STATE OF NORTH CAROLINA

WAKE COUNTY

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
NORTH CAROLINA BUSINESS COURT
04 CVS 11746

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. STEVE ALBRECHT and H. HUGH SHELTON,

Defendants,

- and -

RED HAT, INC., a Delaware corporation,

Nominal Defendant.

OPENING BRIEF IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS THE VERIFIED AMENDED SHAREHOLDER DERIVATIVE COMPLAINT

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Introduction

Plaintiff asserts derivative claims against current and former officers and directors (of Red Hat, Inc. ("Red Hat" or the "Company") for purported breach of their fiduciary duties, abuse of control, waste, illegal insider selling, gross mismanagement and unjust enrichment. Plaintiff's claims are based primarily (and implausibly) on defendants' use of an accounting convention consistently endorsed by Red Hat's independent auditor, PricewaterhouseCoopers LLP ("PwC"). Beginning in 1999, with PwC's approval, Red Hat recognized revenue from subscription contracts one way. In mid-2004, in conjunction with a routine, five-year rotation in lead audit partner, PwC advised Red Hat to use another methodology. This required a restatement of the Company's revenues for the three previous fiscal years (2002 through 2004) and the most recent quarter in fiscal 2005. When Red Hat announced the restatement, its stock price fell. Plaintiff tellingly makes no assertion of wrongdoing against PwC; and fails to mention that Red Hat did not lose a single dollar of revenue in a restatement that merely shifted a tiny percentage (less than one half of one percent) of subscription revenue from the beginning to the end of the restatement period.

Given the implausibility of suing defendants for using an accounting method that the nation's largest auditing firm approved, it is unsurprising that plaintiff cannot plead with particularity why demand on Red Hat's directors would have been futile. Instead of alleging specific facts showing a majority of the directors were disabled from considering demand by a "substantial likelihood" of personal liability or lack of independence, plaintiff relies on the type of generalized, conclusory allegations that courts consistently reject. Plaintiff also fails to state a claim, because he cannot identify any harm to Red Hat except completely speculative exposure in the pending federal securities lawsuit whose allegations he parrots.

Background and Factual Allegations

A. The Parties

Red Hat, a Delaware corporation headquartered in Raleigh, North Carolina, provides enterprise operating system software and systems management services. See Compl. ¶ 13. Plaintiff, purportedly a Red Hat shareholder, brought this suit against seven Red Hat outside directors, Eugene J. McDonald, F. Selby Wellman (a former director), Marye A. Fox, William S. Kaiser, Steve Albrecht, H. Hugh Shelton, and Robert Young, and inside director Matthew J. Szulik (the Company's President and Chief Executive Officer) ("Directors").[1/]

B. Events Precipitating The Suit

Red Hat sells subscriptions permitting customers to obtain updates and support for Linux software. Compl. ¶¶ 4, 54-57. Red Hat offers annual "subscriptions" for updated versions of Linux. Id. ¶¶ 4, 57. Between December 2002 and July 21, 2004 ("Relevant Period"), Red Hat disclosed in its SEC filings that it recognized subscription revenues "ratably over the period of the subscription." See Red Hat 10K For Fiscal Year Ended February 29, 2004 ("2004 10K") at 19, Ex. E.[2/] Neither Red Hat's filings nor the accounting standards that specify that subscription revenue should be recognized "ratably" define the meaning of that term. See, e.g., Red Hat 10K For Fiscal Year Ended February 28, 2002 at 18-20, Ex. G.

Prior to July 2004, Red Hat – with the approval of PwC - recognized revenue on subscription agreements ratably by month beginning in the month the contract was executed. See Compl. ¶ 104. Thus, for a subscription entered during January, Red Hat would recognize one-twelfth of the revenue during January and each of the succeeding eleven months. See id.

[1/] The Complaint also names various Red Hat officers as defendants. See Compl. ¶¶ 15-19. The allegations against them are irrelevant to demand futility, which turns on whether the Board could have fairly evaluated demand, had plaintiff made one.

[2/] The Court may consider SEC filings such as Forms 4 and 10K in evaluating the sufficiency of the Complaint. See, e.g., Suntrust Bank v. Aetna Life Ins. Co., 251 F. Supp. 2d 1282, 1287 (E.D. Va. 2003).

However, in mid-2004, after PwC rotated audit partners pursuant to the Sarbanes-Oxley Act, PwC determined that Red Hat should recognize subscription revenue ratably on a daily basis. See id. Thus, for a subscription entered on January 15, Red Hat would recognize only 17 days worth of revenue for that January, leaving 14 days of revenue to be recognized the following January.

On July 13, 2004, Red Hat announced that it would restate its revenues to reflect the changed accounting method. See id. The restatement did not cause Red Hat to lose even a dollar of revenue. See id. For each subscription, a small percentage of revenue was shifted from its first to its last month, resulting in some restated quarters being slightly higher than originally reported, and some slightly lower. See Red Hat 10Q For First Quarter of Fiscal Year 2005 ("Q1 2005 10Q") at 21, Ex. B; Red Hat 8K filed June 17, 2004 at Exhibit 99.2 ("2004 8K at 99.2"), Ex. C; Red Hat 10K/A For Fiscal Year Ended February 29, 2004 ("2004 10K/A") at 57, 70-71, Ex. D; 2004 10K at 65-66, Ex. E; Red Hat 10K For Fiscal Year Ended February 28, 2003 ("2003 10K") at 15, 62-63, Ex. F. The total shift in revenue from beginning to end of the restatement period was less than one half of one percent (0.37%). Id. Nonetheless, on the day the restatement was announced, Red Hat stock dropped about 45 percent to $15.73 per share from a high of $28.73 on June 1, 2004, apparently due to market uncertainty. Compl. ¶ 106. Three months later, after a federal securities suit was filed, plaintiff filed his original complaint.

C. Plaintiff's Allegations

1. General Allegations of Misconduct

Based on a July 13, 2004 press release, plaintiff alleges that Red Hat recognized subscription revenue incorrectly, and as a result issued false and misleading press releases and financial statements during the Relevant Period. See Compl. ¶¶ 89-92, 94, 96, 102, 110-111.

According to plaintiff, Red Hat's restatement "is an admission that the financial statements originally issued were false and that the overstatement of revenues and income was material." Id. ¶ 115.

Plaintiff asserts defendants "caused or allowed" Red Hat to issue false financial statements, see id. ¶¶ 89-96, or "participated in" their issuance, see id. ¶¶ 14-26, or conspired to "conceal the fact that the Company was improperly misrepresenting its financial results." Id. ¶ 49. He cites a litany of accounting principles, see id. ¶¶ 112-115, 116(a)-(h), but alleges *no facts* showing that any Director knew or should have known that the accounting convention approved by PwC was incorrect, much less that it was somehow being employed to defraud investors.

Plaintiff also alleges two problems with the Company's "internal controls." See id. ¶¶ 8-9. First, plaintiff alleges that Red Hat artificially inflated contract renewal forecasts, but fails to identify any resulting harm to the Company, to link the forecasts to any Director except Mr. Szulik, or to plead Mr. Szulik's knowledge except by a conclusory allegation from an unidentified source that his knowledge was "a given." See id. ¶¶ 66-76. Second, plaintiff alleges that Red Hat prematurely recognized revenue from consulting fees, but fails to identify how much revenue was recognized prematurely, to explain what accounting principle was violated, to link any Director to the practice, or to identify any harm to the Company. See id. ¶¶ 77-78.

Significantly, many of plaintiff's "substantive" allegations, see Compl. ¶¶ 60, 62-63, 65, 67-77, 80-84, 86-88, repeat in mantra-like fashion the phrase "it has been alleged," clearly referring to allegations in the federal securities case. Plaintiff's obvious failure to conduct any independent investigation, demonstrated by his unwillingness to allege key facts directly, shows that he has shirked his obligation under Delaware law to conduct a diligent investigation prior to

bringing suit. See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 981 (Del. Ch. 2003) (hereinafter "Beam I"), aff'd, 845 A.2d 1040 (Del. 2004) (admonishing plaintiffs who plead demand futility without sufficient investigation); Guttman v. Huang, 823 A.2d 492, 504 (Del. Ch. 2003) (same). These "indirect" allegations should not even be considered; but if they are, they still do not excuse failure to make demand. See infra Section I.

2. Insider Trading

Plaintiff's insider trading theory is premised on (1) a recitation of stock sales by certain defendants, only two of whom (Messrs. Szulik and Kaiser) are Directors, Compl. ¶¶ 14-19, 24, 119, 123(a)(i)-(ii), and (2) the conclusion that these two sold when they had "undisclosed material adverse information" regarding improper accounting. Id. ¶ 119. The Complaint sets forth no specific facts concerning what undisclosed material information either man knew at the time of any sale, how he learned it, or when. It contains no other allegations from which wrongful intent might be inferred.

3. Demand Futility.

Plaintiff asserts that demand upon the Board – *seven of eight of whom are outside directors* – would have been a "futile, wasteful and useless act." Id. ¶ 123 Plaintiff offers a variety of conclusory and insubstantial reasons why demand would be futile, see id. ¶¶ 123(a)-(t), none of which (as explained in Section I, infra) come near satisfying Plaintiff's burden of pleading by particularized facts that a majority of Directors are "interested" or lack "independence." Plaintiff claims:

- Messrs. Szulik and Kaiser would not bring this action because they allegedly engaged in "illegal insider selling," id. ¶ 123(a);

- The Directors would not bring this action against Compensation Committee members because "[t]o do so would jeopardize each defendant's personal financial compensation," id. ¶¶ 123(b)-(c);

- Audit Committee members would not bring this action because they allegedly "breached their duties by causing or allowing ... improper financials" id. ¶ 123(d);

- Compensation Committee members would not bring this action because they breached their duties by approving incentive compensation to Red Hat officers that was tied to inflated revenues, id. ¶ 123(e);

- The outside Directors would not bring this action because they

    - are interested in "safeguarding" their compensation, and breached their duties by allowing the Company to issue false and misleading statements while voting to increase their compensation, id. ¶ 123(f); and

    - "would not jeopardize" being able to exercise the options that the Company awarded them and that have or will soon vest, id. ¶ 123(k);

- CFO Kevin B. Thompson, a non-Director, would not bring this action because to do so would "jeopardize" an interest-free $200,000 advance that the Company gave him that has not yet been fully forgiven, id. ¶ 123(j); and

- The Directors would not bring this suit against themselves and/or their ability to do so would be impaired because they

    - breached their fiduciary duties by participating in or permitting the "wrongs" alleged in the Complaint, see id. ¶ 123(l), including issuance of "improper financials," id. ¶ 123(i) (especially McDonald and Albrecht because each had "financial expertise," id. ¶ 123(g)-(h)), thereby subjecting Red Hat to liability for *possibly* violating securities laws, id. ¶ 123(l);

    - would not sue themselves and "persons with whom they have extensive business and personal entanglements," id. ¶ 123(m);

    - would likely "expose their own misconduct," which would expose Red Hat and defendants to more litigation and liability, id. ¶ 123(p)-(r);

    - have not brought suit already, id. ¶¶ 123(j), (t); and

    - would not be covered under the Company's D&O insurance, id. ¶ 123(s).

Argument

I. The Complaint Must Be Dismissed At The Outset Because Plaintiff Fails As A Matter Of Law To Adequately Plead Demand Futility.

A. The Standards For Pleading Demand Futility.[3/]

If a derivative plaintiff fails either to make demand on the Board or to show demand is futile and should be excused, the complaint must be dismissed. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048-49 (Del. 2004) (hereinafter "Beam II"); Kaufman v. Belmont, 479 A2d 282, 286 (Del. Ch. 1984). It is a "cardinal precept" of Delaware corporate law that "directors, rather than shareholders, manage the business and affairs of the corporation." Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), overruled in part on other grounds by Brehm v. Eisner, 746 A.2d 244, 253-54 (Del. 2000); see also Kamen, 500 U.S. at 101 ("decisions of a corporation – including the decision to initiate litigation – should be made by the board of directors or the majority of shareholders") (citation omitted). The demand requirement "exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits." Aronson, 473 A.2d at 811-12; see also Brehm, 746 A.2d at 255.

Demand is deemed "futile" only if plaintiff pleads by particularized facts that a majority of directors could not have impartially assessed demand because *each* member of that majority was (1) "interested" or (2) "lacked independence" from an *interested* director. See Beam II, 845 A.2d at 1048-49; Beam I, 833 A.2d at 976-77; Guttman, 823 A.2d at 499-501; Brehm, 746 A.2d at 254 ("Pleadings in derivative suits...must comply with stringent requirements of factual particularity that differ substantially from...permissive notice pleadings").

[3/] Because Red Hat is a Delaware corporation, Delaware law governs demand futility. Kamen v. Kemper Fin. Servs., 500 U.S. 90, 108-09 (1991).

In order to plead that a director is "interested," a plaintiff must allege specific facts demonstrating that the director faces a "*substantial* likelihood of personal liability" in the lawsuit. See, e.g., Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993); Aronson, 473 A.2d at 815 ("mere threat of personal liability" insufficient); Guttman, 823 A.2d at 500 n.15, 502 (same). This showing is especially difficult to make where, as here, the board's majority consists of mostly outside directors. See Rattner v. Bidzos, No. 19700, 2003 WL 22284323, at *11 (Del. Ch. Sept. 30, 2003).

In order to plead that a director lacks "independence," a plaintiff must show by particularized facts that the director is so beholden to an "interested" director that he or she would be "more willing to risk his or her reputation than risk the relationship with the interested director [by suing him or her]." Beam II, 845 A.2d at 1046, 1052.[4/]

As shown below, plaintiff here fails to meet his pleading burden as to any Director, much less the Board's majority.

B. Plaintiff Fails To Establish a Majority of the Board is "Interested"

1. Conclusory Allegations That Directors Would Not Sue Themselves Are Insufficient

Plaintiff offers several conclusory reasons why the Directors would never sue themselves and demand therefore would be futile: they "participated in" or "permitted" the wrongs alleged in the Complaint, and thus are liable; they would not be covered by the Company's D&O insurance in a derivative suit; and they have not yet sued themselves. See Compl. ¶¶123(g)-(i),

[4/] A plaintiff must rebut the presumption of impartiality with respect to *each* director and cannot rely on wholesale allegations. Beam II, 845 A.2d at 1046, 1049-50; Beam I, 833 A.2d at 981-82.

(l)-(t).[5/] But allegations that directors accused of wrongdoing would not sue themselves are insufficient to establish demand futility. See, e.g., Aronson, 473 A.2d at 818 (demand not excused by directors' alleged participation in wrongs and alleged reluctance to sue themselves); Grimes v. Donald, 673 A.2d 1207, 1216 n.8 (Del. 1996) ("Demand is not excused simply because plaintiff has chosen to sue all directors."), overruled in part on other grounds by Brehm, 746 A.2d at 253-54. Allegations concerning lack of D&O coverage are in substance no different than allegations that directors would not sue themselves because it would expose them to liability. Caruana v. Saligman, No. 111135, 1990 WL 212304, at *4 (Del. Ch. Dec. 21, 1990) (rejecting D&O excuse as "variations on the 'directors suing themselves' and 'participating in wrongs' refrain") (citations omitted). The assertion that futility can be established by directors' failure to sue themselves is equally defective and circular. Lewis v. Graves, 701 F.2d 245, 249 (2d Cir. 1983) ("bald charges of mere failure to take corrective action are . . . inadequate").

2. Plaintiff's Allegations that the Directors "Participated" in Wrongdoing Fail to Establish a Substantial Likelihood of Personal Liability

Conclusory allegations that directors "participated in," "approved of," or "acquiesced in" the wrongdoing alleged in a derivative complaint cannot excuse demand. See, e.g., Aronson, 473 A.2d at 818; Haber v. Bell, 465 A.2d 353, 359 (Del. Ch. 1983). As a Virginia court recently held in dismissing a similar suit, in order to establish a substantial likelihood of liability based on false public statements, a derivative plaintiff must "articulate connections between specific information to which each defendant had access and specific false statements that each made, or caused to be made, to the public." Taddy v. Singh, No. 1:04cv1051, slip op. at 17 (E.D.Va. Dec.

[5/] Plaintiff also alleges that the Directors are disabled from evaluating demand because *one* (Mr. Szulik) is a defendant in In re Red Hat, Inc. Sec. Litig, No. 5:04-CV-473, a pending federal securities suit in the United States Court for the Eastern District of North Carolina, Western Division. This allegation is deficient because seven of eight Directors are *not* named in that suit. Id. Moreover, a shareholder could always avoid demand if courts found futility based on the mere existence of another lawsuit.

8, 2004) ("Primus") (applying Delaware law), Ex. K. Measured against these standards, plaintiff's "substantive" allegations of wrongdoing are insufficient. The Directors supposedly participated in three forms of wrongdoing affecting Red Hat's public statements: inflating revenues by prorating subscription revenue on a monthly basis; inflating revenue forecasts, and prematurely recognizing consulting fees. However, as explained below, plaintiff fails even to identify any "specific information" the Directors had on any of these subjects, much less to "articulate" any "connection" between that information and any specific false statement.

As to subscription revenue, plaintiff points to no specific facts (no source, document, meeting, or conversation) showing that any Director knew or should have known (at any time during the Relevant Period, much less at the time of any specific statement) that the Company's financial statements were inaccurate and would be restated. Any such allegation would be implausible given PwC's approval of the Company's accounting for subscription revenue. Other than the vague allegation that the Audit Committee "approved" the financial statements, plaintiff does not identify any connection between any Director and any statement.

As to alleged "inflation" of revenue forecasts, plaintiff alleges vaguely that forecasts were "disseminated to the public," see Compl. ¶ 8, but fails to identify a specific false public statement containing an inflated forecast. Nor does plaintiff point to any specific facts showing that any Director other than Mr. Szulik knew or should have known about "inflated" forecasts. As to Mr. Szulik, plaintiff can assert only that "it has been alleged" that an unnamed, former "Director of Business Intelligence" claims that his knowledge was a "given." See id. ¶ 76. This allegation: 1) is a naked conclusion, Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992), modified on other grounds by 15 U.S.C. § 78u-4 (conclusory averment that defendant "knew" a fact insufficient); and 2) is not supported by any facts showing the source is

knowledgeable about revenue forecasts or *Mr. Szulik's* knowledge thereof. See, e.g., In re Northpoint Communications Group, Inc., Sec. Litig., 184 F. Supp. 2d 991, 1000 (N.D. Cal. 2001) (rejecting sources because complaint failed to discuss "what the specific duties of these individuals were, or how they came to learn of the information they provide[d] in the complaint"). Moreover, plaintiff identifies no harm to Red Hat from "inflated" forecasts for which the Directors could be liable to the Company. Indeed, he does not even allege that Red Hat made any public disclosures on the subject, so there is no basis to conclude that the forecasts harmed anyone: not shareholders (who could be harmed only by a disclosure leading to stock price decline), and certainly not the Company, which could not recover even if shareholders were harmed. See infra Section II at 22.

As to premature recognition of consulting fees, plaintiff sets out no specific facts showing when or in what amount fees were improperly recognized, thus failing to show that any public statement was materially false. See, e.g., In re Trex Co., Sec. Litig., 212 F. Supp. 2d 596, 611 (W.D. Va. 2002) (dismissing allegations of improper revenue recognition where plaintiffs failed to identify "the amount or percentage of revenues" at issue). Plaintiff also fails to allege any specific facts showing any Director knew or should have known of the alleged problem. Furthermore, plaintiff fails to set out a coherent theory as to how Red Hat was harmed. Consulting fees were not restated, and plaintiff does not identify any public disclosure on the subject. Moreover, no explanation is provided why decisions as to the timing of revenue recognition for financial statement purposes would "deplete" Red Hat's "budget" for consulting fees by the time the fees became due, see Compl. ¶ 9, and in any case no allegation is made that any consultant was not paid.

Plaintiff's claims for waste – in connection with "incentive based bonuses to certain of [Red Hat's] executive officers" and potential exposure to "millions/billions of dollars of legal liability" and fees, see id. ¶ 146 – also do not subject the Directors to any substantial likelihood of personal liability. To sustain a waste claim, plaintiff must show that Red Hat received *nothing* in return for the incentive bonuses and legal costs. See, e.g., Sanders v. Wang, No. 16640, 1999 WL 1044880, at *10 (Del. Ch. Nov. 8, 1999) ("[f]or a waste claim to survive a motion to dismiss, the plaintiff must allege facts sufficient to show that the corporation received no consideration"). Plaintiff plainly fails to allege that Red Hat received *no* benefit as a result of its executives performing their duties and Red Hat obviously has received a defense in exchange for the legal fees paid in the federal case. Plaintiff's waste claim does not even state a claim and thus does not establish any Director's substantial likelihood of personal liability.

3. Messrs. Szulik's and Kaiser's Sales of Red Hat Stock Do Not Render Either "Interested."

The mere fact that Messrs. Szulik and Kaiser sold stock does not create a "substantial likelihood of personal liability." See Guttman, 823 A.2d at 502; Rattner, 2003 WL 22284323, at *11; see also McCall v. Scott, 239 F.3d 808, 825 (6th Cir.), amended on other grounds by 250 F.3d 997 (6th Cir. 2001) (directors and officers who own or receive compensation in stock "should be expected to trade those securities in the normal course of events") (applying Delaware law).

To excuse demand based on insider trading, a derivative plaintiff must allege particular facts demonstrating (1) "that each sale by each individual defendant was entered into and completed on the basis of, and because of, adverse material non-public information," Guttman, 823 A.2d at 505 (citation omitted); see also McCall, 239 F.3d at 824-25; Stepak v. Ross, Civ. A. No. 7047, 1985 WL 21137, at *5 (Del. Ch. Sept. 5, 1985), or (2) a *strong* inference that insider

trading was done with *wrongful intent*. McCall, 239 F.3d at 825; Guttman, 823 A.2d at 493, 505, 508.[6/] The Complaint does not satisfy either test as to either man. Compl. ¶ 123(a).[7/]

a. Plaintiff Fails to Plead Particularized Facts that Messrs. Szulik or Kaiser Sold Red Hat Stock on the Basis of Inside, Material Information

Plaintiff identifies only in conclusory and rhetorical terms *what* information Messrs. Szulik and Kaiser allegedly possessed, see Compl. ¶ 123(a) (they "knew the adverse non-public information regarding the improper accounting"), and *how* they possessed it, see id. (by virtue of their positions, which included access to "internal corporate documents," "conversations," and attendance at "management and Board meetings"). These allegations fail as a matter of law. See, e.g., Guttman, 823 A.2d at 493, 504-05, 508 (demand cannot be excused based on insider trading absent *specific facts* showing defendants knew of accounting irregularities *at the time of sale*).

Moreover, the Complaint itself rebuts any possible inference that they knew any material inside information (i.e., that the Company's accounting practices were improper and that a restatement was forthcoming) *when* they made any sale. The Complaint quotes the Company's July 13, 2004 press release that PwC advised Red Hat to "consider" changing its accounting for subscription revenue on June 16, 2004. See Compl. ¶ 104. But *all* the alleged sales by Messrs. Szulik and Kaiser were months *before* PwC made this suggestion, which is the first alleged

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[6/] The requirements for pleading scienter based on insider trading in securities fraud cases are the same as for pleading wrongful intent with respect to stock sales in derivative cases. See, e.g., McCall, 239 F.3d at 825; Guttman, 823 A.2d at 505 n.31.

[7/] The sales of non-director Defendants Thompson, Cormier, Buckley, Webbink and Pinchev are irrelevant to the demand futility issue because the issue is whether the Board could have impartially evaluated demand.

indication that Red Hat might have to restate its financials. See id. ¶ 119 (alleging Mr. Szulik sold stock from January 7, 2003 to March 5, 2004 and Mr. Kaiser on January 6, 2004).[8/]

b. Plaintiff Fails to Show a Strong Inference that Messrs. Szulik or Kaiser Sold Shares With Wrongful Intent

Unable to directly allege that Messrs. Szulik or Kaiser traded on material inside information, plaintiff alleges that wrongful intent can be inferred from the circumstances of their sales. Wrongful intent can be inferred if sales are "suspicious" both as to amount and timing; sales large in magnitude, standing alone, do not give rise to the requisite inference.[9/]

Although Mr. Szulik sold a substantial number of shares, his timing was not suspicious. First, he sold no stock after March 5, 2004, more than four months before any disclosure of adverse news by Red Hat. See In re Nike, Inc. Sec. Litig., 181 F. Supp. 2d 1160, 1169 (D. Or. 2002) (two-month gap betweens sales and adverse disclosure negates scienter); In re Party City Sec. Litig., 147 F. Supp. 2d 282, 313 (D.N.J. 2001) ("A broad temporal distance between stock sales and a disclosure of bad news defeats any inference of scienter.") (citations omitted). Second, as explained above, all Mr. Szulik's sales took place months before PwC informed Red Hat that it should consider changing its accounting for subscription revenue. One cannot plausibly explain his earlier sales by a desire to "dump" stock prior to a restatement.

Third, Red Hat's stock soared as high as $28.73 during the Relevant Period, yet Mr. Szulik sold more than a million shares in 2003 between $6.05 and $15.35 a share, and all his 2004 sales were between $13.66 and $21.03. See Compl. ¶¶ 106, 119; Yahoo Historical Stock

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[8/] The allegation that an unnamed Red Hat official said there had been "discussions" about subscription revenue recognition "early on," see Compl. ¶ 107, is so vague both as to content and timing that it adds nothing to the analysis.

[9/] See, e.g., In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1093-94 (9th Cir. 2002) (chairman's sale of 74% of holdings suspicious in amount only, but not in timing, and therefore did not create inference of scienter); Wenger v. Lumisys, Inc., 2 F. Supp. 2d 1231, 1238 n.6, 1251 (N.D. Cal. 1998) (individuals' sales of 100% and 91% percent of holdings not at suspicious times and therefore no inference of scienter); Guttman, 823 A.2d at 493, 504 (sale of 100% of holdings insufficient to render defendant interested).

Quote for Red Hat, December 2002 through July 2004, Ex. A;[10/] see also Ronconi v. Larkin, 253 F.3d 423, 435 (9th Cir. 2001) (no strong inference when defendants "miss[ed] the boat" in terms of maximizing profits); In re Cree, Inc. Sec. Litig., 333 F. Supp. 2d 461, 476-77 (M.D.N.C. 2004) (no scienter where sales not calculated to "maximize . . . personal benefit").

Finally, 2.1 of Mr. Szulik's 2.9 million shares sold were sold pursuant to a Rule 10b5-1 trading plan, in which sales are scheduled well in advance. See, e.g., SEC Forms 4 filed by Szulik on September 11, 2003 at n.1 and on February 18, 2004 at n.1, see Ex. I. Such previously locked-in sales are inconsistent with any inference of wrongful intent. See Wietschner v. Monterey Pasta Co., 294 F. Supp. 2d 1102, 1117 (N.D. Cal. 2003) (pre-scheduled sales executed in accordance with10b5-1 trading plan not suspicious). This is particularly true here because it would have been impossible to predict what effect Red Hat's accounting convention would have on results in any future quarter, as reflected by the fact that Red Hat's restatement resulted in both downward and upward adjustments depending on the quarter.

The sales plaintiff attributes to Mr. Kaiser (70,112 shares) in fact were made by partnerships in which he had a "nominal" pecuniary interest. See Compl. ¶ 123(a)(ii); Kaiser's Form 4 filed with the SEC Jan. 7, 2001, nn.1&3, see Ex. H. But even assuming all the partnership's sales count as Mr. Kaiser's sales, plaintiff still cannot allege even a suspicious amount, because plaintiff fails to take into account the stock and vested options Mr. Kaiser held personally. See, e.g., In re E.spire Communications, Inc. Sec. Litig., 127 F. Supp. 2d 734, 743 (D. Md. 2001) (plaintiffs may not overstate percentage of total holdings by excluding vested options). When these holdings are considered, see Kaiser's SEC filings for the Relevant Period, Ex. H, he sold a trivial 7.6% of his total holdings. See, e.g., In re First Union Corp. Sec. Litig.,

[10/] The Court can consider this information on a motion to dismiss. See, e.g., La Grasta v. First Union Sec., Inc., 358 F.3d 840, 842 (11th Cir. 2004) (considering stock prices on motion to dismiss); In re NAHC, Inc. Sec. Litig., 306 F.3d 1314, 1330-31 (3d Cir. 2002) (same)

128 F. Supp. 2d 871, 898 (W.D.N.C. 2001)(8% is "trivial amount of trading affirmatively demonstrat[ing] the absence of scienter."). And, of course, the percentage would be even less if only the shares reflecting Mr. Kaiser's interest in the partnerships were attributed to him.

The *timing* of the sales is equally benign. The partnerships in which Mr. Kaiser had an interest, sold no stock after January 7, 2004, more than six months before Red Hat disclosed any adverse news, and more than five months before PwC advised Red Hat to consider changing its accounting convention. And the partnerships sold the shares for $18.62 per share, see Compl. ¶ 119, more than $10 off the high for the Relevant Period. See cases cited supra at 14 regarding timing of Mr. Szulik's sales.

4. Plaintiff Fails to Establish that Audit Committee Members Are Interested

Plaintiff asserts that demand on the Directors on Red Hat's Audit Committee – Messrs. Wellman, McDonald, Kaiser, and Albrecht and Ms. Fox – would be futile because they breached their duties by causing or allowing the Company to issue false and misleading financial statements. Compl. ¶ 123(d). However, plaintiff cannot satisfy his pleading burden by alleging the mere *fact* of membership on an audit committee. To plead a substantial likelihood of liability, plaintiff must allege by particularized facts that the committee "devoted patently inadequate time to its work," or that the committee "had clear notice of serious accounting irregularities" but failed to take corrective action. Guttman, 823 A.2d at 507. As Delaware courts consistently have recognized, claims premised on a showing "that the directors were conscious . . . they were not doing their jobs" are among the most difficult to prove. Guttman, 823 A.2d at 506; see also, e.g., In re Citigroup Inc. Shareholders Litig., No. 19827, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003) (demand not excused where plaintiff fails to plead specific facts showing directors "either knew or should have known that there were material

inadequacies in the corporation's internal controls"); In re Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 969-70 (Del. Ch. 1996) (substantial likelihood of personal liability requires prior consciousness of, or recklessly ignoring, red flags).

Here, plaintiff alleges no "red flags" suggesting that Audit Committee members knew or should have known of issues with Red Hat's financial statements or internal controls. This is not surprising given that PwC had approved the Company's accounting convention for subscription revenues. See Compl. ¶ 104. Plaintiff instead lards the Complaint with *pages* of the committee's duties taken *verbatim* from the committee's charter, followed by the conclusory assertion that "[n]onetheless, the Audit Committee recommended" and "endorsed" disseminating "improper" financials to the public. See Compl. 123(d). Plaintiff also generally alleges that the Company's internal controls were "a complete mess," see Compl. ¶¶ 8-10, and that Audit Committee members "knew or should have known" this because of access to vaguely referenced "internal corporate documents," or because of unspecified "conversations" and "meetings," or because they "received briefings, reports and internal communications concerning the unlawful practices described" in the Complaint. See id. ¶¶ 10, 21-25, 41-52.

But plaintiff conspicuously fails to identify with *particularity* the content of any "internal document" or "briefing" or "report" that came to the Audit Committee's attention, or the content of any specific "conversation" or "meeting," showing that committee members were on notice of problems.[11/] Plaintiff, therefore fails to meet his pleading burden. See, e.g., Guttman, 823 A.2d at 506; In re Citigroup, 2003 WL 21384599, at *2; In re Caremark, 698 A.2d at 969-70.

The mere fact that Red Hat restated its financials, see Compl. ¶¶ 89-92, 94, 96, 102, 110-111, 115, cannot rectify plaintiff's failure to point to "red flags" putting Audit Committee

11/ That Albrecht and McDonald might have had "financial expertise," see Compl. ¶¶ 123(g)-(h), only begs the question of what specific information came to their attention that should have alerted them to a problem.