P. Muck, Partner, Litigation Group
kmuck@fenwick.com, 415.875.2384

Felix S. Lee, Associate, Litigation Group
flee@fenwick.com, 650.335.7123

Eric Ball, Associate, Litigation Group
eball@fenwick.com, 650.335.7635