STATE OF NORTH CAROLINA

COUNTY OF WAKE

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
Case No. 04CVS11746

ANDREW EGELHOF, Derivatively On Behalf of RED HAT, INC.,
Plaintiff,

vs.

MATTHEW J. SZULIK, KEVIN B. THOMPSON, PAUL J. CORMIER, TIMOTHY J. BUCKLEY, MARK H. WEBBINK, ALEX PINCHEV, ROBERT F.YOUNG, EUGENE J. MCDONALD, F. SELBY WELLMAN, MARYE A. FOX, WILLIAM S. KAISER, DR. W. STEVE ALBRECHT AND H. HUGH SHELTON,

Defendants,

-and-

RED HAT, INC., a Delaware corporation,

Nominal Defendant.

MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S VERIFIED AMENDED SHAREHOLDER DERIVATIVE COMPLAINT

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Plaintiff Andrew Egelhof, derivatively on behalf of nominal defendant Red Hat, Inc. ("Red Hat" or the "Company"), respectfully submits this Memorandum of Law in Opposition to the Defendants' Motion to Dismiss Plaintiff's Verified Amended Shareholder Derivative Complaint ("Defs.' Mem.").

PRELIMINARY STATEMENT

Plaintiff brings this shareholder derivative action on behalf of Red Hat against defendants for their violations of state law, including breaches of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment, which occurred between December 2002 and the present (the "Relevant Period"). ¶1.[1] Defendants' arguments in support of their motion to dismiss are unconvincing and collapse when examined both against the background of the Complaint's specific allegations, which defendants ignore, and in light of case law, which they misapply. Accordingly, defendants' motion to dismiss must be denied.

I. INTRODUCTION

Despite Plaintiff's well-pled Complaint, defendants' seek to have this Court dismiss this action with prejudice on the grounds that plaintiff purportedly failed to adequately plead the futility of demand on the Board of Directors (the "Board") of Red Hat and state claims upon which the Court can grant relief. Even a brief review of plaintiff's Complaint, however, reveals that plaintiff pled particularized facts evidencing the interestedness and lack of independence of each member of the eight member Board. In addition, defendants' arguments in support of their motion to dismiss are unconvincing and collapse when examined both against the background of the Complaint's specific allegations, which defendants ignore, and in light of case law, which they misapply. Under applicable North Carolina and Delaware law, plaintiff's particularized

[1] All paragraph references ("¶_" or "¶¶__") are to Plaintiff's Verified Amended Shareholder Derivative Complaint (the "Complaint") unless otherwise indicated.

allegations clearly demonstrate both futility of demand and well plead claims and justify this Court's denial of defendants' motion to dismiss.

II. STATEMENT OF FACTS

Red Hat is a corporation that has been organized and exists under the laws of the state of Delaware. ¶13.[2] However, its headquarters, officers, majority of operations and employees are located in Raleigh, North Carolina. *Id.* Red Hat is a company dedicated to open source software. ¶¶4, 54. In conjunction, Red Hat sells its technology and service products through annual subscriptions. ¶57. When a subscription agreement is sold, Red Hat receives revenue that must be reported according to Generally Accepted Accounting Principles ("GAAP"), as well as federal securities laws and regulations, which sensibly require that a company not report earned revenue until that revenue has actually been earned. ¶58.

During the Relevant Period, the defendants caused or allowed Red Hat to violate GAAP rules by improperly booking millions of dollars of revenue before it was actually earned. ¶¶5-6, 59. This improper booking of revenue was so large in scale that it led to a three year, twelve quarter restatement of revenue by Red Hat. ¶10. An example of defendants' improper revenue shifting is when a Red Hat customer purchased a subscription on August 28, rather than Red Hat recognizing 4 days of revenue (August 28-31), 31 days of revenue would be improperly booked as if the subscription revenue had been earned from the first day of the month. ¶¶6, 61. Moreover, significant quantities of Red Hat's contracts were signed towards the end of any given month. ¶64. This allowed Red Hat's management to manipulate the premature recognition of revenue in order to hit particular revenue targets and enjoy bonuses and other incentive compensations that were approved by the Compensation Committee. *Id.* The defendants,

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[2] Plaintiff believes the only connection Red Hat has to Delaware is the piece of paper it filed with the Secretary of State of Delaware to effectuate its incorporation.

through their various positions in the Company, on the Board, and on various Board Committees, knew or should have known that these practices were occurring. ¶¶14-26, 64.

Defendants' gross mismanagement of the Company led to internal control problems within Red Hat. ¶¶8, 66. First, Red Hat's subscriber contract renewal forecasts, which were disseminated to the public in the Company's financials and used by analysts as an important metric to gauge Red Hat's business prospects, were grossly inaccurate. *Id.* These inaccuracies were a direct result of Red Hat's management 'encouraging' its sales personnel, through an atmosphere of fear and intimidation, to inflate their subscriber renewal reports. ¶¶66-76, 79-88. Second, revenue recognition was being manipulated with respect to the consulting services that Red Hat offered to its customers. ¶¶9, 77. As a result, future revenues to be earned in particular consulting contracts were pulled into current quarters so that the Company would appear to be meeting its particular revenue targets and defendants could profit from undeserved incentive compensation. ¶¶9, 78. The booking of subscriptions by Red Hat was a central part of the Company's business. ¶57. Therefore, the Board knew about Red Hat's improper revenue recognition on subscription agreements via access to internal corporate documents, conversations and connections with other corporate officers and employees, attendance at management and Board meetings and committees thereof and via reports and other information provided to them in connection therewith. ¶¶14-19. Additionally, while in possession of this material non-public information regarding the Company's complete lack of internal control, directors Szulik and Kaiser sold over $108 million worth of their personally held Red Hat shares. ¶¶10, 119.

Red Hat's various GAAP violations caused the Company to improperly calculate its revenue during the Relevant Period. ¶116. Therefore, Red Hat's press releases involving the Company's financial and business prospects were inaccurate and their financial reports filed with

the SEC were issued in violation of federal securities laws during the Relevant Period. ¶¶89-118. When these GAAP violations were finally revealed, defendants were forced to ***restate the Company's earnings for FY:02 through FY:04***. ¶10. This restatement caused the Company's market capitalization to be damaged by over $2.5 billion, caused the Company's corporate image to be tarnished, exposed Red Hat to potentially billions of dollars worth of liability for violations of federal securities laws and severely hurt the Company's ability to raise equity capital or debt on favorable terms because of a "liar's discount," a term applied due to Red Hat's illegal accounting practices and misleading of the investing public. ¶¶10, 35, 118. In addition, Red Hat's illegal behavior and internal controls problems allowed the granting of lavish incentive based compensation for the employee defendants and the selling of over $108 million in stock by defendants who possessed material non-public information about said illegal behavior and control problems. ¶¶10, 47, 119.

III. DERIVATIVE ACTIONS PLAY A CRUCIAL ROLE IN CORPORATE GOVERNANCE

The United States Supreme Court has observed that corporate managers' interests often deviate from those of the shareholders and that shareholders' derivative suits[3] are one of the most potent devices in corporate law to control these conflicts and assure a modicum of integrity and competence in the management of corporations:

> This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949).

Moreover, corporate governance is in the dominion of state law. Claims of breach of

[3] North Carolina law recognizes the right to bring shareholder derivative suits on behalf of the corporation in North Carolina courts. N.C. Gen. Stat. §55-7-40.

fiduciary duty, unjust enrichment and other related claims, exactly like the claims made in this action, are exclusively state law issues. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478-79 (1977) (the Supreme Court recognized that federal securities laws should not be extended to cover the fiduciary duties traditionally regulated by state corporation laws). North Carolina in particular allows a "minority shareholder derivatively in the name and right of a corporation, to enforce rights or to seek redress accruing to the corporation." *Swenson v. Thibaut*, 250 S.E.2d 279, 294 (N.C. App. 1978). For these reasons, plaintiff, as a shareholder, has properly filed this derivative suit in this Court to redress his grievances.

IV. PLEADING STANDARD FOR A MOTION TO DISMISS IN NORTH CAROLINA

Since plaintiff has filed the action in this Court, the procedural rules of North Carolina apply. *Beall v. Beall*, 577 S.E.2d 356, 358 (N.C. App. 2003) ("[A]s the claim was brought in this State, defendant's current residence, the remedial or procedural laws of North Carolina apply.");[4] *Wohlfahrt v. Schneider*, 345 S.E.2d 448, 451 (N.C. App. 1986) ("Procedural issues, however, must be determined by application of the law of North Carolina."). The standard applied to a motion to dismiss is a procedural issue. *Forbis v. Honeycutt*, 273 S.E.2d 240, 241 (N.C. 1980).

Under North Carolina law, the standard for reviewing a motion to dismiss is "'whether the allegations of the complaint, if treated as true, are sufficient to state a claim upon which relief can be granted under some legal theory.'" *Walker v. City of Durham*, 582 S.E.2d 80 (N.C. App. 2003) (quoting *Thompson v. Waters*, 526 S.E.2d 650 (N.C. App. 2000)). Notably, for purposes of a motion to dismiss, the Court must treat the allegations in the complaint as true. *Hyde v. Abbott Labs., Inc.*, 473 S.E.2d 680, 682-83 (N.C. App. 1996). The Court must also construe the Complaint liberally and must not dismiss the Complaint unless it appears to a legal certainty and

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[4] Here, as throughout, all emphasis is deemed added and all citations are deemed omitted unless otherwise stated.

beyond doubt that plaintiff is entitled to no relief under any state of facts which could be proved in support of the claim. *Id.*; *Jones v. Capitol Broad. Co., Inc.*, 495 S.E.2d 172, 174 (N.C. App. 1998). In short, the purpose of the Complaint is to put defendants on notice of the nature and basis of plaintiff's claim. N.C. Gen. Stat. §1A-1, Rule 1; *Jones v. City of Greensboro*, 277 S.E.2d 562 (N.C. App. 1981). If the Complaint satisfies this lax standard, a motion to dismiss should be denied. *See Gatlin v. Bray*, 344 S.E.2d 814, 817 (N.C. App. 1986).

V. THE COMPLAINT ESTABLISHES THAT PRE-SUIT DEMAND WOULD HAVE BEEN FUTILE

A. Delaware's Substantive Law Applies to the Court's Demand Futility Analysis

The United States Supreme Court has stated that, "a court that is entertaining a derivative action under that statute must apply the demand futility exception as it is defined by the law of the State of incorporation." *Kamen v. Kemper Fin. Servs*, 500 U.S. 90, 108-09 (1991). North Carolina law, which in concurrence with the United States Supreme Court, states: "In any derivative proceeding in the right of a foreign corporation, the matters covered by this Part shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation...." N.C. Gen. Stat. §55-7-47. Pursuant to North Carolina law, plaintiff is required to put the defendants on notice of the nature and basis of the claims brought against them. N.C. Gen. Stat. §1A-1, Rule 8. Therefore, this Court must determine if under Delaware's substantive law on demand futility, plaintiff has put defendants on sufficient notice to satisfy North Carolina's pleading standard.

B. Delaware's Demand Futility Standard

Pursuant to Delaware Chancery Rule 23.1: "The complaint shall also allege with ***particularity*** the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members,

and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Del. Ch. Ct. R. 23.1. Under Delaware law, it is well settled that demand need not be alleged if the facts pled show that such a demand would have been futile. *Aronson v. Lewis*, 473 A.2d 805, 807 (Del. 1984). In assessing demand under Delaware law, all reasonable inferences must be drawn in the light most favorable to the plaintiff. *In re Cendant Corp. Derivative Action Litig.*, 189 F.R.D. 117, 127 (D.N.J. 1999). Moreover, plaintiff is not required to plead evidence, nor is proof of success on the merits required. *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

In the landmark case of *Aronson*, the Delaware Supreme Court established the legal standard for assessing demand futility in shareholder derivative actions. Under *Aronson*, presuit demand is excused where, under the facts alleged, "a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson*, 473 A.2d at 814. Importantly, the test is disjunctive. "If a derivative plaintiff can demonstrate a reasonable doubt as to the first or second prong of the Aronson test, then he has demonstrated that demand would be futile." *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995). *See also Grobow v. Perot*, 539 A.2d 180 (Del. 1988).[5]

Although plaintiff need only satisfy one test to establish demand futility, plaintiff here

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[5] Where a plaintiff challenges more general board action or lack of action, and not a board decision, however, only the first prong of *Aronson* applies. This one-pronged test is known as the "*Rales*" test. *Seminaris*, 662 A.2d at 1354. *See Rales*, 634 A.2d at 930 (where the complaint did not challenge a decision of the board of directors, demand was excused because the plaintiff could show that a majority of the directors were neither disinterested nor independent).

> [A] court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.

Id. at 934.

has established liability under both prongs of *Aronson*. Under the first prong of *Aronson*, plaintiff has shown multiple examples of how the directors lack disinterest and independence. Under the second prong of *Aronson*, plaintiff has established that the Board actively approved false SEC filings. The decisions to approve false filings are not afforded the protection of the business judgment rule.

Defendants do not even challenge plaintiff's Complaint using the second prong of *Aronson*. Therefore, any further analysis by the Court concerning demand futility is unnecessary as defendants have already implicitly accepted that plaintiff has passed the *Aronson* test. As shown below, if this Court does choose to engage in extra analysis, plaintiff has also satisfied the first prong of *Aronson* and *Rales* in pleading demand futility. Thus, plaintiff has more than met his burden of putting defendants on notice of the basis for plaintiff's contention that demand was futile.[6]

C. Demand Futility Must Be Evaluated Using the Reasonable Doubt Standard

In applying the first prong of *Aronson* and the *Rales* test for demand futility, the term "reasonable doubt" can be said to mean "reason to doubt" that the Board is capable of making an independent or disinterested decision. *Grimes v. Donald*, 673 A.2d 1207, 1217 (Del. 1996). In fact, in *Rales*, the Delaware Supreme Court expressly rejected a request for a more stringent standard, holding:

> [W]e ***reject*** the defendants' proposal that, for purposes of this derivative suit and future similar suits, we adopt either a universal demand requirement or a requirement ***that a plaintiff must demonstrate a reasonable probability of success on the merits***.

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[6] Demand will also be excused where plaintiffs demonstrate a majority of the directors were "interested" in the wrongful scheme. *Cendant*, 189 F.R.D. at 128. Applying Delaware law, the *Cendant* court held that in order for demand to be excused, the complaint had created a reasonable doubt of the disinterestedness or independence of at least 15 of the Company's 28 directors at the time the complaint was filed. *Id.* at 129.

634 A.2d at 934. *See also Grobow*, 539 A.2d at 186-87 (rejecting the more stringent "judicial finding" standard for pleading director interest). Under the "reasonable doubt" standard, plaintiff must allege, with particularity, facts that would give a reasonable shareholder reason to doubt the ability of a board of directors to consider disinterestedly a demand. *Id.* (endorsing reasonable doubt standard); *Grimes*, 673 A.2d at 1217 n.17 ("the concept of reasonable doubt is akin to the concept that the stockholder has a 'reasonable belief' that the board lacks independence or that the transaction was not protected by the business judgment rule").

This reasonable doubt standard promotes a strong public policy, since "the derivative suit ... [is a] potent tool[] to redress the conduct of a torpid and unfaithful management." *Rales*, 634 A.2d at 933. It is further particularly appropriate in derivative suits, because a plaintiff typically has not had the benefit of discovery. *Id.* at 934 (requiring a reasonable probability of success on the merits would be "an extremely onerous burden to meet at the pleading stage without the benefit of discovery").[7] The reasonable doubt standard "is sufficiently flexible and workable to provide the stockholder with 'the keys to the courthouse' in an appropriate case where [as here,] the claim is not based on mere suspicions or stated solely in conclusory terms." *Grimes*, 673 A.2d at 1217. Thus, under Delaware law, plaintiff's burden at the pleading stage is only to allege particularized facts which, if true, would give a reasonable shareholder reason to doubt the ability of the Board to consider a demand. Plaintiff amply meets that burden.

D. Demand Is Excused Because There Is Reason to Doubt the Business Judgment of the Board

Plaintiff's particularized allegations are sufficient for demand to be excused under the second prong of *Aronson*; that is, sufficient facts exist to create a "reasonable doubt" that the challenged transactions were the product of a valid exercise of business judgment. *Aronson*, 473 A.2d at 814. Plaintiff has alleged that the Board actively approved grossly overstated financial

[7] The Court *sua ponte* stayed discovery in this case. Therefore, plaintiff has been without benefit of discovery despite a clearly well pled Complaint and should be under no obligation to show a reasonable probability of success on the merits. *Rales*, 634 A.2d at 934.

statements for FY:02 through FY:04, knew the statements to be false, and nevertheless included these false financial statements in Red Hat's 10-Qs and 10-Ks filed with the SEC. ¶¶14-26, 110-111. Defendants Szulik, Thompson, Young, McDonald, Wellman, Kaiser and Fox signed the FY:02 Form 10-K. ¶111. Defendants Szulik, Thompson, Young, McDonald, Wellman, Kaiser, Fox, Albrecht and Shelton signed the FY:03 Form 10-K. *Id.* Defendants Szulik, Thompson, Young, McDonald, Kaiser, Fox, Albrecht and Shelton signed the FY:04 Form 10-K. Defendants Szulik and Thompson signed the Q1:02, Q2:02, Q3:02,Q1:03, Q2:03, Q3:03, Q1:04, Q2:04 and Q3:04 Form 10-Qs. *Id.* These decisions are not afforded the protection of the business judgment rule because the defendants knew that Red Hat's financial statements were not a fair representation of the Company's actual revenue and income. ¶110; *Cendant*, 189 F.R.D. at 129-30 (demand is futile where plaintiff alleges directors published false statements in public corporate documents).

The submission of clearly inaccurate financial statements, contained in the Form 10-Ks and 10-Qs filed with the SEC in FY:02, FY:03 and FY:04, violated both SEC and GAAP rules and resulted in the restatement of its financial statements for three years. ¶¶110-118. This conduct raises serious doubt that the Board's actions and decisions can be attributed to any rational business purpose or that the directors were acting in the best interests of the Company. Thus, the business judgment rule does not protect them. *See*, *e.g.*, *In re Oxford Health Plans, Inc.*, 192 F.R.D. 111, 117 (S.D.N.Y. 2000).

In addition, defendants make no arguments in their motion to dismiss regarding the challenged transactions, the active signing and filing of inaccurate 10-Ks and 10-Qs, being a product of a valid business judgment and instead focus entirely on the "disinterested" and "independent" directors prong of the *Aronson* analysis. Therefore, they have implicitly

acquiesced that plaintiff has satisfied the second prong of the *Aronson* analysis. According to *Seminaris* and its disjunctive analysis of *Aronson*, since plaintiff has already proven the second prong of the *Aronson* test, no further analysis is necessary and plaintiff has successfully established demand futility. *Seminaris* 662 A.2d at 1354.

E. In Accordance with Delaware Law, Plaintiff Has Sufficiently Alleged that Demand Was Futile Because a Majority of the Board Lacked Disinterest and/or Independence

Even if this Court decides it is necessary to perform a first prong *Aronson* analysis, or apply the *Rales* test which uses the same analysis, plaintiff has successfully established demand futility. Under Delaware law, if a plaintiff pled sufficient facts to raise a reasonable doubt that a majority of the Board is either "interested" in the transaction at issue or lacks "independence" from one who is so interested, then demand is futile. *Aronson*, 473 A.2d at 814; *Rales*, 634 A.2d at 935-37. *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1046 (Del. 2004) (citing *Beneville v. York,* 769 A.2d 80, 85-86 (Del. Ch. 2000)). At the time that the plaintiff filed the original complaint, Red Hat's Board consisted of the following eight directors: defendants Szulik, Young, McDonald, Wellman, Fox, Kaiser, Albrecht and Shelton ("Director Defendants"). ¶123. Plaintiff is only required to demonstrate a reason to doubt the disinterestedness or independence of ***four*** of the eight members of the Board for demand to be excused. *McCall v. Scott*, 239 F.3d 808, 815 (6th Cir. 2001). Despite defendants' assertions to the contrary, plaintiff has easily done so.

1. Plaintiff Has Pled with Particularity that Defendant Szulik Lacked Disinterest and/or Independence

a. Defendant Szulik's Insider Trading

Rales provides that "[a] director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."

Rales, 634 A.2d at 936. *See also Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). Without a doubt, insider trading confers this type of personal financial benefit. *In re Gen. Instrument Corp. Sec. Litig*., 23 F. Supp. 2d 867, 875 (N.D. Ill. 1998) (applying Delaware law); *Oxford Health*, 192 F.R.D. at 118 (same). Here, plaintiff alleges that defendant Szulik is interested by virtue of his insider selling of Red Hat stock while in possession of adverse, material non-public information. ¶¶14, 119, 123(a)(i).

Defendants rely primarily on *Guttman v. Huang*, 823 A.2d 492, 503 (Del. Ch. 2003) for the proposition that plaintiff did not adequately plead the futility of demand based upon insider selling. Defs.' Mem. at 12-16. A review of *Guttman*,[8] however, reveals that plaintiff pled the required information. In *Guttman*, the Court found that the plaintiff had not pled "the precise roles" the "directors played at the company, the information that would have come to their attention in those roles, and any indication as to why they would have perceived the accounting irregularities." 823 A.2d at 503. First, plaintiff here has clearly alleged that defendant Szulik's positions were Chief Executive Officer ("CEO"), President and Chairman of the Board of Red Hat. ¶14. Second, plaintiff repeatedly alleged that defendant Szulik sold 3,005,000 shares of Red Hat stock for proceeds of $45,858,568.50 while in possession of adverse, material non-public knowledge. ¶¶14, 119, 123(a)(i). Third, plaintiff alleged that this non-public information came to defendant Szulik through his roles of CEO, President and Chairman of the Board, "via access to internal corporate documents, conversations and connections with other corporate officers and employees, attendance at management and Board meetings and committees thereof and via reports and other information provided to him in connection therewith." ¶¶14, 119.

[8] The other cases relied upon by defendants in challenging plaintiff's insider selling allegations contain essentially the same analysis as *Guttman*. *See Rattner v. Bidzos*, No. 19700, 2003 WL 22284323, at *10 (Del. Ch. Oct. 7, 2003) (relying on *Guttman*); *McCall*, 239 F.3d 808; *Stepak v. Ross*, Civ. A. No. 7047, 1985 WL 21137 (Del. Ch. Sept. 5, 1985). Defs.' Mem. at 12-13.

The court in *Guttman* further criticized the plaintiff for not pleading adequate information regarding the defendants' insider selling in the context of timing or amount to support an inference of insider trading. 823 A.2d at 503-04. Again, in contrast to *Guttman*, the plaintiff here specifically alleges the following regarding defendant Szulik's sale of Red Hat stock. During the Relevant Period, defendant Szulik sold 3,005,000 shares of Red Hat stock for proceeds of $45,858,568.50. ¶123(a)(i). In fact, plaintiff even breaks down defendant Szulik's insider sales by date, number of shares, share price and total proceeds in the Complaint. ¶119. The Complaint further alleges with particularity that defendant Szulik sold over 59% of his Red Hat stock holdings while in possession of the material non-public information and that defendant Szulik made no sales for two years prior to the Relevant Period as well as no sales after July 2004. ¶123(a)(i). Accordingly, as evidenced herein, plaintiff does provide the particulars required by *Guttman* which enable the Court to assess whether the insider sales were suspicious in either timing or amount. The Complaint's detailing of amounts, timing and percentages of defendants Szulik's stock sales clearly satisfy *Guttman*. ¶¶119. Thus, demand futility as to defendant Szulik is clearly established.[9]

b. Defendant Szulik's Principal Employment with Red Hat

In addition to interestedness established from defendant Szulik's insider trading, particularized allegations that employee-directors depend upon their employment position for

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[9] Defendants cite various cases to support the proposition that plaintiff must show that the alleged insider trading was done with wrongful intent or scienter. Defs.' Mem. at 14-16; *In re Nike, Inc. Sec. Litig*., 181 F. Supp. 2d 1169,1169 (D. Or. 2002); *In re Party City Sec. Litig*., 147 F. Supp. 2d 282, 313 (D.N.J. 2001); *In re Cree, Inc. Sec. Litig*., 333 F. Supp. 2d 461, 476-77 (M.D.N.C. 2004); *In re Espire Commc'ns, Inc. Sec. Litig*., 127 F. Supp. 2d 734, 743 (D. Md. 2001); *In re First Union Corp. Sec. Litig*., 128 F. Supp. 2d 871, 898 (W.D. N.C. 2001). All of these cases, however, address a scienter requirement for insider trading under SEC Rule 10b-5. Plaintiff's Complaint, on the other hand, alleges a state law claim for a breach of fiduciary duty for insider selling. Defendants' heightened pleading standard under Rule 10b-5 is, therefore, inapplicable to analyze plaintiff's state law claims.

their livelihood are sufficient to raise a reasonable doubt regarding the employee-directors' independence from other Board members who have the ability to control the employee-directors' employment and compensation. *See Rales*, 634 A.2d at 937 (concluding that "there is a reasonable doubt that [an employee-director] can be expected to act independently considering his substantial financial stake in maintaining his current offices"); *In re Cooper Co., Inc.*, No. 12584, 2000 WL 1664167, at *6-*7 (Del. Ch. Oct. 31, 2000) (allegation that employee-directors "'owed their positions and their livelihood to maintaining the good will'" of other directors "creates reason to doubt that [employee-directors] could have responded impartially to a demand").[10] In the present action, plaintiff alleges with particularity that at the time this action was commenced, the principal professional occupation of defendant Szulik was his employment as CEO, President and Chairman of the Board of Red hat, for which he received over $5.7 million in compensation and over four million options to purchase Red Hat stock during the Relevant Period. ¶¶14, 123(c). Defendant Szulik also enjoyed the profits, power and prestige that his executive and directorial positions at Red Hat brought him. ¶33. Accordingly, defendant Szulik lacked independence from defendants McDonald, Shelton and Albrecht, defendants who are not disinterested and/or independent and who exerted influence over defendants Szulik compensation by virtue of their positions as members of the Compensation Committee. ¶123(c). As noted by numerous courts, these allegations are sufficient to raise a reasonable doubt

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[10] *See also Mizel v. Connelly*, No. 16638, 1999 WL 550369, at *3 (Del. Ch. July 22, 1999) ("Since [employee-directors] each derive their principal income from their employment at [the corporation], it is doubtful that they can consider the demand on its merits without also pondering whether an affirmative vote would endanger their continued employment."). *Accord In re Limited, Inc.*, No. 17148-NC, 2002 WL 537692 (Del. Ch. Mar. 27, 2002); *In re The Student Loan Corp. Derivative Litig.*, No. 17799, 2002 WL 75479 (Del. Ch. Jan. 8, 2002); *Telxon Corp. v. Bogomolny*, 792 A.2d 964, 974 (Del. Ch. 2001); *In re Ply Gem Indus., Inc. S'holder Litig.*, No. 15779-NC, 2001 WL 755133 (Del. Ch. June 26, 2001); *Steiner v. Meyerson*, No. 13139, 1995 WL 441999 (Del. Ch. July 18, 1995).

regarding the independence of defendant Szulik, from the members of this Committee that controls his livelihood, lifestyle and standard of living. *Beam*, 833 A.2d at 978; *Rales*, 634 A.2d at 937. Thus, due to his lack of independence, demand futility is again established as to defendant Szulik.

2. Plaintiff Has Pled with Particularity that Defendant Kaiser Lacked Disinterest and/or Independence

a. Defendant Kaiser's Insider Trading

Following the insider trading analysis for demand futility detailed *supra*, defendant Kaiser is likewise an "interested" party. First, plaintiff has clearly alleged that defendant Kaiser was a director of Red Hat. ¶24. Second, plaintiff repeatedly alleged that defendant Kaiser sold 70,112 shares of Red Hat stock for $1,305,485.44 while in possession of adverse, material non-public knowledge. ¶¶24, 119, 123(a)(ii). Third, plaintiff alleged that this non-public information came to defendant Kaiser through his roles as a director, "via access to internal corporate documents, conversations and connections with other corporate officers and employees, attendance at management and Board meetings and committees thereof and via reports and other information provided to him in connection therewith." ¶¶24, 123(a). Plaintiff even breaks down defendant Kaiser's insider sales by date, number of shares, share price and total proceeds in the Complaint. ¶119. Accordingly, as evidenced herein, plaintiff does provide the particulars required by *Guttman* which enable the Court to assess whether the insider sales were suspicious in either timing or amount. *Guttman*, 823 A.2d at 503. Thus, due to his personal interests in the challenged transaction, demand futility is established as to defendant Kaiser.

b. Defendant Kaiser's Breach of His Audit Committee Duties

Where "directors [are] aware of known violations," because, for instance, they are "members of the Audit Committee," and "chose" not to address the violations, defendants cannot

claim "unconsidered" inaction. *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 806 (7th Cir. 2003). Plaintiff's allegations in the Complaint demonstrate that defendant Kaiser, as a member of the Audit Committee, lacked independence and is interested because he faces a substantial likelihood of liability for breaching his fiduciary duties. *See In re Lernout & Hauspie Sec. Litig.*, 286 B.R. 33, 36, 38-39 (D. Mass. 2002) ("But who will guard these guardians?") (denying motion to dismiss securities claim against "outside" directors comprising Audit Committee for securities fraud even under heightened pleading standard of the Private Securities Litigation Reform Act ("PSLRA")); *Mitzner v. Hastings*, No. C04-3310 FMS, 2005 WL 88966, at *6 (N.D. Cal. Jan. 14, 2005) (membership on the Audit Committee during the Relevant Period may be sufficient to be held liable for allegedly false or misleading information conveyed in annual reports and press releases). [11]

Pursuant to Red Hat's Audit Committee Charter, the Audit Committee is charged with overseeing (1) the integrity of the Company's financial statements; (2) the Company's compliance with legal and regulatory requirements; (3) the independent auditor's qualifications and independence; and (4) the performance of the Company's internal financial, accounting and reporting controls and processes and independent auditors. ¶¶38, 123(d). Thus, defendant Kaiser, as a member of the Audit Committee in FY:02, FY:03 and FY:04, was responsible for

[11] Defendants incorrectly cite to *Guttman*, 823 A.2d at 506-07, *In re Citigroup, Inc. S'holders Litig.*, No. 19827, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003) and *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 969-70 (Del. Ch. 1996) in their analysis of demand futility relating to the Audit Committee members. Defs.' Mem. at 16-18. While defendants' cases deal with a director's knowledge in general, plaintiff offers authority that addresses the specific duties of the Audit Committee members. Plaintiff points to the Audit Committee Charter to establish the specific duties of Audit Committee members, which they subsequently breached. ¶¶38-42. Defendants also cite these cases for the mistaken proposition that plaintiff has not plead with particularity that the defendants were aware of the wrongdoing. As set forth *supra* section V(D)(1) and throughout, plaintiff has plead with particularity the roles, responsibilities, attendance at meetings and various other facts that show and/or allow the Court to reasonably infer that the defendants were aware of the alleged wrongdoing.

meeting with defendants Szulik (CEO, President and Chairman) and Thompson (CFO and Treasurer) as well as the other Director Defendants to discuss Red Hat's improper financial disclosures. *Id.* Nonetheless, in derogation of his duties, defendant Kaiser and rest of the Audit Committee recommended that the Board include the improper audited consolidated financial statements in Red Hat's Annual Report on Form 10-K for the years ended February 29, 2004, February 28, 2003 and February 28, 2002 as filed with the SEC. *Id.* Therefore, the entire Audit Committee is responsible for Red Hat's resulting restatement of ***three years, twelve consecutive quarters***, of inaccurate financial filings with the SEC.

"The *Aronson* case teaches [that] violations of the law concerning the dissemination of false and misleading financial statements cannot be deemed to be the product of a valid exercise of business judgment, and therefore protected from a demand futility allegation by the case law." *Oxford*, 192 F.R.D. at 117.[12] As the Complaint makes clear, the Audit Committee members, including defendant Kaiser, utterly failed to fulfill their duties and obligations and are directly responsible for Red Hat's illicit conduct. Plaintiff further alleged the information defendant Kaiser and the other Audit Committee members were required to review and discuss at meetings of the committees of the Board and how many times each of those committees met during the Relevant Period. ¶¶38-42, 123(d). Thus, plaintiff has pled with particularity how defendant

[12] "Surely the conscious decision to sign off on forms required to be filed with a federal investigative body was intended as a 'vouching' for the accuracy and integrity of the information there provided and, if it is established at trial that that information was materially false and misleading, a bevy of remedies – both criminal and civil – are available to address that wrong. The potential imposition of such sanctions on skilled professionals whose portfolios rest as much upon their personal integrity as it does their financial acumen cannot be underestimated since, for these directors (and their families), this is a far more significant outcome than is the potential need to resign from other boards on which they presently serve or not being asked to serve on the next board. The court concludes that there is reasonable doubt these directors (***all*** –as opposed to a mere majority) are disinterested and independent and there is, thus, reasonable doubt 'that the protections of the business judgment rule are available" to them." *Fina v. Calarco, et al.,* No X01 CV 3-01802635, Order at 14 (Super. Ct. Jud. Dist. Waterbury Sept. 19, 2005).

Kaiser became aware of the material non-public information.[13] Accordingly, as a result of defendant Kaiser's breach of his Audit Committee duties, he is also unable to impartially assess any demand because this breach makes him subject to personal liability and thus he is an interested party.

3. Plaintiff Has Pled with Particularity that Defendants McDonald, Albrecht, Wellman, Fox, Young and Shelton Lacked Disinterest and/or Independence

a. Defendants McDonald, Albrecht, Wellman, Fox and Young Breached Their Audit Committee Duties

Given defendants Szulik and Kaiser's clear lack of independence, plaintiff need only establish reasonable doubt of disinterestedness or independence for two other directors. Following the Audit Committee analysis for demand futility detailed *supra*, defendants McDonald, Albrecht, Wellman, Fox and Young are likewise "interested" parties because they were members of the Audit Committee.[14] ¶¶38, 123(d). As the Complaint makes clear, the Audit Committee members, including defendants Albrecht and McDonald, utterly failed to fulfill

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[13] Plaintiff points the Court to a recent federal decision that acknowledges the common sense approach that demand futility is flexible and a motion to dismiss is thus unnecessary.

> Plaintiff ... particularly alleges ... that [d]efendants permitted and/or approved the dissemination of false and misleading press releases, they violated state law and the fiduciary duties owed to Novastar, they have not sought to recover any part of the damages suffered by Novastar, and they concealed information from the public. Thus, plaintiff has met the particularity requirement of Rule 23.1 and has properly pled why a pre-suit demand would have been futile.

Felker v. Anderson, No. 04-0372-CV-W-ODS, 2005 WL 602974, at *3 (W.D. Mo. Feb. 11, 2005). *See also In re Direct Gen. Corp. Sec. Litig.*, No. 3:05-0158, 2005 WL 1895638, at *1 (M.D. Tenn. Aug. 3, 2005) (In applying a demand requirement analysis in a shareholder derivative case the Court said, "courts have excused the demand requirement when the corporation's officers and directors will themselves be defendants or when the officers and directors are in collusion with those who have injured the corporation").

[14] Defendants Wellman, Kaiser and McDonald were on the Audit Committee in FY:02 and FY:03. Defendants Albrecht, McDonald, Kaiser and Fox were members of the Audit Committee in FY:04. ¶38.

their duties and obligations and are directly responsible for Red Hat's illicit conduct during their respective service on the Audit Committee. ¶¶38-42, 123(d). Accordingly, as a result of defendants McDonald, Albrecht, Wellman, Fox and Young's breach of their Audit Committee duties, which has rendered them personally liable and interested, they are unable to impartially assess any demand.

b. Defendants Albrecht and McDonald's Financial Expertise

Defendants Albrecht and McDonald, by their specialized financial expertise, were in a unique position to understand the business of Red Hat, as well as its finances, markets and present and future business prospects. ¶123(g)-(h). Specifically, plaintiff alleges in the Complaint that defendant Albrecht is the Associate Dean of the Marriott School of Management and Arthur Andersen Professor at Brigham Young University. ¶123(g). Prior to becoming Associate Dean, defendant Albrecht served the director of the School of Accountancy and Information Systems at Brigham Young University for eight years. *Id*. Defendant Albrecht is a certified public accountant, a certified internal auditor and a certified fraud examiner. *Id.* Further defendant Albrecht has been awarded the Cressy Award from the Association of Certified Fraud Examiners, the highest honor given for a lifetime achievement in fraud detection and deterrence. *Id.* Defendant Albrecht has been the author and co-author on over 20 books and 80 professional journal articles on business fraud and other accounting-related topics. *Id.*

Plaintiff also alleged in the Complaint that defendant McDonald is Executive Vice President and Investment Counsel to Duke University, and also serves as Principal and Chief Investment Officer of Quellos Private Capital Markets, LLC. ¶123(h). Defendant McDonald served as Founding President of Duke Management Company, the asset management division of the University from 1990-2000. *Id.* Defendant McDonald has held several positions at Duke

University in Durham, North Carolina since he joined it in 1977 as University Counsel and Vice President. *Id.* For six years, defendant McDonald served as Executive Vice President of the university, discharging the responsibilities of Chief Financial Officer and Chief Non-Academic Administrative Officer. *Id.* Prior to his tenure at Duke, defendant McDonald served as an international business executive in London. *Id.*

Defendants Albrecht and McDonald, because of their unique qualifications, had a heightened duty to insure the accuracy and fairness of Red Hat's financials or least to warn other Audit Committee members about deficiencies in Red Hat's financials before their filing with the SEC. *See In re Emerging Commc'ns, Inc. S'holders Litig*., No. 6415, 2004 WL 1305745 (Del. Ch. June 4, 2004). It is inconceivable that defendants Albrecht and McDonald, with the level of financial sophistication possessed by each, would not discover the ***three years, twelve consecutive quarters*** of inaccurate SEC financial filings. If defendants Albrecht and McDonald had fulfilled their fiduciary duties as directors and Audit Committee members, it is clear that these filings would have been corrected before their filing with the SEC. ¶¶38, 123(g)-(h). Therefore, they breached their duties by causing or allowing the improper financials described herein. As a result of these breaches of duties by defendants Albrecht and McDonald, any demand upon them is futile.

c. Defendants Albrecht, McDonald and Shelton's Breach of Their Compensation Committee Duties

Defendants Albrecht, McDonald and Shelton, as members of the Compensation Committee at the time the original Complaint was filed, were charged with controlling all of Red Hat's officer and director compensation. ¶¶43, 123(b), (e). During the Relevant Period, the Compensation Committee granted incentive based compensation for the Officer Defendants that was based upon Red Hat's revenue reaching particular targets that were set by the Committee.

¶¶45-47, 123(e). Since a substantial part of Red Hat's revenue was inflated due to the improper recognition of earnings from subscription agreements, the Compensation Committee should not have approved any incentive based compensation. ¶46. Defendants Albrecht, McDonald and Shelton, thus breached their duties of care by unduly compensating Red Hat's officers. ¶123(e). In addition, once the truth was revealed about the improper financial recording at Red Hat, defendants Albrecht, McDonald and Shelton had a duty to the Company to recover all incentive based bonuses that they issued based upon the inflated and inaccurate revenue. *See* the Sarbanes-Oxley Act of 2002 §304.[15] Defendants Albrecht, McDonald and Shelton continue to breach their duties of care to Red hat by not seeking the forfeiture of these improper incentive based bonuses. Accordingly, as a result of defendants Albrecht, McDonald and Shelton's breach of their Compensation Committee duties and resultant personal liability from said breaches, they are unable to impartially assess any demand.

F. Failure to Monitor and Supervise by All Defendants Excuses Demand

Although plaintiff has clearly alleged that all defendants are interested or not independent members of Red Hat's Board under the first prong of *Aronson* and *Rales*, plaintiff's allegations also establish for pleading purposes that defendants' failed to monitor and supervise the Company. Thus demand is further excused under this analysis. Nonfeasance by directors of their fiduciary duty to discharge supervisory and monitoring responsibilities constitutes a breach of the fiduciary duty of care and also creates a reasonable doubt excusing demand. *Rales*, 634 A.2d at 934; *Oxford Health Plans*, 192 F.R.D. at 117. Under the standards established in

[15] Defendants cite to *In re Sagent Tech., Inc. Derivative Litig*., 278 F. Supp. 2d 1079, 1089 (N.D.Cal. 2003) to support the proposition that compensation granted from the Compensation Committee is not enough to establish interestedness. Defs.' Mem. at 21. Plaintiff distinguishes these cases by establishing that the Compensation Committee members breached their duty of due care not by granting compensation for incentive based bonuses, but instead failing to seek

Caremark, 698 A.2d at 967, director liability "may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." Directors' lack of good faith is demonstrated by a sustained or systematic failure to exercise oversight and assure adequate record keeping. *Id.* at 971. As explained by the Caremark court:

> [A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

Id. at 970.

In *Oxford Health*, the court analyzed the plaintiff's allegations of accounting fraud under *Caremark* and found that nonfeasance by the board excused demand. Defendants were alleged to have permitted Oxford to issue false statements regarding the company's deficient computer systems and deteriorating business condition. In particular, "'despite their knowledge of these facts [defendants] intentionally caused Oxford to continue its rapid and aggressive campaign of growth without reasonably insuring themselves that fundamental measures were undertaken and controls put in place to ensure the company was accurately keeping account of and reporting its financial results, and otherwise complying with its legal and regulatory obligations.'" *Oxford Health*, 192 F.R.D. at 115.

Similarly, here, plaintiff has alleged specific failures of the Board to act. The defendants failed to maintain adequate controls, practices and procedures for the proper disclosure of information (including but not limited to public reports, press releases and SEC filings) to its shareholders, the markets, analysts and the SEC, all of which artificially inflated the Company's

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forfeiture of these bonuses, in compliance with the Sarbanes-Oxley Act of 2002 §304, when it became clear that they had been improperly granted.

stock for three years/twelve quarters. ¶¶14-26. In addition, plaintiff alleged that the defendants failed to supervise the issuance of the Company's press releases and public filings to ensure that they were truthful and accurate and conformed with federal and state law for ***three years***. ¶¶14-26, 32, 34, 132. Instead, defendants failed to correct any inaccurate or untruthful information for three years. *Id.* Moreover, plaintiff alleged that defendants failed to properly supervise and monitor Red Hat's reporting and disclosure practices, which allowed misleading statements and filings to be issued and made for three years. *Id.*

The nonfeasance by the Director Defendants here by failing to comply with their fiduciary duty to discharge their supervisory and monitoring responsibilities for three years establishes reasonable doubt as to futility in accordance with the standard of *Rales*. *See also Caremark*, 698 A.2d at 972 (holding that a violation of fiduciary duty exists if the directors "either lack good faith in the exercise of their monitoring responsibilities or conscientiously permitted a known violation of law by the corporation to occur"). A lack of good faith, according to the *Caremark* case, can be established by showing a sustained or systematic failure to exercise oversight and assure adequate record keeping. In numerous cases where liability is based upon a failure to supervise and monitor, and to keep adequate supervisory controls in place, demand futility is ordinarily found, especially when the failure involves a scheme of significant magnitude and duration which went undiscovered by the directors. *See Miller v. Schreyer*, 200 A.D.2d 492, 494-95 (N.Y.A.D. 1994).

> This Complaint alleges with particularity the reckless failure of these defendants upon whom demand to sue would have to be made, in supervising or monitoring the affairs of the company.... To the extent that a Defendant violated his or her fiduciary duty by allowing others to make materially false or misleading statements about Oxford's financial matters, the rule of Rales applies, and, as previously discussed, demand is excused.

Oxford Health, 192 F.R.D. at 117. Significantly, the *Oxford Health* court held demand futile

under a nonfeasance theory where the allegations did not even involve accounting improprieties and a restatement of financial results. Furthermore, the *Oxford Health* court found demand futile under Caremark even though five out of the seven directors were outside directors. *Id.* at 113.

Hence, all of the defendants committed nonfeasance. The Board's nonfeasance is clearly demonstrated by the fact that the controls in place were so inadequate that the Board members, and the various Committees on which they served, could not keep track of the Company's renewal subscriptions and improperly inflated revenue from them. ¶¶66-76. By not ensuring that the proper controls were in place, the entire Board has breached its duty of care, and therefore demand is excused. *See Caremark*, 698 A.2d at 970-71.

G. Totality of the Circumstances

Additionally, in evaluating the sufficiency of plaintiff's demand futility allegations, this Court must look to the ***totality*** of the circumstances. *See, e.g.*, *Cendant*, 189 F.R.D. at 128 (D.N.J. 1999) ("[t]he trial court must not rely on any one factor but examine the totality of the circumstances and consider all of the relevant factors") (citing *Harris v. Carter*, 582 A.2d 222, 229 (Del. Ch. 1990)). Notwithstanding plaintiff's ability to overcome each criticism lobbed by defendants at the sufficiency of demand futility allegations, such parsing of defendants and claims is not the proper demand futility analysis. [16] Although plaintiff has made specific

[16] Each defendant's compensation from Red Hat is one such factor in applying a totality of the circumstances analysis. Plaintiff alleges with particularity that defendants Kaiser, Wellman, Fox and Young received compensation from Red Hat in the form of director and committee compensation. ¶¶123(b),(f). Defendant Kaiser receives $75,000, defendant Wellman receives $30,000, defendant Fox receives $45,000 and defendant Young receives $30,000 in respective annual payments. ¶123(f). The Compensation Committee of the Board is comprised of defendants Albrecht, Shelton and McDonald and, according to their charter, is responsible for CEO, Executive and Director compensation. ¶123(b). As directors, defendants Kaiser, Wellman, Fox and Young's personal financial compensation was solely controlled by the Compensation Committee. Defendants Kaiser, Wellman, Fox and Young, therefore, will not institute action against any Compensation Committee member because they are interested in maintaining their compensation. Furthermore, each of their interestedness must be taken as a

allegations as to the individual directors and their respective positions both within and outside Red Hat that prevent that director from making an independent, disinterested decision about whether to bring action, the sufficiency of plaintiff's demand futility allegations do not hinge on any particular allegation about a specific director. The overwhelming majority of courts have held that the court should engage in a single demand futility analysis for the entire action, taking account of the totality of a plaintiff's allegations.[17]

The Court must determine, in light of the totality of the allegations pled, whether a majority of the Board is "antagonistic, adversely interested, or involved in the transactions attacked" in the Petition or otherwise would be opposed to this action. *Cathedral Estates v. Taft Realty Corp.*, 228 F.2d 85, 88 (2d Cir. 1955). Even if none of plaintiff's demand futility allegations standing alone is sufficient to excuse demand, the Court "must consider whether the totality of these reasons raises a reasonable doubt as to the directors' disinterest or independence." *Storage Tech.*, 804 F. Supp. at 1375. *Accord Gen. Instrument*, 23 F. Supp. 2d at 875. Therefore, a finding by this Court of one allegation being insufficient standing alone, will not necessarily affect plaintiff's remaining demand futility allegations.[18]

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whole and applied to a totality of the circumstances test. Under this analysis demand upon defendants Kaiser, Wellman, Fox and Young is clearly futile.

[17] *See also Oxford Health,* 192 F.R.D. at 118 (applying Delaware law) (in evaluating demand futility the court considered the totality of the circumstances); *Gen. Instrument,* 23 F. Supp. 2d at 875 (citing *In re Storage Tech. Corp. Secs. Litig.*, 804 F. Supp. 1368, 1375-76 (D. Colo. 1992)) (applying Delaware law) (same); *Edgeworth v. First Nat'l Bank of Chicago*, 677 F. Supp. 982, 993 (S.D. Ind. 1988) (applying federal law) (same); *Bergstein v. Texas Int'l Co.*, 453 A.2d 467, 469 (Del. Ch. 1982) (applying Delaware law) (same).

[18] For example, defendants contend that director and officer insurance coverage does not establish demand futility. Defs.' Mem. at 9. Although plaintiff's allegation of insurance alone might not be enough to establish demand futility, it is evidence that should be considered in connection with plaintiff's other demand futility allegation. In addition, some courts have recognized the common sense proposition that demand is excused where director defendants would be forced to abrogate insurance coverage under a directors' and officers' liability policy to bring an action against themselves. *In re FirstEnergy S'holder Derivative Litig.*, 320 F. Supp. 2d

VI. PLAINTIFF HAS ADEQUATELY PLED DAMAGES TO RED HAT

Plaintiff adequately pled all claims in the Complaint. Defendants implicitly concede that the elements of each of the claims are well pled, with the exception of damages, because they raise no other objection to the pleadings of said claims in their motion to dismiss. Defs.' Mem. at 22-23. Defendants erroneously assert that this shareholder derivative action is "unripe" because there has been no determination of defendants' liability under the federal securities laws. Defs.' Mem. at 22. In making this assertion, defendants have improperly mischaracterized plaintiff's claims, and misapplied applicable pleading standards.[19]

As alleged in the Complaint, defendants have also caused Red Hat to suffer loss of goodwill, damages to its reputation, loss of market capitalization in the amount of over $2.5 billion, and payment of monies to directors of the Company. *Id.* These damages amounted to billions of dollars. ¶¶10, 118(ii). None of these damages, however, are "premature, speculative

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625 (N.D. Ohio 2004); *Drage v. Procter & Gamble,* 694 N.E.2d 479, 484 (Ohio App. 1 Dist. 1997) ("Certainly, a provision prohibiting directors from bringing suits against each other would deprive the directors 'of the ability to exercise independent judgment as to the advisability of instituting action against any officer or director for mismanagement, and thereby [divest them] of the power to govern this aspect of the corporation's affairs.'") (quoting *Grill v. Hobiltzell*, 771 F. Supp. 709, 713 (D. Md. 1991)). In *Drage*, the court held that the allegations of the complaint with regard to insurance coverage was insufficient to render demand futile, but only because mere allegations that "coverage ***may be*** adversely affected falls far short of the allegations in the cases cited by appellant wherein the directors were ***prohibited*** from bringing suit against other directors." *Drage*, 694 N.E.2d at 484 (emphasis in original). Therefore, defendants' liability policy should be considered as a component of the overall demand futility analysis.

[19] Cases cited by defendants for their "unripeness" argument are inapposite. Defs.' Mem at 22-23. For example, the defendants misread *In re Symbol Techs. Sec. Litig*., 762 F. Supp. 510 (E.D.N.Y. 1991). The plaintiffs in *Symbol* had attempted simply to rely on the outcome of the class action, rather than pleading specific violations and damages in the derivative action, i*d.* at 516, as plaintiff did here. Although the court in *Symbol* granted the motion to dismiss with prejudice as against certain defendants, it allowed plaintiffs leave to replead as against other defendants. Significantly, the court stated "[i]n the event that plaintiff repleads in this derivative action, the fact that there may be private Rule 10b-5 class actions for damages ... will not be a basis for dismissal." *Id.* at 517. Likewise, *In re United Telecomms*, *Inc. Sec. Litig*., No. 90-2251-EEO, 1993 WL 100202 (D. Kan. Mar. 4, 1993) is distinguishable in that those plaintiffs took the position that the directors should answer for any damages the corporation sustained as a result of the class action. Here, plaintiff does not hang his hat solely on the outcome of the class action.

or defectively conclusory," as defendants assert. Defs.' Mem. at 22. Rather, these monies are ripe and ascertainable. In fact, the insider trading proceeds amount to over $108 million dollars in clearly "ripe" damages. ¶¶118(ii), 119.

Red Hat's reputation in the business community has also been irreparably tarnished. ¶35. "Damage to one's business and reputation is a cognizable injury for which damages may be awarded if the underlying charges are proved." *Cendant*, 189 F.R.D. at 135. For at least the foreseeable future, the Company will suffer from the "liar's discount," a term applied to the stocks of companies that have been implicated in misconduct and have misled securities analysts and the investing public, such that Red Hat's ability to raise equity capital on favorable terms in the future will be impaired. ¶35. The Company has already incurred those damages – they are neither speculative nor contingent upon the outcome of the federal class action. In any event, the extent and ripeness of damages is not to be determined at the pleadings stage as it involves issues of fact. Accordingly, both the causes of action and the damages alleged in the Complaint are well-pleaded and "ripe." Thus, defendants' motion to dismiss on these grounds should be denied.[20]

VII. RED HAT'S CERTIFICATE OF INCORPORATION DOES NOT SHIELD DEFENDANTS FROM LIABILITY

Defendants' improper attempt to avail themselves of Red Hat's exculpatory charter provision must be rejected. Defs.' Mem. at 19-20. Defendants themselves recognize that Red Hat's Certificate of Incorporation does not and cannot immunize defendants for conduct that is in breach of their fiduciary duty of loyalty, acts committed in bad faith, or transactions from which

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[20] Plaintiff has demonstrated that defendants' motion to dismiss should be denied in its entirety. If the Court, however, grants defendants' motion to dismiss, plaintiff requests leave to amend the Complaint pursuant to N.C. Gen. Stat. §1A-1, Rule 15. "Leave to amend a pleading should be freely given." *Carolina Garage, Inc. v. Holston*, 253 S.E.2d 7, 9 (N.C. App. 1979). *See also*

they received personal benefits. 8 Del. C. §102(b)(7); Defs.' Mem. at 20. First, the Court must take Plaintiff's well plead allegations as true. *Lane v. City of Kinston*, 544 S.E.2d 810 (N.C. App. 2001). Second, taking the well-pleaded allegations of the Complaint as true, plaintiff has alleged numerous breaches of defendants' duty of loyalty, their failure to act in good faith, and their receipt of improper personal benefits. ¶¶124-151. Hence, §102(b)(7) does not apply. In the face of the plaintiff's allegations of defendants' breaches of the duties of loyalty and good faith, it would be improper to consider the §102(b)(7) affirmative defense at the pleading stage. *See Emerald Partners v. Berlin,* 726 A.2d 1215, 1223 (Del. 1999) (the use of exculpatory provisions to shield directors from personal liability presents an affirmative defense not amenable for pre-trial disposition); *Sanders v. Wang*, No. 16640, 1999 Del. Ch. LEXIS 203, at *34-*35 (Del. Ch. Nov. 8, 1999) ("defendants will have the opportunity to present their affirmative defense as the case progresses. At this stage of the proceedings, [the court] can not conclude as a matter of law that the Board acted in good faith and that their actions constituted no more than mere carelessness."). Consequently, plaintiff's causes of action should be sustained in their entirety.

VIII. CONCLUSION

For the reasons detailed above, plaintiff believes that defendants' motion to dismiss the Complaint should be denied in its entirety.

This 31st day of October, 2005.

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Vernon v. Crist, 231 S.E2d 591 (N.C. 1977); *Roberts v. Reynolds Mem. Park*, 187 S.E.2d 721 (N.C. 1972).

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CERTIFICATE OF SERVICE

I hereby certify that I served a copy of the foregoing by placing said copy in a prepaid envelope, addressed to counsel for the Defendants, at the address stated below, by depositing said envelope and its contents in the United States Mail at Charlotte, North Carolina.

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This 31st day of October, 2005.

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