

David Shaev Profit Sharing Account v Cayne

2004 NY Slip Op 30289(U)

July 12, 2004

Supreme Court, New York County

Docket Number: 601599103

Judge: Bernard J. Fried

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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: BERNARD J. FRIED
Justice

PART 60

DAVID SHAEV PROFIT SHARING ACCOUNT
F/B/O DAVID SHAEV, ON BEHALF OF HIMSELF
AND ALL OTHERS SIMILARLY SITUATED,

INDEX NO. 601599/03

Plaintiff,

MOTION DATE 3-29-04

- v -

MOTION SEQ. NO. 2

JAMES E. CAYNE, CARL D. GLICKMAN,
ALAN C. GREENBERG, DONALD J. HARRINGTON, et. al.,

MOTION CAL. NO. 5

Defendants,

-and-

THE BEAR STEARNS COMPANIES, INC.,

Nominal Defendant.

The following papers, numbered 1 to _____ were read on this motion to/for _____

Notice of Motion/ Order to Show Cause — Affidavits — Exhibits 1..

Answering Affidavits — Exhibits _____

Replying Affidavits _____

PAPERS NUMBERED

Cross-Motion: Yes No

FILED

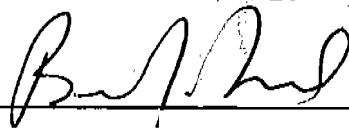
JUL 13 2004

MOTION IS DECIDED IN ACCORDANCE
WITH ACCOMPANYING MEMORANDUM
DECISION

NEW YORK
COUNTY CLERK'S OFFICE

BERNARD J. FRIED
J.S.C.

Dated: 7/12/04


J.S.C.

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DONOTPOST

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 60

-----X
DAVID SHAEV PROFIT SHARING ACCOUNT
F/B/O DAVID SHAEV, ON BEHALF OF HIMSELF
AND ALL OTHERS SIMILARLY SITUATED,

Index No.: 601599103

Plaintiff,

-against-

JAMES E. CAYNE, CARL D. GLICKMAN,
ALAN C. GREENBERG, DONALD J.
HARRINGTON, WILLIAM L. MACK, FRANK T.
MCKELL, PAUL A. NOVELLY, FREDERJCK V.
SALERNO, ALAN D. SCHWARTZ, WARREN J.
SPECTOR, VINCENT TESE and FRED WILPON,

Defendants,

-and-

THE BEAR STEARNS COMPANIES, INC.,

Nominal Defendant.

-----X
FRIED J.:

Plaintiff, David Shaev, a shareholder of nominal defendant Bear Steams
Companies, Inc. (“Bear Steams”), has brought this shareholder derivative action against
the company’s Board of Directors and one former member’ (“Defendants”) for losses
resulting from their breach of fiduciary duties. All defendants have moved for dismissal
of plaintiffs amended shareholder derivative complaint (“Complaint”) on the grounds
that: (1) plaintiff failed to make a pre-suit demand upon Bear Steams’ Board of Directors

¹ Members of the Board of Directors are James E. Cayne (“Cayne”), Carl D. Glickman (“Glickman”), Alan C. Greenberg (“Greenberg”), Donald J. Harrington (“Harrington”), William L. Mack (“Mack”), Frank T. Nickell (“Nickell”), Frederic V. Salerno (“Salemo”), Alan D. Schwartz (“Schwartz”), Warren J. Spector (“Spector”), Vincent Tese (“Tese”), and Paul A. Novelly (“Novelly”). Fred Wilpon (“Wilpon”) resigned as a director in July 2003.

or establish demand futility via particularized allegations pursuant to Delaware law; (2) Bear Stearns' Certificate of Incorporation precludes director liability on plaintiffs claims; and (3) the Complaint does not satisfy the particularized pleading requirements of CPLR 3016. For the reasons discussed below, the motion to dismiss is granted.

Bear Stearns is a Delaware corporation which provides investment banking, securities and derivative trading, and clearance and brokerage services to investors worldwide. The individual defendants are the company's eleven current Board of Directors and one former member. Four of the twelve defendants are "inside" defendants because they are executive officers of the company.² Plaintiff questions the company's IPO allocation practices; however, the gravamen of the Complaint is the alleged illicit relationship between the equity research and investment banking divisions. Plaintiff alleges that defendants approved, or with conscious disregard failed to put in place, procedures to detect that the equity research department was run as an adjunct to the investment banking division to curry favor with the firm's potential and existing investment banking clients.

The investment banking division, which generates a significant amount of the firm's revenues,³ advises and assists corporate clients in executing various financial transactions, including the issuance of stock and initial public offerings ("IPOs"). The equity research analysis division reviews performance of certain companies in a broad

² Cayne is Chief Executive Officer and Chairman of the Board, Greenberg is Chairman of the Executive Committee, Schwartz and Spector are joint Presidents and Co-Chief Operating Officers.

³ Bear Stearns was ranked as the 10th highest grossing investment banking firms in 1999 with \$2.09 billion in proceeds. In 2000, the company was ranked 13th with \$863 million in proceeds.

range of industry sectors. Analysts traditionally examine financial information contained in the company's public filings, question company management, investigate customer and supplier relationships, and evaluate the companies' products or services offered to determine whether these companies present good investment opportunities. They publish reports which rate the companies, from most to least positive, as "Buy," "Attractive," "Neutral," or "Sell" and these reports are available to clients and sometimes the public.

The Complaint alleges that the improper interrelation of the investment banking and equity research divisions was fostered and effected by the compensation policy enumerated in the company's Proxy Statements, which states that compensation of senior executives should be directly linked to overall company performance. Plaintiff claims that analysts understood that negative ratings and recommendations could adversely affect Bear Stearns' ability to attract and retain investment banking business and in turn, reduce their salaries. Plaintiff supports this contention by citing meeting notes reflecting comments by the Head of Research to analysts that "being a partner with banking is part of the analyst job description...Working on transactions is not incremental to your compensation, it is an expected part of it."

Plaintiff claims that issuers often select an investment **bank** based on its analysts' reputation of writing positive reports on companies in that sector and the frequency of coverage given to these companies. The Complaint states that analysts were used as marketing tools and points to "pitch books" given to prospective clients which often identified analysts by name and highlighted information regarding their background, their reputation for issuing favorable reports, the success rates of underwritten IPOs covered by

these analysts, and the number of lead and co-managed IPOs that Bear Stearns has under research coverage. Plaintiff argues that this information was intended to convey to the issuer that such favorable treatment would be afforded to them if Bear Stearns obtained their investment banking business.

Plaintiff contends that analysts' conflicts of interest were illustrated by their active participation or assistance in investment banking deals: analysts identified companies to solicit for investment banking services; they participated in "pitches," or presentations, to potential investment banking clients; they attended "road shows" to market an upcoming underwriting; many analysts regularly communicated with covered companies' employees via telephone, e-mail, analyst calls, or at company-sponsored events; and they **spoke** to investors to generate interest in underwriting transactions. Plaintiff also alleges analysts often participated in the Commitment Committee and were involved in due diligence underwriting transactions and sometimes assisted the investment banking department in providing merger and acquisition and other advisory services to clients. In addition, the Complaint states that in vying for a company's investment banking business, research analysts nominated that company to participate at Bear Stearns-sponsored conferences; took the company's management on non-deal road shows; hosted field trips for institutional investors; and arranged other meetings between institutional investor clients and that company.

According to plaintiff, prospective clients also consider an investment bank's aftermarket trading support as a factor in selecting an investment bank and argues that analysts were heavily involved in promoting aftermarket trading. Plaintiff states that the

“Trading Focus List,” which named stocks of prospective investment banking clients, was distributed to sales and trading personnel as well as research analysts. Plaintiff also cites numerous e-mails from one analyst to Equity Trading asking for increased trading support for covered companies. In a December 10, 1999 e-mail, the analyst states that the management of one of his covered companies is “extremely happy with our research coverage and banking services. But they have repeatedly indicated to me that our trading stat. is not satisfactory...CEO hinted to me many times that we have a chance for the books for the secondary if we improve the trading...” In another e-mail, dated September 14, 2000, the analyst asked equity traders to boost trading for a banking client and stated, “Help us here since this important technology client indicated to me that if we do not improve, it will hurt our banking relationship with the company.”

In regards to analysts’ rating of companies, plaintiff alleges that if the company was to participate in an equity offering, it was expected to be given an initial “Buy” rating. Plaintiff states that if an analyst was to issue a report with less than a “Buy” rating, he or she was required to inform the investment bank in advance. The Complaint also alleges that Bear Stearns published exaggerated or unwarranted research and cites an April 2002 e-mail from an analyst to an investment banker, stating

I have to tell you, I feel a bit compromised today. I have told every client on the phone that they should avoid or short the stock over the last few months...The artificial Buy rating on the stock, while artificial, still makes me look bad...I’d like to have more leeway with the ratings, even for companies like Digital River, where we have a relationship on the banking side.

Defendants Glickman (Chairman), Harrington, Nickell, and Tese are members of the Compensation Committee which establishes the compensation structure of all

executive officers and other senior directors. Defendants Cayne, Greenberg, Schwartz, and Spector comprise the Executive Committee which provides input to the Compensation Committee regarding the compensation structure. Plaintiff alleges that these members “approved or recklessly ignored” the improper analyst compensation structure which linked analyst pay to investment banking activities.

Plaintiff further alleges that defendants intentionally or recklessly failed to supervise or put in place basic oversight and monitoring procedures. To the extent that each defendant was unaware of the actions described, plaintiff contends that the lack of knowledge resulted from a sustained and systematic failure to not only assure that the Board was properly informed about its business activities, but also to supervise such activities properly. Plaintiff claims this failure was reckless and did not constitute a good faith business judgment.

The Complaint alleges that the company’s executive officers, including the inside defendants, consistently chose to put profits before Bear Stearns’ compliance with regulations and legal obligations to customers, investors, and stockholders and claims that Bear Stearns’ profit increase⁴ since 1999 coincided with the increasing level of unlawful business practices. Plaintiff states that defendant’s breach and/or culpable disregard of their fiduciary duties and lack of good faith supervision already cost Bear Stearns \$80 million in fines and subjected the company to potential losses in connection with class action investor lawsuits, in addition to future examinations by numerous regulators. Plaintiff claims that the company’s stock price only grew at half the rate of its competitor

⁴ In 2000, Bear Stearns’ net income grew to \$773 million, an increase of 25% from 1997 and 42% from 1998. Similarly, net revenues grew to \$5.476 billion, an increase of 42% from 1999 and 31% from 1998.

because of this continued illicit activity. Allegedly violated knowingly or recklessly by defendants were the following rules:

a) NYSE Rules 401; 472; 476(a)(6); NASD Rules 2110, 2210 for issuing research reports that were not based on principles of good faith and fair dealing and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about covered companies and/or contained opinions for which there was no reasonable basis.

b) NASD Rule 3010 and NYSE Rule 342 for failing to monitor adequate supervision over research and investment banking operations.

In support of these claims, plaintiff alleges that there were numerous red flags visible to all defendants that should have warned them of the unlawful conduct. Plaintiff states that the two 1999 SEC administrative proceedings regarding fraudulent conduct and the SEC suit filed in April 2003 in the Southern District of New York, concerning research analysts' conflicts of interest, should have put the Board on notice. In this federal action before Judge William H. Pauley, Bear Stearns agreed to pay, as part of a global settlement with nine other brokerage firms, \$80 million⁶ to include penalties, disgorgement, procurement of independent research, and investor education. Plaintiff also cites a May 12, 2003 Wall Street Journal article which stated that days after the federal case settled, "Bear Stearns Cos. reverted to the practice of using an analyst to

⁵ Bear Stearns entered into a settlement with the SEC over allegations that there was misconduct (1) in market making transactions in two stocks in which Bear Stearns was a market maker; (2) in entering fictitious quotations in market making transactions in seven stocks for which Bear Stearns was a market maker; and (3) in Bear Stearns' failure to supervise its NASDAQ market making activities. Bear Stearns was ordered to pay a \$225,000 fine and implement any practices recommended by an "Independent Consultant" appointed by the SEC to review the company's compliance policies. In mid-1999, the SEC found that Bear Stearns engaged in fraudulent conduct in connection with the fraudulent activities of A.R. Baron & Co. Bear Stearns was ordered to pay a \$5 million fine and implement any practices recommended by a SEC appointed "Independent Consultant." In a parallel proceeding brought by the New York County District Attorney office, Bear Stearns agreed to pay \$30 million.

⁶ In his Order, Judge Pauley stated that the \$80 million paid by Bear Stearns does not "close off any avenue of recovery against any of the defendants by any aggrieved investor."

promote a new stock offering” and when questions were raised, the company took the “embarrassing step” of delaying the JPO of credit card-processing firm, JPayment Inc.

The Complaint states that numerous internal documents magnified the alignment of the two divisions. In self-evaluations, analysts provided extensive information regarding their assistance to investment banking deals, including accomplishments, goals, participation, and sometimes revenue generated in lead, and co-managed, underwritings. One analyst noted in his 2000 evaluation that “certain banking clients felt that our research and public comments weren’t sensitive to their interests...we will continue to make every effort to be sensitive to our clients and banking partners.” In addition, analysts’ business plans had a “Banking” section in which analysts were asked about their plans to market transactions or to introduce merger and acquisition activity. One analyst remarked, “If I were any more aggressive in the banking area, my office would be on the third floor [location of Bear Stearns’ investment banking division].” Plaintiff contends that internal e-mails further illustrated the analysts’ conflicts of interest. In an October 24, 2000 e-mail to the Head of Research summarizing his key accomplishments during fiscal year 2000, an analyst stated that he identified a new industry category which resulted in two IPO deals. He also stated that Bear Stearns unsuccessfully pitched for Agilent Technologies’ business, but after “he went in,” he “re-won the business” and “generated fees of around \$2.5 million to the firm.” In addition, plaintiff points to an April 19, 2002 e-mail from a supervisory analyst to an associate analyst that stated before he could drop coverage of a company, he needed “to get permission from both: 1. The market makers on the trading desk, 2. the bankers.”

In addition, the Complaint argues that defendants were bombarded with numerous exposes. Plaintiff cites two newspaper articles⁷ and an SEC legal bulletin regarding IPO allocation practices, none of which specifically name Bear Stearns. Plaintiff cites SEC Chairman Arthur Levitt's Address' at the Investors' Town meeting and more than six newspaper articles' regarding unlawful underwriting practices. Two of these articles mention a former Bear Stearns' analyst, Sean Ryan who claims that he was berated by his boss for jeopardizing investment banking business after publishing a negative report, was pressured by senior management to issue "Buy" recommendations," and that analysts' bonuses were based on, among other things, how well the analysts worked with the investment banking group." Plaintiff also cites an August 2001 Frontline interview of Scott Ehrrens, a former Bear Stearns' analyst who covered Internet stocks, who stated, "When you're doing an underwriting, of course you have a buy...how could you underwrite stock and have a sell recommendation on it?" Plaintiff argues that "given the general circulation of these periodicals" and that "defendants were active participants in

⁷ Trying to Avoid the Flippers, *The Wall Street Journal*, Dec. 6, 2000; Susan Pulliman & Randall Smith, U.S. Probes Inflated Commissions for Hot IPOs, *Wall Street Journal*, Dec. 7, 2000.

⁸ Arthur Levitt, Address at the Investors' Town Meeting, Albuquerque, New Mexico, Nov. 20, 1999.

⁹ Analyst Reports Pressures of Employer's Trading, *The Wall Street Journal*, Sept. 4, 2001; Bad Advice, *Bloomberg*, July 2000; Steve Bajly & Steven Syre, Taking Analysts Tempting Forecasts with a Grain of Salt, *The Boston Globe*, Oct. 23, 1996; Jeffrey Laderman, Who Can You Trust?, *Bus. Week*, Oct. 5, 1998 ("brokerage firms are not about to break up the money matching that pairs analysts with dealmakers. And analysts are not about to risk offending the companies they cover"); Erick Schonfeld, The High Price of Research, *Fortune*, Mar. 20, 2000 ("Analysts of all stripes ...increasingly derive a portion of their compensation, directly, or indirectly, from the companies they cover"); Eileen Buckley, Holding Analysts Accountable, *The Industry Standards*, June 12, 2000.

¹⁰ Analyst Reports Pressures of Employer's Trading, *The Wall Street Journal*, Sept. 4, 2001.

¹¹ Bad Advice, *Bloomberg*, July 2000.

capital market activities,” it may be presumed that defendants were aware of them.

ANALYSIS ¹²

Because this case concerns issues of corporate governance, it is undisputed that the law of Bear Stearns state of incorporation, Delaware, applies. (See e.g., Hart v. General Motors Corp., 129 AD2d 179, 183 [1st Dept., 1987] citing Diamond v. Oreamuno, 24 NY2d 494, 503 [N.Y., 1969]).

The threshold issue is whether plaintiffs’ allegations support their assertion that a pre-suit demand on the Board would be futile. Under Delaware Chancery Court Rule 23.1, a plaintiff in a derivative suit must seek remedial action on a claim from the corporation’s Board of Directors before empowered to sue derivatively. The purpose of a pre-suit demand is to assure that the stockholder affords the Board the opportunity to address an alleged wrong without litigation, to decide whether to invest the resources of the corporation in litigation, and to control any litigation which does occur. (Spiegel v. Buntrock, 571 A2d 767, 773 [Del., 1990] citing Kaplan v. Peat, Marwick, Mitchell & Co., 540 A2d 726, 730 [Del., 1988]). Delaware courts have articulated two standards for determining when this demand may be excused as futile. In cases such as Aronson v. Lewis, 473 A2d 805, 814 (Del., 1984), where Board actions are at issue, demand will not be excused unless plaintiff alleges with particularity facts creating a reasonable doubt that (1) the directors are disinterested and independent or (2) whether the transaction at issue resulted from a valid exercise of business judgment. However, it has been held where the

¹² This analysis is similar to Striffler v. Purcell, et al. (Index No, 601935/03), in which I dismissed a shareholder derivative complaint against Morgan Stanley & Co., Inc.’s Board of Directors. Since the Complaint here mirrors Striffler’s amended complaint, much of that analysis is relevant and repeated.

wrong alleged is the Board's inaction or failure to monitor and supervise, a court need only determine that the complaint meets the first prong of the Aronson test regarding independence and disinterestedness. (Rales v. Blasband, 634 A2d 927, 934 [Del., 1993]). The inquiry is highly factual and must be decided on a case-by-case basis, employing an objective analysis. (Grobow v. Perot, 539 A2d 180 [Del., 1987]).

Plaintiff claims that he did not make the pre-suit demand required by Delaware law because it would have been futile for the following reasons: (1) the majority of directors lack independence because they are either executive officers or have material business relations with the company (2) they are not disinterested because their failure to execute watchdog functions subjected them to a substantial likelihood of liability and because their multi-million compensation packages made them beneficiaries of the wrongful transactions; (3) the Board's approval of a compensation structure which perpetuated illegal conduct was not a product of good business judgment; and (4) Bear Stearns' Certificate of Incorporation does not immunize defendants' inexcusable pattern of inattention, failure to act with good faith, and knowing or reckless abdication of their supervisory responsibilities. Because plaintiffs challenge the Board's institution of a compensation policy that allegedly created the conflict of interest, in addition to their failure to exercise oversight to prevent the alignment of the research and investment banking divisions, both prongs of the Aronson test are discussed.

I. ARONSON TEST

A. Complaint Fails to Raise Reasonable Doubt that Defendants Are Independent and Disinterested

Under Delaware law, it is required that a shareholder derivative complaint plead

particularized facts that raise a reasonable doubt as to whether a majority of the Board on which demand would be made was able to exercise independent and disinterested judgment. (Aronson, 473 A2d at 814). Independence involves an inquiry into whether the director's decision resulted from that director being controlled by another, either by a close family relationship, force of will, or if the director is beholden to a controlling entity. (Orman v. Cullman, 794 A2d 5, 25 [Del. Ch., 2002]). Allegations of personal friendships or outside business relationships alone are insufficient to raise a reasonable doubt regarding a director's independence. A plaintiff must plead facts showing that the director is beholden to or so under the influence of a controlling person or entity that he is unable to exercise appropriate discretion with respect to corporate decisions. (Litt v. Wycoff, 2003 WL 1794724 [Del. Ch., March 28, 2003]).

Plaintiff claims that the four inside defendants are not independent because they are company officers or employees; however, employment or a position as an officer of a company does not automatically render a defendant incapable of independent judgment. (See Benerofe v. Cha, 1996 WL 535405 [Del. Ch., Sept. 12, 1996]). Plaintiff also claims that because the inside directors received millions of dollars in compensation in the last three years, they are not independent and argues that this case is on point with Rales v. Blasband, 634 A2d 927, in which demand on the Board was excused because a reasonable doubt as to the inside defendants' independence was raised. Two of the defendants, the Rales brothers, received large salaries; however, the case is distinguishable because the court determined that the remaining Board members were beholden to the brothers who owned 44% of the company's stock. Here, no controlling

shareholder is identified. According to the 2004 Proxy Statements, none of the inside directors own more than 7% of stock. Thus, a reasonable doubt as to the inside defendants' independence has not been raised.

Plaintiff also claims that outside defendants Mack, Novelly, Nickell, and Wilpon lack independence because they have "substantial business relationships" with Bear Stearns that are subject to the control of the company's inside directors." The Complaint merely states that Mack, Novelly, and Nickell are executive officers and/or Board members of other companies that have conducted various business transactions with Bear Stearns. There are no well-pleaded allegations that these defendants have any financial interest or ownership stake in a company that might have been materially affected by these transactions or that they are beholden by any controlling persons. (See Litt 2003 WL 1794724, at *4; Zimmerman v. Braddock, 2002 WL 31926608 [Del. Ch., Dec. 20, 2002]). In regards to Wilpon, whose real estate company developed and manages Bear Stearns' New York Headquarters, plaintiff relies on Orman v. Cullman, 794 A2d 5 (Del. Ch., 2002), where a director's receipt of \$75,000 in consulting fees ~~was~~ enough to raise a reasonable doubt as to his independence. However, this reliance is misplaced because the

¹³ Mack is Chairman of the Board of Directors and Chairman of the Executive Committee of Mack-Cali Realty Corporation and the Managing Partner of Apollo Real Estate Advisers. In June 2003, Bear Stearns raised \$100 million in financing for Mack-Cali and in 1999, Bear Stearns represented Apollo in connection with a \$1 billion investment in Patriot American Hotels. Novelly is Chairman of the Board, Chief Executive Officer and controlling stockholder of Apex Oil. Apex Oil and Bear Stearns jointly own Liquid Funding, LLC. Bear Stearns also provided a \$15 million line of credit to a wholly owned affiliate of Apex Oil. Nickell is President and Chief Executive Officer of Kelso & Company. Bear Stearns was a lead underwriter of a stock offering in July 2003 by Erida Pharmaceuticals Holdings, Inc. which is owned by Kelso. In 1999, Bear Stearns provided a company controlled by Kelso a fairness opinion relating to an acquisition of Citation Corporation, Wilpon is owner and founder of Sterling Equities, a real estate conglomerate. Sterling has received more than \$17 million in connection with the development and management of Bear Stearns's World Headquarters in New York City. Plaintiff also claims that Bear Stearns paid an unspecified company, alleged to be controlled by Wilpon and his family, more than \$2 million for consulting services.

issue of independence related to whether the director could vote on a transaction, rather than in the context of demand futility.¹⁴ Nevertheless, it was determined that a director was beholden to a controlling shareholder group found to be “in a position to determine whether particular contracts are to be renewed as well as the extent to which the company will make use of the consulting services already under contract.” (*Id.* at 30). Here, plaintiff makes no allegation that Wilpon is beholden to any person who may be in the position to affect the services already under contract. Also, the allegations regarding the transactions between the company of which Wilpon and his family purportedly are majority owners are insufficient because the Complaint does not specify who these family members are, whether these payments are material to them, or whether these fees were at an above-market rate or otherwise inappropriate. (*See Litt* 2003 WL 1794724, at *5). Thus, plaintiff’s claim falls short of the types of entanglements necessary to establish a majority of directors’ lack of independence.

Plaintiff also alleges lack of disinterest which requires him to demonstrate a majority of the directors could not have been disinterested in considering a demand. (*See Rattner v. Bidzos*, 2003 WL 22284323 [Del, Ch., Sept. 30, 2003]). A Board member is considered “interested” if accused of self-dealing or appearing on both sides of a transaction. (*Aronson*, 473 A2d at 812). Other indicators include receiving a personal financial benefit from a transaction not equally shared by stockholders or if a corporate decision will have a materially detrimental impact on its directors. (*Rales*, 643 A2d at

¹⁴ *Orman*, a shareholder class action suit against defendant cigar manufacturer and distributor corporation and its eleven directors, involved alleged breaches of fiduciary loyalty duties and of proxy statement disclosure duties in connection with the corporation’s cash-out merger of the public shareholders.

936). Plaintiff claims that demand should be excused because the directors “will wrongfully refuse to prosecute this action against themselves.” However, the law makes clear that unless facts are alleged with particularity, “a bare claim of this sort raises no legally cognizable issue under Delaware corporate law.” (Aronson, 473 A2d at 818). Plaintiff also claims that the four insider directors are interested because their enormous compensation packages constitute a personal benefit from the illicit transactions not equally shared by stockholders. However, receipt of salary based on the overall profitability of a company does not amount to such disabling interest without allegations that the director appeared on both sides of a transaction or expected to derive any personal financial benefit from it in the sense of self-dealing. (Id. at 805).

Plaintiff also argues that the defendants are “interested” because they face a substantial likelihood of liability for breaching their fiduciary duties by failing to perform their crucial watchdog and oversight functions. This type of claim, alleging that directors allowed a situation to develop and continue consequently exposing the corporation to enormous legal liability, is known as a “Caremark claim.” (See In re Caremark International, Inc. Deriv. Litig., 698 A2d 959 [Del. Ch., 1996]). Caremark held, “Only a sustained and systematic failure of the Board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability.” (Id. at 971). A plaintiff must plead particularized facts of egregious conduct by a majority of the directors demonstrating that they were “grossly negligent in failing to supervise these subordinates” in order to excuse demand. (Rattner, 2003 WL 22284323, at *12 quoting

Seminaris v. Landa, 662 A2d 1350, 1355 [Del. Ch., 1995]). Such a claim has been said to be “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” (Wilson v. Tully, 243 AD2d 230,234 [1st Dept., 1998]).

A “Caremark” claim was addressed in a well-reasoned and entirely dispositive opinion by Justice Richard B. Lowe, III in Spear v. Conway, Index No. 410919/03 (N.Y. Sup. Ct., Oct. 24, 2003). In this unreported decision, a shareholder derivative suit against the Board of Merrill Lynch was dismissed for failure to make a pre-suit demand. Spear alleged that Merrill Lynch’s internet analysts routinely made false and fraudulent recommendations regarding internet stocks to generate investment banking business. Spear also claimed that the defendant directors intentionally ignored, or in bad faith refused, to prevent the alleged conflicts of interest despite a number of circumstances that put the directors on notice of this illegal activity. The circumstances alleged by Spear are similar to those alleged here: a compensation structure linking the equity research and investment banking divisions, past settlements with various regulators, and a 1999 SEC public criticism of Wall Street brokerage firms regarding biased equity analysis. Spear relied on In re Abbott Laboratories Derivative Shareholders Litigation, 325 F3d 795 (7th Cir., 2003), where a demand was excused as futile because the particularized allegations made clear that the Food and Drug Administration explicitly notified Abbott’s Board members of the company’s regulatory violations; the plaintiff identified warning letters from the FDA sent directly to various members of the Board, including the chairman; and the company also filed with the SEC acknowledging that the FDA issued them a notice of noncompliance. Justice Lowe, however, held that Spear’s “Caremark claim” was not

analogous to Abbott and concluded:

Plaintiffs' allegations, even if true, suggest only that a wrongdoing was committed somewhere within Merrill Lynch. Other than conclusory statements, the Complaint contains no allegations linking the alleged wrongful conduct by the internet group to Merrill Lynch's Board of Directors, or leading to an inference that the director defendants knew of said misconduct and made a conscious decision not to act in response thereto ... Nor are the supposed "red flags" identified by plaintiff sufficient to impute or suggest the director defendants' knowledge of the internet group's wrongdoing. Thus, "despite all of the plaintiffs' conclusory allegations, there is no well-grounded evidentiary showing that a reasonable doubt exists as to whether any of the defendant directors' alleged actions or inaction with regard to the so-called 'red flags' cited by plaintiffs were other than valid exercises of the directors' business judgment and fiduciary responsibility to Merrill Lynch." Wilson v. Tully, supra, 243 AD2d at 237.

Id. at 10.

Here, plaintiff argues that his "Caremark claim" is sufficient because a reasonable doubt is raised about the defendants' disinterestedness due to the scope of the fraud, coupled with the defendants' knowledge of the circumstances. In this regard, plaintiff also relies on Abbott. However, for the same reasons set forth in Spear, plaintiffs' pleading falls short of satisfying the pleading requirements of a "Caremark claim." As in Spear, plaintiffs' reliance on Abbott is misplaced because nothing in the Complaint points to any egregious conduct or letters linking defendants directly to the alleged illegal activity. Plaintiffs' allegations, even if true, are that wrongdoing was being committed somewhere within Bear Stearns, specifically the research department, and fail to show, as required, that individual directors knew of this supposed misconduct and ignored it in bad faith or that danger signs were so obvious and oversight failures so systematic that board members must have known of it. (In re Baxter Int'l Shareholders Litig., 654 A2d

1268, 1270 [Del. Ch., 19951). Thus, the Complaint fails to meet the first prong of the Aronson test.

B. Complaint Fails to Raise a Reasonable Doubt that the Compensation Policy was a Product of a Valid Exercise of Business Judgment

Plaintiff alleges that the Compensation Committee defendants put in place a compensation structure which led directly to the research analysts' conflicted positions. Under Delaware law, it is presumed that the Board of Directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation when making a business decision. (Aronson, 473 A2d at 812). Directors' decisions will be respected by courts unless it is particularly alleged that they are "interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available." (Brehm v. Eisner, 746 A2d 244 [Del., 2000]). It is the plaintiff's burden to allege with particularity that the improper motive in a given set of circumstances, i.e., perpetuation of self in office or otherwise in control, was the sole or primary purpose of the wrongdoer's conduct. (Pogostin v. Rice, 480 A2d 619 [Del., 1984]).

Plaintiff refers to Bear Stearns' 2001 Proxy Statements which states that senior executives' compensation should be directly linked to company performance and that the Compensation Committee, with input from the Executive Committee, approve the compensation of executive and other senior officers. Plaintiff conclusorily states that as

these defendants “approved, or recklessly ignored” the compensation structure in which analysts were improperly compensated based on investment banking activities. However, because such a general incentive-based compensation policy is a universal practice and is permitted by Delaware Corporation Law,¹⁵ this claim cannot constitute a reasonable doubt. Moreover, there are no allegations of wrongful intent or improper motivation that could rebut the presumption of the business judgment rule.

II. COMPLAINT DOES NOT SATISFY DELAWARE CHANCERY RULE 23.1's PARTICULARITY REQUIREMENT

Plaintiff argues that the Complaint satisfactorily alleged facts pursuant to the particularity requirement of Rule 23.1 which mandates that there must be allegations that “are specific, and if conclusory, supported by sufficient factual allegations that corroborate the conclusion and support the proposition that demand is futile.”

(Richardson v. Graves, C.A. No. 6717, 1983 WL 21 109, at *2 [Del. Ch., Mar. 7, 1983]).

Cursory contentions of wrongdoing are not a substitute for the pleading of particularized facts. (Guttman v. Jen-Hsun Huang, 823 A2d 492 [Del. Ch., 2003]).

Plaintiff contends that the level of factual details in Simon v. Becherer,¹⁶ Index

¹⁵ See 8 Del. Code § 122(15).

¹⁶ In Simon, plaintiffs brought a shareholder derivative suit against the Board of Directors of J P. Morgan Chase & Co. (“Chase”) regarding the company’s role in the Enron debacle. Plaintiffs alleged that Chase entered into six fraudulent transactions with Enron where allegedly disguised loans appeared as revenue on Enron’s books, fraudulently boosting liquidity and earnings, while actually concealing approximately \$3.9 billion of debt that should have appeared on the balance sheet. Plaintiffs claimed that the directors breached their fiduciary duties by approving these decisions to engage in high-risk transactions and that the Board failed to perform oversight functions. Justice Lowc found that the nature of the transactions, Chase’s history of similar wrongful transactions with clients other than Enron, and the existence internal communications alleged in the complaint put defendants on notice of the wrongful conduct alleged and excused demand.

No. 600480/02 (N.Y. Sup. Ct., Aug. 5, 2003), an unreported decision by Justice Lowe in which a pre-suit demand was excused as futile, is “substantially similar to those here alleged,” and therefore the complaint should be sustained. However, on April 27, 2004, after oral argument in this case, the First Department reversed Simon’s denial of the motion to dismiss because plaintiff shareholders did not allege sufficiently particularized facts to support their contention that a pre-suit demand would have been futile. (Simon v. Becherer, -AD3d-, 775 NYS2d 313 [1st Dept., 2004]). The Court held that lack of particularity was pervasive in plaintiff’s pleading: Simon alleged that Chase executives invested in and profited from an illicit partnership, but did not allege that any individual Board member did so; the allegation that Chase’s losses were the reckless result of either the Board members’ knowing approval of the transactions, or of the Board’s sustained, systematic failure to establish an effective system of internal reporting and controls, was not supported by specific facts showing either that the Board approved of those transactions or the nature of the purported systematic failure to provide appropriate oversight; and there was no allegation that the Board was aware of the “myriad of red flags,” what these red flags were, or what additional measures the Board might have taken. Since the Complaint here is similar to that in Simon, it must be dismissed on particularity grounds.


In addition to the lack of particularity of plaintiff’s claims relating to defendants’ independence, interestedness, and the business judgment rule, plaintiff fails to allege well-pleaded facts regarding the myriad of red flags that “something” was knowable and that the defendants were in a position to know it. (See Iotex Communications, Inc. v.

Defries, 1998 WL 914265, at *4 [Del. Ch., Dec. 21, 1998]).

The Complaint states that the three SEC violations should have put the Board on notice, but only one dealt with investment banking and research practices. Plaintiff also alleges that defendants were bombarded with investigative exposes regarding conflicts affecting analyst research and states that two of the articles and an interview specifically mention Bear Stearns analysts who emphasized the ties between the divisions. However, plaintiff only presumes that defendants were aware of the articles because of the general circulation of the periodicals and because defendants were active participants in capital market activities. There are no fact-based allegations that any defendant was aware of them. Finally, plaintiff claims there were internal e-mails, memoranda, and other internal documents, which defendants deliberately or indifferently failed to heed; however, no documents that supposedly came to the attention of any director or other communications were identified in the Complaint, "Red flags are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer." (In re Citigroup, Inc. Shareholders Litigation, 2003 WL 19827 [Del. Ch., June 5, 2003]). Here, nothing in the Amended Complaint suggests or permits me to infer that any of these red flags came to the attention of the defendants or any committee of the board. Thus, the Complaint on its face fails to meet Rule 23.1's particularity requirement.

Accordingly, the motion to dismiss the Complaint is granted,...

Dated: 7/12/04



BERNARD J. FRIED J.S.C.
BERNARD J. FRIED J.S.C.

FILED

JUL 13 2004