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.

DEFENDANTS' REPLY IN SUPPORT OF MOTION TO DISMISS PLAINTIFF'S VERIFIED AMENDED SHAREHOLDER DERIVATIVE COMPLAINT

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Introduction

The Opposition ignores Defendants' central point -- Plaintiff has not pleaded with particularity any specific "red flags" or other contemporaneous facts showing that any Director knew or should have known, before Red Hat changed its method of accounting and restated its financials, that subscription accounting was a matter of concern. Nothing in the Amended Complaint plausibly explains how Defendants could have breached fiduciary duties in connection with financial statements based on an accounting method that the Company's outside auditor PriceWaterhouseCoopers ("PwC") had endorsed. Remarkably, the 28-page Opposition does not even *mention* PwC.

Plaintiff similarly fails to challenge many of Defendants' other points: Red Hat lost no revenues as a result of the restatement; the differences between original and restated revenues were small; and there was nothing "suspicious" about Mr. Szulik's or Mr. Kaiser's[1] stock sales. Plaintiff also appears to abandon allegations of "inflated" revenue forecasts, improper recognition of consulting fees, and "waste."

Plaintiff also fails to defend many of his demand futility allegations, including that the Directors cannot be expected to sue themselves, have not yet taken corrective action, were beholden to the Compensation Committee (Plaintiff now asserts only Mr. Szulik was beholden), and had disabling "entanglements." Unable to point to any particularized facts sustaining the remaining futility allegations, Plaintiff instead blatantly misreads the law, including by disingenuously suggesting that only a notice pleading

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[1] Plaintiff mischaracterizes -- and miscalculates -- the sales attributed to Mr. Kaiser. *See* Opening Brief in Support of Defendants' Motion to Dismiss the Verified Amended Shareholder Derivative Complaint (Defs' Mem.) at 15-16.

standard applies,[2] improperly injecting the business judgment rule into the demand futility analysis, and misstating insider trading law.

In short, the Opposition confirms that Plaintiff offers nothing to excuse demand beyond the naked conclusion that because Red Hat restated its revenues later, the Directors *must* have been remiss in discharging their duties earlier. Under Delaware law, such conclusory allegations, no matter how often repeated, are insufficient to wrest from the board the decision whether to institute litigation.[3] Thus, this case should be dismissed with prejudice.[4]

Argument

1. The Business Judgment Rule Is Inapplicable. Although failure to exercise business judgment is not even mentioned in the Complaint's demand futility allegations (*see* Compl. ¶¶ 120-28), Plaintiff argues that under *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), demand is excused -- even if a majority of board members were disinterested and independent -- because the board did not exercise its business judgment. (Opp. at 7-9). Under settled Delaware law, however, as Plaintiff concedes (Opp. at 7 n.5), the business judgment prong of *Aronson* has no application where, as here, a derivative plaintiff challenges a course of conduct rather than a specific board action, such as a vote to approve a merger. In such a case, the sole question is whether interest and/or lack of independence prevent a majority of directors from objectively considering demand. *See, e.g., Rales v. Blasband*, 634 A.2d 927, 930-31 (Del. 1993); *Beam ex. rel. Martha Stewart*

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[2] After much misleading discussion of notice pleading, Plaintiff eventually acknowledges his burden to plead demand futility with particularity. *See* Opp. at 6-9.

[3] The Court has requested that Defendants wait for oral argument to address the import of *In re Pozen Shareholders Litig.*, 2005 NCBC 7 (N.C. Bus. Ct. Nov. 10, 2005).

[4] Plaintiff fails to distinguish the authorities demonstrating that neither speculative damage based on the pending federal suit nor conclusory, unquantified allegations of "reputational" harm suffice to state a claim. *See* Defs' Mem. at 22-23.

Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048-49 (Del. 2004) (hereinafter "*Beam II*").

Plaintiff does not challenge any specific action or decision by the Red Hat board, but alleges that the Directors failed to monitor the Company's financial statements over a period of several years. Compl. ¶¶ 41, 47, 60-78, 80-97, 101-02, 114-19; *see also In re Baxter Int'l, Inc. Shareholders Litig.*, 654 A.2d 1268, 1269 (Del. Ch. 1995) (applying *Rales* where directors allegedly failed to supervise corporation). While Plaintiff asserts that the board "actively approved false SEC filings," (Opp. at 8), he does not (and cannot) point to any *specific board decision* approving SEC filings or (more importantly) Red Hat's subscription accounting convention.[5] In any event, Plaintiff has not come close to pleading particularized facts showing that the board failed to exercise its business judgment. He offers only the same conclusory (and defective) rhetoric he recites throughout the Opposition: Red Hat's financial statements were false, so the board *must* not have exercised business judgment. *See* Opp. at 10 (relying exclusively on "submission of clearly inaccurate financial statements"); *Greenwald v. Batterson*, No. 16475, 1999 WL 596276, at *7 (Del. Ch. 1999) (conclusory allegations board failed to exercise business judgment insufficient to excuse demand).

2. Plaintiff Misstates the Law of Insider Trading. Plaintiff does not even attempt to identify specific inside information Messrs. Szulik or Kaiser possessed when they made any sale, or to suggest anything "suspicious" about the circumstances of their sales. Instead, he asserts without citing any authority that "Defendants' heightened pleading standard ... is inapplicable" (*see* Opp. at 13 n.9). Then, purporting to rely on

[5] Given that business judgment is not even mentioned in the Complaint's demand futility allegations, the contention that Defendants have "implicitly acquiesced that Plaintiff has satisfied the second prong of the *Aronson* analysis" (Opp. at 10-11) is fallacious.

Guttman v. Huang, 823 A.2d 492, 505 (Del. Ch. 2003), he claims that merely *identifying* dates and amounts of sales is enough to establish "interest" (*see* Opp. at 13, 15).

However, it is well established that stock sales create a disabling "interest" only if wrongful intent can be inferred either from (1) *specific* allegations that trading defendants possessed material, non-public information, *Guttman*, 823 A.2d at 505 (citation omitted);[6] *see also McCall v. Scott*, 239 F.3d 808, 824-25 (6th Cir.), *amended on other grounds by* 250 F.3d 997 (6th Cir. 2001); *Stepak v. Ross*, Civ. A. No. 7047, 1985 WL 21137, at *5 (Del. Ch. Sept. 5, 1985), or (2) circumstances demonstrating that trades were "suspicious" in timing and amount. *McCall*, 239 F.3d at 825 (following federal "suspiciousness" standard); *Amalgamated Bank v. Yost*, No. Civ.A. 04-0972, 2005 WL 226117, at *13 (E.D. Pa. Jan. 31, 2005) (same).

Plaintiff's reliance on *Guttman* for the proposition that identifying sales by date and amount is enough is wrong. There, though plaintiffs *did* identify the sales at issue, 823 A.2d at 494-95, the court held that plaintiffs failed to identify with the requisite particularity what material, non-public information defendants possessed. *Id.* at 503, *cited in* Opp. at 12 (demand not excused absent allegations as to "precise roles [sellers] 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"). This Complaint is defective for precisely these reasons. Plaintiff does nothing beyond recite Messrs. Szulik's and Kaiser's job titles and make boilerplate allegations about their access to unspecified internal documents, "conversations" and "connections," and attendance at unspecified "meetings," without any description of their

[6] In *Guttman*, the court decisively rejected the notion that trading stock automatically creates an "interest" in a challenged transaction as an "attempt to extend concepts designed to fit classic self-dealing transactions into another context that is quite different." 823 A.2d at 502.

contents or substance. In any event, it is unrebutted that Messrs. Szulik and Kaiser *did not* trade on the basis of inside information because all their sales occurred long before PwC told Red Hat an error had been made. Defs' Mem. at 14-16.

3. Mr. Szulik Does Not Lack Independence from Compensation Committee Members. Abandoning the allegation that five Directors lack independence from Compensation Committee members, Plaintiff presses that contention only with respect to Mr. Szulik. According to Plaintiff, the Compensation Committee controls Mr. Szulik's "livelihood, lifestyle, and standard of living." Opp. at 15.

But the Complaint contains no allegations concerning Mr. Szulik's "lifestyle" or "standard of living" or his ability to obtain employment elsewhere, and there is no basis to infer he is so beholden to committee members that he would rather "risk his reputation" than authorize suit against them. *Beam II*, 845 A.2d at 1046, 1052. Without more, an allegation that a director's compensation is controlled by other directors does not establish lack of independence. *See, e.g., Beam ex. rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 976-77 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004); *Taddy v. Singh*, No. 1:04cv1051, slip op. at 17 (E.D. Va. Dec. 8, 2004), attached as Ex. K to Defs' Mem.; *In re Sagent Tech., Inc. Derivative Litig.*, 278 F. Supp. 2d 1079, 1089 (N.D.Cal. 2003). Moreover, only lack of independence from an *interested* director is disqualifying, *Beam II*, 845 A.2d at 1050, and Compensation Committee members are not interested, *see* Section 5, *infra* and Defs' Mem. at 18-19.

4. Audit Committee Members Are Not Interested. Delaware law mandates that to excuse demand, claims based on directors not doing their jobs must be supported by particularized facts showing that those directors consciously or recklessly ignored "red

flags" or "specific obvious danger signs" alerting them to improprieties or material inadequacies in internal controls. *Guttman*, 823 A.2d at 506; *In re Citigroup Inc. Shareholders Litig.*, No. 19827, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003); *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 969-70 (Del. Ch. 1996); *In re Baxter*, 654 A.2d at 1270-71 .[7] Plaintiff has not alleged a single such specific "red flag" or "danger sign"; to the contrary, the Complaint does not specify the content or substance of a single "internal document," "conversation" or "meeting" allegedly conveying to the Audit Committee any information suggesting there was any problem with the Company's subscription accounting. Nor does Plaintiff explain how, in light of PwC's approval of Red Hat's prior accounting methodology, Audit Committee members nonetheless knew or should have known at the time financial statements were issued that it someday would be changed, resulting in a restatement.

Ignoring all this, the Opposition simply asserts conclusions that Audit Committee members *must* have breached their duties because Red Hat's financials were restated. *See, e.g.*, Opp. at 17 (Audit Committee "responsible" for restatement); *id.* at 17, 18 (committee members "utterly failed to fulfill their duties and obligations"). These naked conclusions cannot excuse demand. *See Guttman*, 823 A.2d at 506-07 (absent specific allegations that "the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them," plaintiffs "have not even come close to pleading a *Caremark* claim").

Plaintiff also argues that because of their financial backgrounds, it is "inconceivable" that Messrs. Albrecht and McDonald would not have discovered the

[7] Plaintiff's recitation of the duties of the Audit Committee, Opp. at 16 n.11, misses the point. Conspicuously absent are specific factual allegations showing committee members *breached* those duties. *See Guttman*, 823 A.2d at 506-07.

inaccuracies in the financial statements. Opp. at 19-20. But allegations that a defendant "must have known" something are insufficient to establish a strong inference that he did know it. *See, e.g., Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992), *modified on other grounds* by 15 U.S.C. § 78u-4; *Fink v. Komansky*, No. 03CV0388, 2004 WL 2813166, at *4 (S.D.N.Y. Dec. 8, 2004). More importantly, the accounting standards that specify subscription revenue should be recognized "ratably" do not define the meaning of that term. *See* Defs' Mem. at 2. Interpreting those standards, PwC approved Red Hat's prior practice of recognizing subscription revenue ratably by month. *See* Compl. ¶ 104. Clearly, it was reasonable for even sophisticated directors to rely on PwC's approval of Red Hat's methodology, *see Prince v. Bensinger*, 244 A.2d 89, 94 (Del. Ch. 1968), and there is no basis to infer Messrs. Albrecht and McDonald knew or should have known Red Hat's financial statements were inaccurate.

5. Compensation Committee Members Are Not Interested. Essentially conceding he pleaded no particulars showing Compensation Committee members knowingly or recklessly approved compensation based on inflated revenues, Plaintiff now contends they breached duties under § 304 of the Sarbanes-Oxley Act to recover that compensation *after* the restatement was issued. S*ee* Opp. at 20-21 & n.15. But § 304 imposes duties only on a company's CEO and CFO, *not* compensation committee members, and in any event applies only where a restatement is due to "material noncompliance ... with any financial reporting requirement" *and* is the "result of misconduct" -- which Plaintiff clearly has failed to plead with the requisite particularity.

6. The Entire Board Is Not Interested by Virtue of "Failure to Monitor". Plaintiff contends that the entire board faces a substantial likelihood of liability for

"failure to monitor." Opp. at 21-22. He cites *Caremark* for the proposition that liability *can* arise from a failure to exercise oversight, but then ignores its holding that to excuse demand, derivative plaintiffs must offer specific allegations of "red flags" alerting directors that something was amiss. *In re Caremark*, 698 A.2d at 969-70; *see also In re Baxter*, 654 A.2d at 1270-71. Instead of pointing to a single specific document, conversation, meeting, or other fact constituting such a "red flag" or "danger sign," Plaintiff again relies entirely on conclusions and rhetoric. *See* Opp. at 22 (defendants "failed to maintain adequate controls, practices and procedures"); *id.* at 23 (defendants "failed to supervise the issuance of the Company's press releases and public filings"). Again, this fails as a matter of law. *See Guttman*, 823 A.2d at 507 (demand not excused because "there are not well-pleaded factual allegations – as opposed to wholly conclusory statements – that the ... directors committed any culpable failure of oversight under the *Caremark* standard").[8]

7. The "Totality of the Circumstances" Does Not Save the Complaint.

Finally, Plaintiff desperately suggests that even if his allegations are separately deficient, taken together they excuse demand. While the general proposition that courts must evaluate the "totality" of the circumstances is true, no court has held that a series of utterly conclusory and/or legally irrelevant grounds for not making demand, through some magical additive process, can sustain a derivative complaint.

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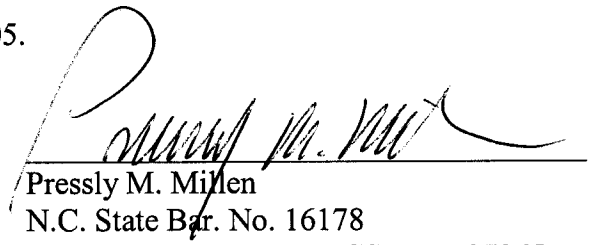
[8] Word limits keep Defendants from distinguishing each of the numerous cases cited by Plaintiff. By way of illustration, the two cases on which Plaintiff appears to place the most reliance, *Oxford* and *Cendant,* fail to support any of his claims. In *Oxford*, the court purposely did not describe the allegations in the complaint in detail but referred the reader to the pleadings in a related MDL proceeding, so there is no context in which to evaluate the court's holding that the allegations were sufficient. *In re Oxford Health Plans, Inc. Sec. Litig.*, 192 F.R.D. 111, 114 (S.D.N.Y. 2000).

In *Cendant*, plaintiff specifically alleged the "existence of numerous red-flags regarding ... accounting machinations," and also alleged "interest" based on receipt of special compensation packages and the grant of fees in connection with a specific challenged transaction. *In re Cendant Corp. Deriv. Action Litig.*, 189 F.R.D. 117, 125, 128 (D.N.J. 1999).

Conclusion

For the reasons set out above and in Defendants' Opening Brief, this case should be dismissed with prejudice.

This the 15th day of November, 2005.



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