Supreme Court No. 81817-7

United States District Court
Western District of Washington No. C06-0794 RSL

SUPREME COURT
OF THE STATE OF WASHINGTON

Glenn Hutton, et al., Plaintiffs,

v.

John McAdam, et al., Defendants,

and

F5 Networks, Inc., Nominal Defendant.

REPLY BRIEF OF NOMINAL DEFENDANT
F5 NETWORKS, INC.

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I. SUMMARY

Plaintiffs urge this Court to do something extraordinary: to depart from over a century of Washington law requiring demand as a prerequisite to a shareholder derivative action and instead to adopt wholesale a complex, and much-criticized, "demand futility" exception developed entirely through the law of another state (Delaware). Plaintiffs' Brief On Certified Question ("Plaintiffs' Brief" or "PB") is well-written and has visceral appeal. But the superficial charm of Plaintiffs' arguments derives, in large part, from the fact that Plaintiffs oversimplify issues that warrant more rigorous and nuanced analysis. More importantly, Plaintiffs' Brief is grounded in three key premises, all of which are demonstrably false.

The first fallacy underlying Plaintiffs' arguments is that a universal demand standard "eviscerates" the shareholder derivative mechanism (which, Plaintiffs correctly note, serves the public interest). In fact, exactly the opposite is true. The overwhelming modern trend away from "demand futility" reflects the fact that a strict demand requirement actually *strengthens* the derivative process, by making it less complicated, less costly, and less susceptible to abuse. Universal demand more effectively promotes the public good by properly balancing the interests of shareholders, corporations, and corporate management.

The second fallacy underlying Plaintiffs' arguments is that "adoption" of a universal demand standard would constitute a "seismic shift" in Washington law. To the contrary, this Court' s recognition of a universal demand requirement — with extremely limited exceptions for when demand is not "futile" but impossible — merely affirms the status quo in Washington. Our state has never applied *any* form of "futility" exception to the demand requirement, let alone a standard remotely resembling Delaware's convoluted "demand futility" doctrine. Nor does Washington's purely procedural demand statute contain, in either its plain language or its legislative history, *any* notion of a "demand futility" exception. Despite Plaintiffs' stern warnings to the Court about "judicial restraint," affirming universal demand requires no judicial activism whatsoever.

The third fallacy underlying Plaintiffs' arguments is that Delaware's "demand futility" doctrine, embodied in *Aronson v. Lewis* and its progeny, is "widely embraced." In fact, only five states follow the *Aronson* approach, compared to ***44*** states that do ***not*** apply Delaware's flawed "futility" standards. Plaintiffs invite this Court to join the tiny minority of states that engage in Delaware's costly "demand futility" process, which requires a trial court to undertake a complicated preliminary analysis to assess a corporate board of directors' competency to govern corporate affairs. It would require an unprecedented level of "judicial activism" for the Court to swallow whole a body of law, created entirely by another state, that is unheralded in Washington's common law or statutes.

Finally, Plaintiffs hope to divert the Court's attention from the relevant issues by making this proceeding a referendum on options "backdating." But Plaintiffs' arguments strategically ignore how stock options are granted in the real world. The lack of SEC and Justice Department enforcement activity related to options "backdating" reflects the fact that the vast majority of erroneous grant dates result from innocent mistake, not fraud. There is no options fraud rampant in most corporate boardrooms (including F5's), and the Court should not permit misplaced concern about corporate scandal to make bad law.

II. AUTHORITY AND ANALYSIS

A. Universal Demand Preserves And Strengthens Derivative Proceedings.

The most pervasive and misleading fallacy in Plaintiffs' Brief is the notion that, by urging the Court to affirm some form of universal demand, F5 seeks to "gut the shareholder derivative action in this state." PB at 10. In fact, modern analysis of derivative proceedings — embodied in the clear national trend *away from* "demand futility" — recognizes that universal demand significantly improves the derivative mechanism and more effectively promotes all relevant interests.[1]

There is no dispute that "derivative actions serve an important public interest function." PB at 1. And Plaintiffs are, of course, correct that Washington "has no documented hostility to shareholder protections." PB at 8. The derivative mechanism is just one of the panoply of tools shareholders may employ, in their role as "private Attorneys General," to help prevent and police corporate misconduct. PB at 13. But the issue here is *not* whether shareholder derivative proceedings are useful or important (they are); the issue is how such proceedings should be structured in order to most effectively and efficiently balance the interests of shareholders, corporations, and corporate management.

Derivative proceedings are fundamentally different than private shareholder lawsuits. A derivative proceeding circumvents the standard processes of corporate governance and allows a shareholder to usurp the

[1] "Universal demand," as used in this brief, is shorthand for any derivative procedure that requires demand in virtually all circumstances and, most importantly, that rejects any notion of "demand futility." As discussed in the Opening Brief Of Nominal Defendant F5 Networks, Inc. ("Opening Brief" or "OB"), F5 does *not* contend that demand may *never* be excused, only that the Court should not adopt a futility exception.

role of the duly elected board of directors to manage corporate affairs. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 101 (1991) ("[T]he demand requirement implements the basic principle of corporate governance that ***the decisions of a corporation–including the decision to initiate litigation–should be made by the board of directors or the majority of shareholders***"; internal quotation omitted; emphasis added). That is precisely why "[d]erivative suits are disfavored and may be brought only in exceptional circumstances." *Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wn.2d 107, 147, 744 P.2d 1032 (1987). Plaintiffs belittle this critical issue, accusing F5 of trying to "overplay" the importance of these bedrock corporate governance principles. PB at 21. But the point is pivotal: by design, derivative actions are intended to be rare proceedings, difficult to plead and difficult to sustain.

The challenge, therefore, in devising an effective derivative mechanism is to balance the interests of corporations, directors, and shareholders in the orderly and structured governance of corporate matters against the need, in only "exceptional circumstances," to upset that order. *See Schwarzmann v. Ass'n of Apartment Owners*, 33 Wn. App. 397, 402, 655 P.2d 1177 (1982) ("Courts are reluctant to interfere with the internal management of corporations and generally refuse to substitute their judgment for that of the directors"). In assessing universal demand, the Court must consider that the "public interest" in this context goes well beyond the desire of would-be derivative plaintiffs to have ready access to the courthouse. Against that backdrop, "both the case law and the academic commentary have been moving strongly in [the] direction" of "narrowing, if not eliminating, the exceptions from the demand requirement." *Boland v. Engle*, 113 F.3d 706, 712 (7^{th} Cir. 1997).

Contrary to Plaintiffs' assertion, a "universal demand" requirement ***strengthens*** the derivative process, for several compelling reasons. First, as discussed at length in F5's Opening Brief, universal demand makes derivative proceedings less susceptible to abuse as a vehicle for meritless strike suits. *See* OB at 22-24. That is so because a shareholder genuinely concerned with remedying a harm to the corporation should have no objection to making demand; if the demand does not result in redress, the shareholder may still challenge (on the corporation's behalf) the board's failure to act. *Id.* at 24. Plaintiffs do not deny that a primary benefit of universal demand is deterrence of strike suits.

Second, universal demand acts as a form of alternative dispute resolution by permitting corporate management to respond to a shareholder complaint before the courts intervene. *See* OB at 25-27. Plaintiffs completely ignore this point, but the benefit is real. In states that permit a board of directors to appoint a special committee to act in the board's stead — as Washington does (*see* RCW 23B.08.250) — even an allegedly "interested" board can respond in a neutral way to shareholder concerns. *Id.* Universal demand is true to Washington's longstanding rule that a derivative plaintiff "must make an earnest not a simulated effort with the managing body of the corporation to induce remedial action on their part, and this must be made apparent to the court." *Elliott v. Puget Sound Wood Prod. Co.*, 52 Wash. 637, 643, 101 P. 228 (1909). Moreover, this approach promotes judicial efficiency by potentially narrowing the issues subject to a derivative action or by obviating a lawsuit altogether.

Third, universal demand eliminates a lengthy and costly initial phase of derivative litigation that does nothing to advance the merits of the dispute. Modern commentators (led by the ABA and ALI) have uniformly recognized this as one significant advantage of rejecting "demand futility." *See* OB at 27-29. Plaintiffs' response is to selectively quote *Kamen* to suggest that universal demand will "merely shift the focus of threshold litigation from the question whether demand is excused to the question whether the directors' decision to terminate the suit is entitled to deference." PB at 27 (quoting *Kamen*, 500 U.S. at 106). ***But Kamen was not analyzing universal demand***; the Supreme Court was responding to a proposal that it "develop a body of principles that would replicate the substantive effect of the State's demand futility doctrine but that would be applied *after* demand has been made and refused," *i.e.*, a federal law overlay on state law demand standards. 500 U.S. at 104. The Court's point in the above quote (which Plaintiffs misleadingly truncate without ellipses) was that a separate federal demand standard (which the Court declined to adopt) would simply add another layer of analysis to the derivative process. *Id.* at 106.[2] Plaintiffs are forced to misquote *Kamen* because there is no legitimate dispute, among courts or commentators, that universal demand streamlines derivative proceedings.

[2] Plaintiffs' mischaracterization of *Kamen* does not end there. Rejiggering another *Kamen* quote to mask its context, Plaintiffs claim the Supreme Court "observed" that universal demand "tilts the playing field too heavily in the board's favor." PB at 26. Not true. The Court merely noted that, in Delaware and the very few states that "follow its lead," imposing a federal universal demand requirement would conflict with the "demand futility" standards those few particular states have chosen to adopt. 500 U.S. at 103. The *Kamen* Court expressly disavowed *any* judgment on the value of universal demand "as a matter of legal reform" (*id.* at 104), and the Supreme Court has *never* contradicted the modern national consensus that universal demand is the superior approach.

Importantly, all of the advantages of universal demand discussed above benefit shareholders because those advantages save corporate expense. Plaintiffs claim to be pursuing this action to recover "money that should have gone into F5's corporate coffers." PB at 5. If that aim is genuine, Plaintiffs should not oppose procedures that reduce the costs of derivative litigation, because the corporation bears those costs.

Indeed, Plaintiffs' own arguments reveal the core defects in their position. Plaintiffs lament that "it is not easy to prosecute [derivative] actions successfully after passing arguments over presuit demand." PB at 27. ***But it is not supposed to be easy to sue derivatively.*** To the contrary, as discussed above, derivative actions are intended to be exceedingly rare events. Plaintiffs complain further:

> A shareholder bold enough to take on the board, with even highly meritorious claims, must navigate multiple statutory requirements. In Washington, these include shareholder standing limitations, verified complaints, judicial power to stay the case while the corporation investigates the derivative claim, court approval of settlements or dismissals, notice to shareholders if the resolution will substantially affect their rights, and even payment of defense expenses within the court's discretion for abusive derivative litigation (thereby deterring "strike suits").

PB at 27. Each one of those "strictures" (as Plaintiffs characterize them) is a critical safeguard designed to preserve traditional corporate governance principles, and to properly balance the interests of corporations and shareholders. In other words, what Plaintiffs predictably view as improper hurdles to a derivative suit are, in fact, key elements of how derivative proceedings are *intended* to operate.

Shareholder demand has been a requirement in Washington for over a century, *Elliott*, 52 Wash. at 641-43, and is the rule in every state in the nation. *Kamen*, 500 U.S. at 102 n.7. But Plaintiffs' position would make "futility" the rule and demand the exception. As Justice Jacobs of the Delaware Supreme Court noted, in "demand futility" states demand is effectively *never* made because "doing so invites the board of directors to take the lawsuit out of counsel's hands," and "eliminate[s] the opportunity for plaintiffs' counsel to receive a court-awarded fee, which motivates most derivative lawsuits." Justice Jack B. Jacobs, *The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay*, 41 Suffolk U. L. Rev. 1, 3 (2007). Thus, while Plaintiffs falsely paint the "demand futility" exception as an integral component of the derivative mechanism, in practice, introduction of futility reverses (and eliminates) the fundamental presumption that demand must be made.

Plaintiffs' contention that universal demand "gut[s] the derivative action as a tool for holding corporate wrongdoers accountable" (PB at 27) is worse than hyperbole. Plaintiffs would have this Court believe that the many states that reject "demand futility" — joined by the ABA, the ALI, and virtually every modern academic and commentator — are all part of a national movement to weaken derivative proceedings and undermine shareholder protections. In fact, the analysis and commentary supporting the established and expanding trend toward universal demand makes clear that the goal is to ***improve*** the derivative mechanism. *See* OB at 20-29. In summary, under a universal demand requirement, derivative actions can and will go forward, but in a manner that minimizes the burden and expense on corporations (and, indirectly, shareholders) while preserving the ability of shareholders to challenge improper corporate actions.

B. <u>The Court Should Affirm Washington's Universal Demand Requirement.</u>

Plaintiffs argue that this Court is powerless to act in response to Judge Lasnik's certified questions because "a seismic shift to universal demand is for the Legislature." PB at 21. But the Court *must* act. Whether Washington recognizes a "demand futility" exception has profound implications for all putative derivative litigation in this state.[3] As Judge Lasnik found, there is currently ***no*** Washington authority addressing "demand futility." Show Cause Order [App. 2] at 4. It is this Court's fundamental role to declare what the law is, for the guidance of lower courts, litigants, and (in this case) the U.S. District Court. *See City of Redmond v. Cent. Puget Sound Growth Mgmt. Hearings Bd.*, 136 Wn.2d 38, 46, 959 P.2d 1091 (1998) ("Concerning conclusions of state law this court is the final arbiter ...").[4] *Only* this Court can answer whether, *under existing Washington law*, demand is always required (unless it would be effectively impossible) or, alternatively, demand is excused when it would be "futile." It is beyond genuine debate that the most straightforward course, and the approach most consistent with "judicial restraint," is for the Court to affirm Washington's existing universal demand requirement and decline to adopt, for the first time in this state, Delaware's complicated "demand futility" doctrine.

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[3] Judge Darvas of the King County Superior Court recently stayed a derivative action against nominal defendant Costco Wholesale Corporation (Case No. 08-2-23783-4 SEA) pending this Court's dispositive rulings on "demand futility" in this proceeding. *See* Supplemental Appendix ("Supp. App.") No. 1 at 2-3.

[4] The Legislature could certainly choose to act in the future and codify a "demand futility" rule or other exceptions to the demand requirement (though, as discussed below, the Legislature has never previously seen fit to do so). But this Court's essential function is indisputably to declare the current state of the law. Leaving the lower courts, litigants, and Washington federal courts rudderless on these critical issues is not a viable option.

Put simply, this Court's task is to declare whether Washington is a universal demand state or a "demand futility" state. In this context, universal demand refers to any derivative standard that strictly requires demand and rejects the concept of demand being "futile." The Court may embrace universal demand (as the majority of states have done) without going quite as far as the ABA, which now advocates a standard requiring demand "in all cases." *See* 2 Model Bus. Corp. Act Annot. ("MBCAA") § 7.42, official cmt., 7-317 (4th ed. 2007). As discussed further below, F5 urges the Court to affirm Washington's *existing* universal demand standard, which requires demand unless it would be useless (*i.e.*, objectively impossible to effectuate).[5]

On the other side of the coin, in this context, "demand futility" is not merely a turn of phrase but is a term of art. "Demand futility" invokes a complicated process, developed through decades of Delaware common law, that requires a trial court to undertake a convoluted threshold analysis — quasi-legal/quasi-factual, and performed without the benefit of any discovery or development of the record — regarding whether a corporate board of directors is sufficiently "independent" and "disinterested" to properly respond to a shareholder demand. Plaintiffs require two full pages of their brief, and seven different case citations, just to *summarize* the basic "demand futility" standards. *See* PB at 32-33. And each element of those standards (*e.g.*, a plaintiff must show a "reasonable belief," and more than "mere suspicions," of a director's

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[5] As discussed in F5's Opening Brief, it would also be reasonable for the Court to recognize (as the ALI has done) that the demand requirement may be *temporarily* suspended in order to prevent "irreparable injury." *See* OB at 30-31.

"interestedness") is subject to an entire body of jurisprudence that Plaintiffs do not reference. Indeed, even the initial question of which of the two seminal Delaware "futility" cases — *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), or *Rales v. Blasband*, 634 A.2d 927 (Del. 1993) — applies under particular circumstances requires separate analysis (and is frequently subject to debate). In short, "demand futility" is much more than a concept: it is an extremely complex and shifting body of law.

1. **The Washington Courts Have Never Addressed Or Applied A "Demand Futility" Exception.**

In its Opening Brief, F5 undertook a comprehensive and detailed analysis of Washington's common law and demonstrated that our state has always strictly required demand as a prerequisite to a derivative action and has never recognized a "demand futility" exception. OB at 6-15. Plaintiffs made no similar effort. Instead, Plaintiffs summarily (and erroneously) conclude that Washington courts have historically "applied, in today's parlance, a demand futility standard." PB at 19. In support of that conclusion, as F5 predicted, Plaintiffs primarily rely on *Williams v. Erie Mountain Consolidated Mining Co.*, 47 Wash. 360, 91 P. 1091 (1907). But *Williams* did *not* adopt or apply any futility exception; the Court merely quoted, in dicta, a treatise acknowledging that some courts *do* recognize such an exception. *See* OB at 10-12. And any doubt regarding that fact was erased by the Court's decision, two years later, in *Elliott* (which Plaintiffs cite without discussion). *Id.* at 12-13.[6]

[6] In support of their contention that Washington has adopted a "demand futility" exception, Plaintiffs also cite, without discussion, *Kneeland Investment Co. v. Berendes*, 81 Wash. 372, 142 P. 869 (1914), and *Haberman*. But Plaintiffs conspicuously ignore F5's analysis of those cases. *See* OB at 13 n.8; 14 n.9. Neither case recognized "demand futility": *Kneeland* referred, in dicta and without citation, to "uselessness" but never discussed "futility," and *Haberman* did not even involve shareholder demand. *Id.*

Succumbing to the lack of authority for their position, Plaintiffs also cite *Burrows v. McCalley*, 17 Wash. 269, 49 P. 508 (1897), a case involving a mortgage foreclosure that had absolutely nothing to do with shareholder derivative actions or demand, let alone "demand futility." PB at 18.[7]

Notably, no Washington court has ever cited *Aronson* for any point (despite the opinion having been issued over 20 years ago). And only one Washington court has ever cited *Rales*, but in a non-derivative case involving a Delaware corporation, and for a point entirely irrelevant here. *See Rodriguez v. Loudeye Corp.*, 144 Wn. App. 709, 725 n.39, 189 P.3d 168 (2008). On this note, Washington joins the ***43*** other states that do ***not*** follow Delaware's "demand futility" standards. Indeed, the lack of any Washington law addressing "demand futility" is precisely why Judge Lasnik felt constrained to certify the question to this Court. Certification Order at 2; *see also* Show Cause Order at 6.

The *only* Washington case that has ever applied *any* exception to the demand requirement is *LaHue v. Keystone Investment Co.*, 6 Wn. App. 765, 496 P.2d 343 (1972), and *LaHue* recognized only that, under certain circumstances, demand may be objectively useless or impossible (*e.g.*, when the corporation has ceased to exist). *See* OB at 14.[8] Nothing

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[7] Invocation of the axiom that "the law does not require a useless act" does nothing to help Plaintiffs' cause. PB at 18. There is patently a difference between an act that is objectively useless and the complex, subjective notion of "demand futility."

[8] Modern commentary supporting universal demand also recognizes that, even where a shareholder demand might be deemed "futile" under Delaware's "demand futility" standards, that demand could still have practical utility. *See, e.g.*, 2 MBCAA § 7.42, official cmt., 7-317 ("[E]ven though no director may be 'qualified,' ... the demand will give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action"). In other words, demand may be "futile" but not useless. Contrary to Plaintiffs' assertion, those terms clearly are *not* "interchangeable" (PB at 18), and this is not a semantic debate; a "demand futility" standard, "in today's parlance," connotes the full substance of the Delaware doctrine.

in *LaHue* (or any other Washington case) even hints at a "demand futility" exception. The concept of impossibility is, however, compatible with universal demand. *See* OB at 30-31. It is also entirely consistent with Washington's procedural demand statute (as discussed in the following section).[9] In short, Washington's existing common law embodies a universal demand requirement, with *no* provision for futility.

2. <u>Washington's Procedural Statute Does Not And Cannot Establish A "Demand Futility" Exception.</u>

Plaintiffs effectively concede (through anemic analysis) that the Washington courts have never recognized or applied a futility exception. In light of that fact, Plaintiffs' vanguard argument is that Washington's derivative statute, RCW 23B.07.400, purportedly codifies a "demand futility" standard. That argument fails on every level of analysis.

As an initial matter, and perhaps most importantly, Plaintiffs do not dispute that RCW 23B.07.400(2) — the provision requiring a would-be derivative plaintiff to "allege with particularity the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored or why a demand was not made" — is purely

[9] Plaintiffs erroneously claim that universal demand "is unquestionably a legislative phenomenon, not a judicial one." PB at 2. It is true that a number of state legislatures have chosen to adopt the 1990 version of the Model Business Corporation Act ("MBCA"), which codifies the most draconian iteration of universal demand, requiring demand "in all cases." But (unlike Washington) many of those states recognized some form of demand futility as a matter of common law; consequently, it was more likely the legislature would abolish the futility standard in those states than the courts overruling their own precedents. *See, e.g.*, *McCann v. McCann*, 61 P.3d 585, 593 (Idaho 2002) (recognizing legislature's abrogation of common law futility exception). Other states had statutes establishing a demand futility exception, meaning that *only* the legislature could make the shift to universal demand in those states. *See, e.g.*, *Webber v. Webber Oil Co.*, 495 A.2d 1215, 1222-23 (Me. 1985) (interpreting Me. Rev. Stat. Ann. 13A § 627). Finally, and most importantly, the fact that a state's legislature acted first to affirm a universal demand standard does *not* mean the courts lacked the power to do so.

procedural. The Western District of Washington has repeatedly noted that RCW 23B.07.400(2) does not create *any* substantive derivative standards. *See* Show Cause Order at 4; *In re Cray, Inc.* 431 F. Supp. 2d 1114, 1119 (W.D. Wash. 2006). That fact alone (which, again, Plaintiffs do not contest) makes RCW 23B.07.400(2) utterly irrelevant to this certification proceeding.[10] *Only* this Court can declare whether Washington currently recognizes a substantive "demand futility" standard.

Even if there were some dispute that RCW 23B.07.400(2) is purely procedural, the language of the statute plainly imposes nothing more than a pleading requirement. The first part of RCW 23B.07.400 establishes a substantive prerequisite to a derivative action, stating affirmatively that "[a] person may not commence a proceeding in the right of a domestic or foreign corporation unless the person was a shareholder of the corporation when the transaction complained of occurred." RCW 23B.07.400(1). In contrast, RCW 23B.07.400(2) provides only that a derivative <u>complaint</u> must contain certain information — *i.e.*, that demand was made and refused, or why demand was not made — but contains *no* language regarding the impact, if any, that demand or the failure to make demand might have on a shareholder's right to sue derivatively. The language of § .400(2) is materially the same as FED. R. CIV. P. ("FRCP") 23.1 and Washington Civil Rule 23.1 (modeled on FRCP 23.1), which require that a derivative complaint allege with particularity the demand made on the corporation or the reasons for the failure to make demand. The Supreme

[10] "A statute abrogates the common law if the provisions of the statute are so inconsistent with and repugnant to the common law that both cannot simultaneously be in force." *Ballard Square Condo. Owners Ass'n v. Dynasty Constr. Co.*, 158 Wn.2d 603, 621, 146 P.3d 914 (2006) (Johnson, J., concurring). There is no inconsistency at all between Washington's procedural statute and common law universal demand requirement.

Court has held that, while such language "clearly *contemplates* both the demand requirement and the possibility that demand may be excused, it does not *create* a demand requirement of any particular dimension." *Kamen*, 500 U.S. at 96. As with RCW 23B.07.400(2), "Rule 23.1 speaks only to the adequacy of the shareholder representative's pleadings." *Id.*[11]

Plaintiffs' contention that "RCW 23B.07.400(2) provides for a demand futility standard" (PB at 14) can only charitably be described as disingenuous. As the *Kamen* Court noted, requiring a would-be derivative plaintiff to plead why demand was not made *contemplates* that demand *might* be excused, but RCW 23B.07.400(2) provides literally no guidance to Washington courts or litigants on the facts or circumstances (if any) that excuse demand. Under Washington's common law, we know (per *LaHue*) that demand may be excused when it would be objectively impossible; we also know that no futility exception exists in this state. Had the Legislature intended, as Plaintiffs claim, to codify a demand exception of a "particular dimension," it would have been quite simple to provide, in RCW 23B.07.400(2), that "a person may not commence a proceeding in the right of a domestic or foreign corporation unless the person first makes demand on the directors for the relief sought, but demand is excused if it would be futile."[12] Instead, the Legislature merely identified what a

[11] Plaintiffs claim that "[n]o state following universal demand has a statute written like RCW 23B.07.400(2)," implying that Washington's statute is incompatible with a universal demand requirement. PB at 23. What Plaintiffs omit is that many universal demand states also have a civil rule akin to FRCP 23.1, which has precisely the same practical effect as RCW 23B.07.400(2). Arizona, Hawaii, Idaho, Massachusetts, Montana, Pennsylvania, Rhode Island, Utah, and Wyoming all have such a civil rule.

[12] The "demand futility" doctrine was well-known in 1989, when RCW 23B.07.400(2) was enacted. Indeed, *Aronson*, the flagship case for the current articulation of Delaware's doctrine, was decided in 1984. *See also Koster v. (Am.) Lumbermens Mut. Cas. Co.*, 330 U.S. 518, 522 (1947) (acknowledging demand futility concept).

derivative shareholder must *plead*, and left it to this Court to determine and declare the substantive consequences of failing to make demand.

Plaintiffs attempt to draw the Court into an analysis of the legislative history of RCW 23B.07.400 (*see* PB at 15-18), but that approach "puts the proverbial cart before the horse." *Tesoro Ref. & Mktg. Co. v. State Dep't of Revenue*, 164 Wn.2d 310, 318 n.3, 190 P.3d 28 (2008). As the Court has very recently observed, "[o]nly after we determine the statute is ambiguous may we resort to tools of statutory construction like legislative history." *Id.* It is error to look to legislative history (or any other external source) to create an ambiguity in an otherwise unambiguous statute. *Id.*; *accord State Dep't of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 11-12, 43 P.3d 4 (2002).[13] RCW 23B.07.400(2) is not the least bit unclear: it states plainly what a derivative complaint must plead. The dispute here centers not on the meaning of the statutory language, but on the substantive consequences that flow from those unambiguous procedural requirements.

If the Court were nevertheless inclined to review legislative history, that review would compel affirmation of Washington's existing universal demand standard and rejection of any futility exception. The Legislature's commentary to RCW 23B.07.400 confirms Washington's century-old rule

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[13] Plaintiffs contend that, because the Washington Legislature has not adopted the 1990 amendments to the MBCA, the Legislature has somehow "rejected" universal demand. PB at 22. Because RCW 23B.07.400(2) is not ambiguous, it is error to consider the Legislature's actions outside the four corners of the WBCA. *Campbell*, 146 Wn.2d at 11. Even so, it is undisputed that the Legislature considered and adopted the 1984 version of the MBCA, *not* the 1990 version. Had the Legislature ever considered the 1990 version of the MBCA, at most it could be said that the Legislature rejected the ABA's extreme version of universal demand, which requires demand "in all cases" and recognizes no exceptions whatsoever (even where demand is impossible). But, as discussed, that is *not* Washington's universal demand standard, nor is F5 suggesting that it should be.

that a derivative plaintiff must make demand "in most circumstances." OFFICIAL LEGISLATIVE HISTORY, Senate Journal 51st Leg., App. A, 3030, 3031 (1989). But the Legislature's commentary also notes that there may be instances when demand would be "useless." *Id.* That is consistent with Washington's notion, adopted in *LaHue*, that in rare circumstances demand may be impossible to effectuate.[14] But there is not a single mention of "demand futility" in the legislative history (though the doctrine was well-developed at the time), nor any inkling that Washington intended to follow Delaware's lead.

Plaintiffs instruct the Court to exercise "judicial restraint." PB at 26. In that spirit, F5 asks the Court to merely affirm existing Washington law, which requires demand in every case, unless demand is objectively impossible (as when the corporation has dissolved). But Plaintiffs urge the Court to do something there is no indication it has *ever* done: "enact" an entire body of law developed through decades of jurisprudence from another state. There is no justification (legal, policy-based, or otherwise) for the Court to engage in such an unprecedented level of judicial activism. Moreover, even if the Court were to recognize some concept of futility beyond current Washington law, there is no reason whatsoever for Washington to become only the sixth state in the nation that follows Delaware's sprawling and confusing "demand futility" doctrine.

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[14] Other sections of the WBCA confirm this conclusion. *Campbell*, 146 Wn.2d at 11 (statutory "meaning is discerned from all that the Legislature has said in the statute and related statutes"). In 1989, when RCW 23B.07.400(2) was adopted, the Legislature also enacted RCW 23B.14.340, which preserves claims against dissolved corporations and their directors and officers. If a shareholder sought to assert derivative claims against the directors of a dissolved corporation, obviously there would be no board upon which to make demand. That would be a circumstance where RCW 23B.07.400(2) would require a shareholder to explain to the court why demand was not made, and where demand would logically be excused as useless under Washington's existing common law.

C. The Court Should Decline To Adopt Delaware's Deficient "Demand Futility" Doctrine.

Plaintiffs urge this Court to leap a wide chasm, from a strict demand requirement in Washington (that has never allowed a futility exception) to the wholesale adoption of Delaware's approach to "demand futility." Plaintiffs' support for that unusual request is twofold. First, Plaintiffs argue that Delaware's corporate law is "influential." Even if that were generally true, it is beyond dispute that Washington is *not* a state in lockstep with Delaware. Second, Plaintiffs claim that Delaware's "demand futility" doctrine is "widely followed." PB at 3. That assertion is flatly wrong: only a tiny minority of states (five) choose to follow Delaware's complicated "demand futility" process.

1. Whether Delaware Law Is Generally "Influential" Is Irrelevant To The Court's Inquiry.

Plaintiffs argue that "Delaware is recognized as a pacesetter in the area of corporate law." PB at 29. While certain states unquestionably look to Delaware for guidance, F5 explained in detail (and Plaintiffs ignore) that Washington does *not* generally follow Delaware's lead. *See* OB at 32-35. Indeed, Plaintiffs' own example of Delaware's "influence" vividly proves F5's point. Plaintiffs note that New Mexico recently adopted Delaware law on an issue related to the scope of dissenters' rights. PB at 29 (citing *McMinn v. MBF Operating Acquisition Corp.*, 164 P.3d 41, 53 (N.M. 2007)). But less than six months ago, Washington ***rejected*** Delaware law (and *McMinn*) on ***precisely*** the same legal issue. *See Sound Infiniti, Inc. v. Snyder*, 145 Wn. App. 333, 347-49, 186 P.3d 1107 (2008); OB at 33-34. Countering Plaintiffs' assertion that "Delaware corporation law is national corporation law" (PB at 29), Delaware law is clearly *not* Washington law.

More to the point, the crux of Plaintiffs' arguments regarding Delaware's purported "preeminence" on corporate issues is that Delaware has traditionally been a place where businesses choose to incorporate. PB at 30-31. (Plaintiffs also note, however, that Delaware may be a less "friendly home" for corporations than it once was. *Id.*) But the potential benefits and disadvantages of incorporating (or litigating) in Delaware are completely irrelevant here. Many corporations, like F5, choose *not* to incorporate in Delaware, and the issue before the Court is what derivative proceeding standards apply to corporations that opt for Washington.[15]

2. <u>Delaware's "Demand Futility" Doctrine Has Not Been "Widely Followed".</u>

Whether or not Delaware corporate law is generally influential, one fact is undeniable: Delaware's "demand futility" doctrine does ***not*** "set the pace" nationally but has, instead, been largely rejected.

As an initial matter, Plaintiffs do not dispute that 23 states have expressly established universal demand and eliminated any futility exception. *See* OB at 22 n.14. Notably, most of those states adopted the 1990 MBCA, which includes the most extreme version of universal demand (recognizing no exceptions at all). Thus, nearly half the states have renounced Delaware's approach in the most definitive way.

Of the remaining 26 states (excluding Delaware), four — North Dakota, Vermont, Washington, and West Virginia — have never adopted

[15] Plaintiffs make much of the fact that F5 cited Delaware law on "demand futility" to the District Court. PB at 6-7, 29. ***F5 had no choice.*** When F5's dismissal motions were briefed, the law in the Western District of Washington was that Delaware's "demand futility" standards applied to Washington derivative actions. *See, e.g.*, *Cray*, 431 F. Supp. 2d at 1120. Only *after* that briefing was complete did Chief Judge Lasnik identify as sheer "speculation" the District Court's assumption that Washington would follow Delaware. Show Cause Order at 6. F5 merely cited the law of the Western District as it existed; but F5 *never* defended Delaware's doctrine as the right approach.

or applied any futility exception to the demand requirement. Thus, like Washington, those states are all *de facto* universal demand states.

Of the remaining 22 states, three — Maryland, New York, and Alaska — have established a futility exception but, in doing so, expressly rejected Delaware's formulation of "demand futility." In its Opening Brief, F5 discussed the key Maryland case, *Werbowsky v. Collomb*, 766 A.2d 123 (Md. 2001). *See* OB at 43-44. The Court declined to adopt Delaware's doctrine, noting that "few, if any, States have abandoned their existing law in favor of that approach." *Id.* at 143. Similarly, in *Marx v. Akers*, 88 N.Y.2d 189, 200-01 (1996), the Court condemned the "reasonable doubt" element of Delaware's standard and adopted a limited futility exception with a much higher pleading burden.[16] *See also Jerue v. Millett*, 66 P.3d 736, 746 (Alaska 2003) (retaining a futility exception but specifically refusing to adopt Delaware's "demand futility" doctrine).

Of the remaining 19 states, 14 have arguably adopted and applied some form of futility exception to the demand requirement, but have clearly *not* followed the Delaware approach.[17] A recent and seminal

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[16] *See* Ralph C. Ferrara, Kevin T. Abikoff & Laura Leedy Gansler, *Shareholder Derivative Litigation: Besieging the Board*, § 6.03[2], 6-15 (Law Journal Press, 2007) (recognizing New York's limited and more exacting futility standard). The *Marx* Court declined to adopt universal demand because New York had a well-established common law futility exception, and the New York legislature had thrice rejected universal demand (considerations that, as discussed, do not apply in Washington). *Marx*, 88 N.Y.2d at 197.

[17] *See James v. James*, 768 So. 2d 356, 360 (Ala. 2000); *Morgan v. Robertson*, 609 S.W.2d 662, 665 (Ark. Ct. App. 1980); *Neusteter v. Dist. Court*, 675 P.2d 1, 7 (Colo. 1984); *In re Guidant S'holders Deriv. Litig.*, 841 N.E.2d 571, 575 (Ind. 2006); *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1141-42 (Kan. 1978); *Allied Ready Mix Co., Inc. v. Allen*, 994 S.W.2d 4, 7-9 (Ky. Ct. App. 1998); *Robinson v. Snell's Limbs & Braces of New Orleans, Inc.*, 538 So. 2d 1045, 1046-47 (La. Ct. App. 1989); *compare Winter v. Farmers Educ. & Coop. Union of Am.*, 107 N.W.2d 226, 234 (Minn. 1961), *with Reimel v. MacFarlane*, 9 F. Supp. 2d 1062, 1065-67 (D. Minn. 1998) (concluding Minnesota's futility exception differs from Delaware's, and Minnesota would reject Delaware's

example is *In re Guidant* (discussed at length in F5's Opening Brief). *See* OB at 40-43. In *Guidant*, the Court considered universal demand, but felt obligated to retain a nominal vestige of futility. 841 N.E.2d at 574.[18] Importantly, in the course of its detailed discussion of futility, the Court never even *mentioned* Delaware's "demand futility" doctrine, let alone considered adopting Delaware's standards. Particularly noteworthy on this point are Kansas and Oklahoma; despite having rejected the MBCA and adopted Delaware's General Corporation Law, both states nevertheless (rather remarkably) decline to follow Delaware's "demand futility" standards. *See Newton*, 582 P.2d at 1141-42; *Hargrave*, 792 P.2d at 54-55. Thus, even states that directly pattern their corporate law on Delaware's depart from Delaware on the issue of "demand futility."[19]

A thorough nationwide analysis refutes Plaintiffs' assertion that Delaware's "demand futility" doctrine is "widely embraced." PB at 34. In actuality, only ***five*** states — California, Illinois, Nevada, New Jersey,

standards); *Saigh ex rel. Anheuser-Busch, Inc. v. Busch*, 396 S.W.2d 9, 17 (Mo. Ct. App. 1965); *White ex rel. Banes Co. Deriv. Action v. Banes Co.*, 866 P.2d 339, 344 (N.M. 1993); *Drage v. Procter & Gamble*, 694 N.E.2d 479, 486 (Ohio Ct. App. 1997); *Hargrave v. Can. Valley Elec. Coop., Inc.*, 792 P.2d 50, 54-55 (Okla. 1990); *Carolina First Corp. v. Whittle*, 539 S.E.2d 402, 410-13 (S.C. Ct. App. 2000); *Lewis ex rel. Citizens Sav. Bank & Trust Co. v. Boyd*, 838 S.W.2d 215, 221-22 (Tenn. Ct. App. 1992).

[18] The principal basis for the *Guidant* Court's rejection of universal demand was that a futility exception was deeply "implanted" in Indiana's common law. 841 N.E.2d at 574. That is the key way in which Indiana differs from Washington: our state has never recognized any form of "demand futility." Plaintiffs attempt to distinguish *Guidant* because Indiana has a statute specifically authorizing appointment of a special litigation committee to consider the wisdom of pursuing litigation. PB at 25. But Washington has a materially similar statute. *See* RCW 23B.08.250. The *Guidant* Court's point, equally applicable here, is that once a disinterested committee has been constituted to consider demand or litigation, "demand futility is no longer an issue." 841 N.E.2d at 575.

[19] Some of the states identified in Footnote 17 *supra* cite Delaware cases on other points of corporate law — for example, the importance of the demand requirement — but have never adopted Delaware's "demand futility" standards. *See, e.g.*, *Jerue*, 66 P.3d at 744; *Allied Ready Mix*, 994 S.W.2d at 7-9; *Carolina First Corp.*, 539 S.E.2d at 409-13.

and Oregon — follow Delaware's lead.[20] Plaintiffs misleadingly purport to identify these five states "by way of illustration" (PB at 35 n.6), but Plaintiffs' short list is exhaustive.[21] Plaintiffs ask the Court to declare Washington only the ***sixth*** state in the country to follow Delaware's "demand futility" standards, while the modern approach to derivative proceedings is undeniably trending in the opposite direction.

It is not surprising that only a tiny minority of states embrace Delaware's approach to "demand futility." As thoroughly addressed in F5's Opening Brief, Delaware's standards (as set forth in *Aronson*, *Rales*, and their progeny) have been extensively criticized as being excessively complicated, subjective, confusing, and vulnerable to widely inconsistent applications. *See* OB at 37. Plaintiffs respond that "F5's objections to *Aronson* lack merit" (PB at 35), but these are not *F5*'s objections. These are the criticisms of a multitude of influential authorities, including the ALI, the ABA, respected academics such as Columbia law professor John Coffee, and venerated jurists such as Judge Easterbrook (validated, at least tacitly, by the courts and legislatures of all but five states). OB at 35-39. The modern commentary on "demand futility" speaks for itself.

Tellingly, Plaintiffs cite virtually no authority *in defense of* the Delaware approach. Plaintiffs cite Delaware Justice Jacobs's essay for the

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[20] New Jersey, California, and Nevada have also stated that they look to Delaware generally for guidance. *See Casey v. Brennan*, 780 A.2d 553, 567 (N.J. Super. Ct. App. Div. 2001); *Oakland Raiders v. Nat'l Football League*, 93 Cal. App. 4th 572, 586 n.5 (2001); *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1346 (D. Nev. 1997). Washington, conversely, does *not* routinely hew to Delaware. *See* OB at 32-35.

[21] In fact, Plaintiffs' list of states following Delaware's "demand futility" approach is *over*-inclusive. Plaintiffs identify Arizona, but Arizona adopted the 1990 MBCA and is a universal demand state. *See* Ariz. Rev. Stat. Ann. § 10-742. The case Plaintiffs cite — *Blumenthal v. Teets*, 745 P.2d 181 (Ariz. Ct. App. 1987) — involved a Delaware corporation; other states must obviously apply Delaware law to Delaware corporations.

proposition that the *Aronson* test can potentially screen out "groundless" suits (PB at 38), but even Justice Jacobs generally faults Delaware's "demand futility" process as being too complicated, time-consuming, and expensive. OB at 39 n.35. Moreover, while Delaware's standards may be fine for Delaware, they translate quite poorly to other states. As Plaintiffs note, Delaware's Court of Chancery is "a specialty tribunal for business disputes." PB at 3. The Chancery Court has spent decades developing the "demand futility" doctrine and is uniquely suited to administer it.[22] Thus, "even if the judges of the Delaware Court of Chancery understand *Aronson* and interpret it consistently, federal district courts applying Delaware law in diversity cases demonstrably do not." Coffee, 48 Bus. Law. at 1412-13.[23] Additionally, the Chancery Court does not consider criminal or tort matters, which prevents backlogs and allows the Court to "hear cases and render decisions quickly" (mitigating the delay and cost of the "demand futility" process). Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation?*, 20 Del. J. Corp. L. 965, 975 (1995).

The risks of confusion and disparate application inherent in Delaware's "demand futility" standards are not illusory; if Washington adopts those standards, it inevitably inherits those risks.

22 Plaintiffs' attempt to minimize the risks inherent in Delaware's "reasonable doubt" element aptly proves the point. Plaintiffs refer to "reasonable doubt" as "such a familiar standard" (PB at 37), but "reasonable doubt" is exclusively a criminal law concept in every venue other than Delaware. Only Delaware's Chancery Court is "familiar" with "reasonable doubt" as a civil yardstick for director "interestedness."

23 Indeed, on this point, the Court need look no further than the Western District of Washington. In August 2006, applying Delaware's "demand futility" standards, Chief Judge Lasnik dismissed the "backdating" complaint against F5 by engaging in a "detailed, grant-specific analysis" and rejecting the *Maxim* approach. *See* Show Cause Order at 7. Less than six months later, also applying Delaware's "demand futility" standards, Judge Robart sustained a similar "backdating" complaint against Getty Images by adopting *Maxim*'s reasoning. *Edmonds v. Getty*, 524 F. Supp. 2d 1267, 1276 (W.D. Wash. 2007). Those opinions both apply Delaware law but reach irreconcilable results.

D. The "Backdating" Scandal Has Been Overblown.

Plaintiffs hope the Court will ignore the far-reaching implications of the certified questions at issue and instead pass judgment on options "backdating" generally and F5 specifically. But this proceeding is *not* about options "backdating" or whether F5's management behaved badly; this proceeding is about the efficient and balanced administration of shareholder derivative proceedings in Washington.

Taking Plaintiffs' Brief at face value, one would conclude that the average corporate boardroom is a den of thieves intent on manipulating options to enrich themselves at shareholders' expense. Plaintiffs contend that only derivative actions can curb these purported abuses, noting that hundreds of companies have been investigated for alleged "backdating," but the SEC "has brought only approximately 30 civil actions and there has been just one notable criminal conviction." PB at 12. Plaintiffs draw the self-serving conclusion that the SEC and U.S. Department of Justice have been derelict in their enforcement duties. In fact, the relative dearth of "backdating" enforcement reflects the SEC's recognition that:

> Backdating of options sounds bad, but the mere fact that options were backdated does not mean that the securities laws were violated. Purposefully backdated options that are properly accounted for and do not run afoul of the company's public disclosure are legal. Similarly, there is no securities law issue if backdating results from an administrative, paperwork delay.

Paul S. Atkins, SEC Commissioner, *Remarks Before the International Corporate Governance Network 11th Annual Conference* (July 6, 2006).[24]

[24] *See* Supp. App. No. 2. In addition to outlining the important corporate goals served by stock options, Commissioner Atkins advises "taking a step back before we plunge headlong into wholesale condemnation of all options practices. We need to distinguish scenarios that are black-and-white fraud ***from legitimate practices that are being attacked with attenuated theories of liability***." *Id.* at 4 (emphasis added).

In short, the original furor regarding options "backdating" has been dramatically overblown.[25]

Plaintiffs also expend considerable energy trying to poison the well by repeating their unfounded accusations against F5's management. It is ultimately a task for the District Court, not this Court, to decide whether a derivative action should proceed against F5. It is worth noting, however, that Judge Lasnik already concluded that Plaintiffs have ***not*** alleged any actionable "backdating" at F5.[26] Judge Lasnik found that Plaintiffs' odds-based allegations do not reflect "any type of statistical model"; in fact, the Court twice "admonished" Plaintiffs for deliberately skewing their options charts to make grant dates appear more favorable. Dismissal Order at 23, 15 n.8, 18 n.10. Moreover, Judge Lasnik ***rejected*** the *Maxim* approach.

In the *Maxim* opinion, all the risks of Delaware's "demand futility" standards, and all the inflated concern about "backdating" scandals, are manifest. A cursory review of *Maxim* makes clear that the Court proceeded from the assumption that backdating a stock option is inherently fraudulent, an assumption the SEC and most courts recognize as false. Applying Delaware's loose "reasonable doubt" standard, and relying on statistical "analysis" that is objectively meaningless (OB at 45-50), the *Maxim* Court found that "futility" had been pled. F5 set forth some of the myriad problems with that approach (*id.*), but the real danger lies in its practical application: if *Maxim* is the law, then "demand futility" (at least in the options "backdating" context) is essentially a foregone conclusion (which turns Washington's derivative process on its head).

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[25] *See also* Holman Jenkins, *The "Backdating" Witch Hunt*, Wall St. J., June 21, 2006, at A13; Holman Jenkins, *A Typical Miscreant – II*, Wall St. J., Jan. 3, 2007, at A12.

[26] *See* Order Granting Nominal Defendant F5 Networks, Inc.'s Motion To Dismiss For Failure To Make Demand (the "Dismissal Order") [Record No. 69; Supp. App. No. 3].

RESPECTFULLY SUBMITTED this 18th day of December, 2008.

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SUPPLEMENTAL APPENDIX TO REPLY BRIEF OF NOMINAL DEFENDANT F5 NETWORKS, INC.

Supreme Court No. 81817-7

SUPPLEMENTAL APPENDIX
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SUPERIOR COURT OF WASHINGTON FOR KING COUNTY

SANDRA DONNELLY, Derivatively on behalf of COSTCO WHOLESALE CORPORATION, Plaintiff, vs. JAMES D. SINEGAL, et al., Defendants. and COSTCO WHOLESALE CORPORATION, a Washington corporation, Nominal Defendant.	NO. 08-2-23783-4 SEA MEMORANDUM AND ORDER RE: NOMINAL DEFENDANT COSTCO WHOLESALE CORPORATION'S MOTION TO STAY PROCEEDINGS

THIS MATTER came on for hearing before the undersigned on the nominal defendant Costco Wholesale Corporation's ("Costco's") motion to stay proceedings in this action pending a decision by the Washington Supreme Court on a question certified in *In re F5 Networks, Inc. Derivative Litigation*, a case pending before the Federal District Court for the Western District of Washington. There, the Supreme Court accepted certification on the issue of whether and when Washington law excuses a shareholder seeking to initiate derivative litigation for alleged improper backdating of stock options from first making demand on the board of directors to bring such

Judge Andrea Darvas
King County Superior Court W941
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litigation on behalf of the corporation. This court considered: Costco's motion; the declaration of Stellman Keehnel in Support; Plaintiff's Opposition brief; the Declaration of Rebecca Peterson in opposition to stay; and Costco's Reply. Being fully advised, now, therefore, it is hereby

ORDERED that Costco's motion is GRANTED for the following reasons:

The question of whether litigation should be stayed is discretionary, and in ruling on a motion for a stay, a court should consider the factors set forth in *King v. Olympic Pipeline Co.*, 104 Wn. App. 338, 350-53 (2000). These factors are: (1) the similarities between the two cases; (2) the status of the other litigation; (3) the convenience of the court and the efficient use of judicial resources; (4) the plaintiff's interest in proceeding expeditiously with the litigation, as well as the prejudice to the plaintiff from any stay; (5) the burden on defendants if a stay is denied; (6) the interest of any non-parties; and (7) the public interest.

Here, it appears that there are substantial parallels between the *In re F5 Networks* litigation and the case at bar, as both of these cases involve claims by shareholders of improper acts on the part of corporate directors in backdating stock option grant dates. In each case, the plaintiffs failed to make demand on the board prior to bringing their shareholder derivative lawsuits, citing the "demand futility" exception to the general rule that demand on the board is a prerequisite to the filing of a shareholder derivative action. Washington's appellate courts have not directly addressed the issue of whether Washington recognizes a "demand futility" exception, and if so, under what circumstances. This is an issue that will need to be decided in the instant litigation, and the plaintiff has not suggested how, if at all, the *F5 Networks* case which is currently before the Washington Supreme Court and scheduled for argument in March of 2009 would not be dispositive on this issue. Given the pendency of the *F5 Networks* case, parallel litigation in the instant case is not an efficient use of the Superior Court's resources at the present time. Defendants have

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indicated that they intend to bring a motion to dismiss based on the plaintiff's failure to make demand on the Board before initiating suit. If the motion were granted, plaintiff undoubtedly would appeal, and the result of the appeal would almost certainly be determined by the Supreme Court's decision in the *F5 Networks* case. If the motion were denied, there would be a risk that subsequent litigation and trial would be nullified by the Supreme Court's decision in the *F5 Networks* case. This would be a poor use of the resources of the parties and the court.

Any prejudice to the plaintiff from a stay appears to be minimal. Plaintiff acknowledges that her lawsuit arises from alleged improper conduct that occurred "between the years of 1997 and 2002". (Plaintiff's opposition brief at 2). Thus, even the most recent of the events that plaintiff claims gives rise to her lawsuit occurred some six years before plaintiff initiated her lawsuit in mid 2008. It is unlikely that a stay of several months to a year would significantly impact the quality of the evidence available to the plaintiff.

Plaintiff has not raised any issues concerning the interest of non-parties or of the public in general.

The motion for stay of proceedings is granted for a period of six months, until June 1, 2009, at which time the parties should confer with the court so the court may determine whether the stay should be extended further, or lifted at that time.

DATED this 1st day of December, 2008.

Andrea Darvas

JUDGE ANDREA DARVAS

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A:2

U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Remarks Before the International Corporate Governance Network 11th Annual Conference

by

Commissioner Paul S. Atkins

U.S. Securities and Exchange Commission

Washington, D.C.
July 6, 2006

Thank you Alastair for the kind introduction. It is a pleasure to be a part of this international discussion of corporate governance issues. Before I begin my remarks, I must tell you that the views that I express here are my own and do not necessarily represent those of the Securities and Exchange Commission or my fellow commissioners.

The title of this conference, "Creating Value — Building Trust" is refreshingly upbeat. It is certainly appropriate for the nearly 57 million American households and the millions of other international investors that own stock in U.S. markets directly or through mutual funds to feel positive about their prospects these days. Although many press reports would have you believe otherwise, America's economy is strong and growing.

The Dow Jones Industrials is currently at around 11,200, nearing the all-time peak it reached on January 14, 2000. The gross domestic product expanded at a solid 3.5 percent pace last year. In the first quarter of this year, the American economy grew at an impressive rate of 4.8% — the fastest of any industrialized nation. Unemployment has fallen to 4.6 percent, lower than the average for any decade since the 1950s, and more Americans than ever own their own homes. Without doubt, the U.S. capital markets have created value for those who have invested over the last several years. With the U.S. Treasury estimating about $7 trillion in foreign holdings of U.S. securities, investors from all over the world have contributed to and enjoyed this growth.

Although the current state of the American economy is a success story — one that I take great pleasure in telling two days after we celebrated our 230th> Independence Day — the issues that you are discussing at this conference span national borders. Multi-national groups like this one, by bringing together a wide variety of perspectives, can be a fruitful source of ideas for improving corporate governance.

As a regulator, I believe that it is not best to mandate any particular model of corporate governance. My agency tried that recently in the mutual fund context. We adopted a rule mandating that the chairman and 75 percent of the directors of mutual fund boards be independent of the advisor of the funds. After an embarrassing defeat in court, we are rethinking our options.

The main reason that I reject the notion of regulators' prescribing corporate governance models on the macro-level is that *shareowners* are best placed to determine the governance model of their corporations. History has shown that one-size-fits-all models rarely produce good results and tend to stymie innovation. Stockholders are, after all, the owners of the corporations in which they invest. I believe that it is my obligation as a regulator to remain vigilant in protecting the rights of shareowners.

Managers are stewards of stockholders' property and are charged with maximizing the value of that property for the stockholders. The problem is that the interests of managers are not perfectly aligned with those of the shareholders. Adam Smith recognized the agency problem of management when, in the *Wealth of Nations*, he wrote the following assessment of management:

> being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.[1]

These are tough words, but they clearly set out the inherent challenge. In the face of such potential for managers' conflicts of interest, directors, as shareholders' elected representatives, act as watchdogs. They are bound to guard zealously the interests of shareholders and to ensure that managers do their jobs. They also perform an extremely important advisory role to management. The dispersion of ownership and the consequent gaping divide between owners and managers that characterizes the modern corporation makes the role of directors all the more important.

The importance of having the interests of those who manage property on behalf of owners aligned with the interests of owners is a key thread underlying the Sarbanes-Oxley Act, which Congress adopted and the SEC implemented in the wake of the corporate scandals of the early part of this decade. Fundamentally, the Act acknowledges the importance of stockholder value. It takes steps to strengthen the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interests. Even the Act's Section 404, cited as the law's most costly provision because of the excessive way in which accountants and management have implemented it, can serve to improve the quality of financial information provided to stockholders. But we must work towards better implementation.

The recognition that corporations exist for the benefit of stockholders has led me to oppose the imposition of financial penalties on corporations in instances, such as financial frauds, in which the stockowners have been harmed by the very misconduct at issue. Last January, the Commission took an important step on this front when it issued its statement concerning the imposition of financial penalties against corporations in enforcement actions. The statement recognized the too-often-overlooked concept that "[i]f the victims are shareholders of the corporation being penalized, they will still bear the cost of issuer penalty payments (which is the case with any penalty against a corporate entity)."[2] We will continue to work on this issue as the policy statement is applied to the facts and circumstances of the cases before the Commission. It would be unfortunate if, after all our efforts to the contrary, the Commission were to allow a boiler-plate nod to the penalty statement, thereby reverting to its prior practice of inappropriately imposing penalties on stockholders.

Although a corporation is a private entity, it is an artificial person created by law. One of the key rights of the owners of the corporation is their vote. As with any voting system, we must ensure that the proxy process has integrity. One encouraging recent step is the Commission's so-called e-proxy proposal. This proposed rulemaking, which we published last December, would allow for the Internet delivery of proxy materials. Issuers could take advantage of the Internet, which would achieve cost savings that would inure to the benefit of the stockholders. The time is right for such a move. The Internet has become not only a more common source of information for people in all walks of life, but is the preferred source for many. Shareholders who prefer paper, of course, would be able to continue to receive proxy materials in paper form. The convenience and interactive potential of the Internet offers those shareholders who choose Internet delivery an opportunity to achieve a deeper level of familiarity with the companies in which they invest.

Another effort that the SEC is pursuing concerns our proposal regarding disclosure to stockholders of the compensation that they pay to their top management. This issue goes to the heart of Adam Smith's ambivalence about a corporation as a form of ownership structure: his worry about agents' operating in their self-interest, rather than in their employers' best interests. Executive compensation has provoked comment like no other issue, chiefly because many shareholders have a keen and legitimate interest in knowing how boards are compensating top executives — they want to know whether the managers' interests are aligned with their own. Shareholders have a particular interest in transparency in this area.

In ICGN's comment letter on the executive compensation proposal, ICGN referred to its own ongoing efforts to update its Executive Remuneration Guidelines. That sparked my curiosity, so I went over to the website to take a look at the draft guidelines, which I found to be very thoughtful and thought-provoking.[3] Indeed, one section of the document so struck me that I was inspired to comment myself. However, because the due date for comments was five days ago, I decided to provide my comments here today.

The issue that caught my attention is one that has garnered a fair amount of attention from many quarters in recent months — the practices by which companies grant stock options. Yes, stock options. A controversial topic, perhaps, and a concept that has become anathema in some quarters. We all know of the abuses that many have ascribed to stock options: pussy-cat boards of directors showering fat-cat CEOs and other top officers of a company with millions and millions of dollars worth of options grants in return for poor or average corporate performance.

Section 3.4.2 of the ICGN draft Executive Remuneration Guidelines describes "discount options; re-load provisions; gross-up provisions; accelerated vesting upon change in control; and, repricing without shareholder approval" as "inappropriate." That Section also directs companies to "provide clear guidance regarding the circumstances under which key plan criteria may be amended, including performance targets, including notification to shareowners ... ." The Section later states that "[e]quity grants should be scheduled at regular annual intervals," directs companies to "adopt and disclose a formal pricing methodology for establishing the strike price of grants," and deems as altogether unacceptable the backdating of options grants to achieve a more favorable strike price.

I respect the ICGN for weighing in on this issue and look forward to seeing the Guidelines in final form. My own views are driven by looking at options grants from the perspective of the stockowner. Imagine, if you will, that you are a shareowner in a young, promising, cash-strapped business. Key to the success of the budding corporation is the ability to attract and retain good talent. This is particularly so in small, innovative companies that lack the perfectly manicured corporate campuses, plush offices, generous benefit packages, and lavish expense accounts of their more established, successful competitors. Would you not normally prefer to work in such comfort than in a spartan cubicle in a dreary warehouse?

What does it take to attract people to take a bigger risk on a company that is long on dreams and short on cash? Boards of these companies often find that they can lock in the talent that they need only by offering talented employees a future potential ownership interest in the company — not cash up front. Although options do have a cost to shareholders in the overhang of dilution, the options do not drain cash from the company's coffers; granting options does not require resources to be diverted from other aspects of the business. In addition, for companies at all stages of maturity, options, which do not vest immediately, provide a strong incentive for employees to stay and devote their energy to the company's success. Would you as the shareholder not applaud a board that employed such a clever, cash-preserving approach to compensation?

After all, you are a shareowner because you are not averse to risk — otherwise you could invest in bonds or insurance policies. Options are an arrangement between current shareholders and *potential* shareholders. They are a quid pro quo: you work for me to build value, and you are rewarded with stock so that you can share in that value.

In the United States, broad-based stock options have been the catalyst for corporate success since they were pioneered by venture capitalists over four decades ago. Their theory was that stock option grants to employees, not just to executives, would result in a new owner class of employees who would be given an incentive to maximize the value of the company's stock. This theory proved correct, and employee stock options have been one of the main reasons that innovative corporations have flourished.

Recently, however, there have been a slew of stories regarding alleged transgressions in the granting of stock options. Indeed, some of the reported facts are grim — stories of executives and directors conspiring to manipulate stock option prices for their own gain, or purposefully "backdating" options grants, in contravention of the company's public disclosure, to avoid recognizing compensation expenses. If true, I expect there will be little sympathy for, and intense regulatory reaction to, these scenarios.

But it is worth taking a step back before we plunge headlong into wholesale condemnation of all options practices. We need to distinguish scenarios that are black-and-white fraud from legitimate practices that are being attacked with attenuated theories of liability. With respect to the former, there have been many reported stories of clear-cut doctoring of documents done knowingly by executives and/or directors. I will not quibble with the vigorous pursuit of the knowing perpetrators of this kind of activity: a fraud is a fraud. Attempts to evade legal obligations through intentional alteration of documents or deliberate flouting of internal controls cannot be tolerated, because they strike at the core of our system of corporate governance.

Backdating of options sounds bad, but the mere fact that options were backdated does not mean that the securities laws were violated. Purposefully backdated options that are properly accounted for and do not run afoul of the company's public disclosure are legal. Similarly, there is no securities law issue if backdating results from an administrative, paperwork delay. A board, for example, might approve an options grant over the telephone, but the board members' signatures may take a few days to trickle in. One could argue that the grant date is the date on which the last director signed, but this argument does not necessarily reflect standard corporate practice or the logistical practicalities of getting many geographically dispersed and busy, part-time people to sign a document. It also ignores that these actions reflect a true meeting of the minds of the directors, memorialized by executing a unanimous written consent.

I suspect that the bulk of the questionable options granting activity occurred before Sarbanes-Oxley was enacted in 2002. After Sarbanes-Oxley, companies have been subject to tougher internal control requirements, and have filled compensation committees with independent directors. More importantly, the SEC requirement for disclosure of stock option grants to executives and directors has been greatly accelerated to two days from the previous one-year requirement. Moreover, I anticipate that the Commission will include additional disclosure requirements for options grants in the pending executive compensation rules.

Many of the hypothetical fact patterns being bandied about seem to be rooted in a questionable reading of the law. A scenario that has drawn much attention is the colorfully named "springloading," which has been defined as the practice by which a company purposefully schedules an option grant ahead of good news, or purposefully postpones an option grant until after bad news. I am not sure where the term springloading came from, but it certainly has an ominous ring to it.

Not only are there difficult factual issues that need to be proven, such as the nexus between the grant decision and the subsequent news event, but there are also substantive legal issues that need to be addressed. Specifically, we need to ask ourselves whether there has been a securities law violation even if a nexus can be identified between the grant and the news event. Isn't the grant a product of the exercise of business judgment by the board? For example, a board may approve an options grant for senior management ahead of what is expected to be a positive quarterly earnings report. In approving the grant, the directors may determine that they can grant fewer options to get the same economic effect because they anticipate that the share price will rise. Who are we to second-guess that decision? Why isn't that decision in the best interests of the shareholders? We also need to remember that predicting the stock price effect of an upcoming event is difficult, let alone predicting the trajectory of the stock price over the next twenty quarters until the options vest.

Also swirling about are accusations of insider trading by corporate boards in connection with options grants. Again, one has to ask whether there is a legitimate legal rationale for pursuing *any* theory of insider trading in connection with option grants. Boards, in the exercise of their business judgment, should use all the information that they have at hand to make option grant decisions. An insider trading theory falls flat in this context where there is no counterparty who could be harmed by an options grant. The counterparty here *is* the corporation — and thus the shareholders!

They are intended to benefit from the decision.

Practically speaking, because corporate boards are almost always in possession of material nonpublic information, it would be difficult (if not impossible) to require them to refrain from making options grants when they are in possession of such information. Along those lines, would we call it insider trading if a board chose not to grant options because it knew of impending bad news?

We should also consider some of the business purposes behind such grants. Imagine yourself a board member, whose job it is, as I discussed earlier, to maximize shareholder value. The shareholders have entrusted you and the rest of the board with a fixed number of shares to allocate with options. You ought not simply hand out options with abandon. Your job is to use these options, as you use any other corporate resource, to maximize shareholder value. Deciding to whom and when to grant these options is a complicated calculus that is fraught with uncertainty since one never knows what will happen to the stock price. As with other business decisions, it is protected by the business judgment rule. Over the years, the courts in the various States have built up what we call the "business judgment rule", a rule under which courts will not second-guess judgments regarding business matters made by corporate officers and directors in good faith. Judges, recognizing that business decisions often must be made quickly on sketchy information, refrain from substituting their own views in hindsight.

Of course, even boards that try to issue options at opportune times for the recipients often may miss the mark because they cannot perfectly predict how the stock price will move. A further element of uncertainty is added by the fact that options are typically subject to a vesting period; the ultimate value of the option to a recipient only becomes clear at the end of the vesting period.

In the best exercise of their business judgment, directors might very well conclude that options should be granted in advance of good news. What better way to maximize the value that the option recipient attaches to the option? Conversely, a board would avoid granting options right before bad news hits since recipients are likely to place a lower value on such options. A board that times its options grants wisely can achieve the same result that it would by granting more options at a time when the stock price is likely to stagnate or drop. A board that makes a consistent practice of timing options grants before the stock price rises should be able to pay lower cash salaries than a board that makes options grants without taking into consideration likely prospective changes in the stock price, precisely because there is a greater chance of the options being worth something and achieving their intended objective.

As the ICGN's draft Guidelines remind us, "boards and their mechanisms for deciding upon executive pay play a critical role in representing owners in the process of remuneration design and oversight."[4] Part of what this entails is using resources in a way that gets the biggest bang for the buck. A board, by issuing options at an opportune time, maximizes the effect of those options. In other words, it takes fewer well-timed options to make the employee happy, and the company does not need to burn cash. So from the shareholders' point of view and from the point of view of the board member who is representing the shareholders' interests, there is good reason why options grants would not be made according to a rigid, pre-set schedule. In fact, underwater options actually do more harm than good. They make employees *more* susceptible to being picked off by competitors than no options at all. They give the employee no reason to stay to exercise the option and they are a constant reminder of the firm's diminished prospects.

It is true that when granting *any* form of compensation to themselves, there is a potential conflict of interest between the board members and the best interests of the shareholders. Safeguards are in place, however, to deal with these conflicts, such as disclosure requirements. Investors, of course, should monitor this situation just as they do other compensation matters. One comforting aspect is that shareholders have the directors' own personal reputation as a protection against abuse — because most directors have had successful careers in their own right (that is why, after all, they are invited to become directors in the first place), most directors have a great incentive to maintain their own reputation.

And, this is an important point on which to end. I hear over and over from lawyers, investment bankers, institutional investors, and directors that it is becoming more and more difficult to find good men and women willing to serve as directors. Directors are already a nervous lot following the scandals of the past and the increased risk and liability that they feel that they carry for their actions.

Following the reforms of the last few years, we have more disclosure, more transparency, more accountability, and more tools for directors and stockholders than ever before. We should not through enforcement actions undercut the business judgment rule — we do so to the peril of stockholders. When we focus on corporate compensation arrangements and on practices regarding granting of stock options, we must take care not to undermine a compensation arrangement that has served shareowners so well for so many years.

Thank you for indulging me by listening to my comments this afternoon. I am interested in hearing your comments as well, either today or sometime in the future when you are back in Washington and have a chance to drop by my office.

[1] Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, at Book V, Chapter I (1776) (available at: http://www.econlib.org/LIBRARY/Smith/smWN.html).

[2] Statement of the Securities and Exchange Commission Concerning Financial Penalties, Release 2006-4, Jan. 4, 2006 (available at: http://www.sec.gov/news/press/2006-4.htm).

[3] http://www.icgn.org/issues/2006/consultations/erc/executive_remuneration_guidelines.doc

[4] *Id.*

http://www.sec.gov/news/speech/2006/spch070606psa.htm

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UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.

Master File No. C06-794RSL

ORDER GRANTING NOMINAL DEFENDANT F5 NETWORKS, INC.'S MOTION TO DISMISS FOR FAILURE TO MAKE DEMAND

I. INTRODUCTION

This matter comes before the Court on nominal defendant "F5 Networks, Inc.'s Motion to Dismiss for Failure to Make Demand" (Dkt. #49). In its motion, nominal defendant F5 Networks, Inc. ("F5") requests dismissal of plaintiffs' derivative complaint because plaintiffs did not make a pre-litigation demand on F5's board of directors and plaintiffs have failed to plead particularized facts showing that demand was excused as futile. The Court held a hearing on the motion on August 1, 2007 and heard oral argument from counsel for plaintiffs and defendant F5. For the reasons set forth below, the Court grants defendant F5's motion to dismiss.

II. DISCUSSION

A. Background

This action arises out of the recent publicity focused on companies that allegedly backdated stock options as a form of compensation to high-level executives. On May 16, 2006, the Center for Financial Research and Analysis ("CFRA") issued a report entitled "Options

Backdating, Which Companies Are At Risk?" in which CFRA reviewed the option prices of 100 public companies and, based upon an analysis of the exercise prices of option grants with reference to the companies' stock prices, concluded that 17% of the subject companies, were in CFRA's view, "at risk for having backdated option grants during the period 1997 to 2002." See Dkt. #54, Ex. 1 (F5's Form 10-K/A filed with the SEC on December 12, 2006) at 20.[1] F5 was one of the 17 companies so identified. Id.; see also James Bandler et al., Criminal Probe Of UnitedHealth's Options Begins, Wall St. J., May 18, 2006, at C1 ("An accounting-research firm this week identified 17 companies it termed as having 'the highest risk of having backdated options.'"). Shortly thereafter, F5 announced that it had received a grand jury subpoena from the Eastern District of New York and a notice of informal inquiry from the Securities and Exchange Commission ("SEC"). See Dkt. #54, Ex. 1 at 10. This set off a rush to the courthouse.

1. Procedural history

Last year, there were a total of six F5 related shareholder derivative actions pending before this Court: (1) Hutton v. McAdam, et al. (Case No. C06-794RSL); (2) Wright v. Amdahl, et al. (Case No. C06-872RSL); (3) Adams v. Amdahl, et al. (Case No. C06-873RSL); (4) Locals 302 and 612 of the Int'l Union of Operating Eng'rs-Employers Constr. Indus. Ret. Trust v. McAdam, et al. (Case No. 06-1057RSL) (hereinafter "Locals Trust"); (5) Easton v. McAdam, et al. (Case No. C06-1145RSL); and (6) Sommer v. McAdam, et al. (Case No. C06-1229RSL). On September 12, 2006, the Court remanded the Wright and Adams actions to King County Superior Court, and on September 28, 2006, the Court signed an order granting the parties' stipulation for remand in Sommer. See Dkt. #22 in C06-872; Dkt. #34 in C06-873; and

[1] Under Fed. R. Evid. 201, the Court takes judicial notice of this document, as well as F5's stock prices and documents filed with the SEC. See Dkt. #67 (Order Granting In Part and Denying In Part Plaintiffs' Motion for Judicial Notice).

Dkt. #18 in C06-1229. Wright, Adams, and Sommer were consolidated in King County Superior Court before the Honorable William L. Downing and have been stayed pending the federal court actions (see King County Superior Court Nos. 06-2-17195-1SEA; 06-2-19159-5SEA; and 06-2-26248-4SEA). On October 2, 2006, the Court signed an order on the parties' stipulation in Hutton, Locals Trust, and Easton, consolidating these actions for all purposes, appointing lead plaintiff and lead counsel, and setting the schedule for filing a consolidated complaint. See Dkt. #37 in C06-794. Under this order, Locals 302 and 612 of the International Union of Operating Engineers-Employers Construction Industry Retirement Trust (hereinafter "Locals 302 and 612" or "lead plaintiff") was appointed lead plaintiff charged with filing a consolidated complaint. Id. at 3. On November 20, 2006, lead plaintiff filed a "Consolidated Verified Shareholders Derivative Complaint" (Dkt. #39) (hereinafter the "Complaint"), which is now the operative pleading in this matter.

On February 2, 2007, the parties in this consolidated action filed a joint motion to establish a briefing schedule for motions directed at the Complaint (Dkt. #45). Based on this motion, the Court set a bifurcated briefing schedule for motions to dismiss, requiring submission of motions to dismiss based on demand futility prior to the filing of other Fed. R. Civ. P. 12 dismissal motions. See Dkt. #46. Pursuant to this order, on February 28, 2007, defendant F5 filed a motion to dismiss for failure to make demand, which is now pending before the Court for consideration. See Dkt. #49 (hereinafter "Motion").

2. The parties

Lead plaintiff Locals 302 and 612, plaintiff Glenn Hutton, and plaintiff Allen Easton are, and have been at relevant times, current shareholders of F5. See Complaint at ¶22.

Nominal defendant F5 is incorporated in the State of Washington and has its principal place of business in Seattle. Id. at ¶25. F5 provides application delivery networking products that improve the performance, availability and security of applications running on networks using the Internet Protocol (IP). Id. As described below, the individual defendants are current and former F5 officers and directors.

a. F5's Board of Directors at the time of the lawsuit's filing

Plaintiffs first filed suit on June 8, 2006. Id. at ¶152. At that time, F5's board consisted of six directors who have been named as individual defendants in this action: (1) John McAdam; (2) Alan Higginson; (3) Karl Guelich; (4) Keith Grinstein; (5) Rich Malone; and (6) Gary Ames. Id.

Defendant John McAdam has been F5's CEO, President and a director since 2000. See Complaint at ¶26. Plaintiffs allege that as an executive and director, Mr. McAdam authorized, approved and or/received the backdated stock options at issue in this case, including at least 1,255,000 backdated options worth at least $13.9 million, and has sold at least 1.2 million shares of his personal F5 stock, for unlawful insider trading proceeds of at least $42.9 million. Id.

Defendant Alan Higginson has been F5's Chairman since April 2004 and a director since May 1996, and has also served as a member of F5's Audit and/or Compensation Committees since 1999. Id. at ¶28. Plaintiffs allege that as a director, Mr. Higginson authorized, approved and/or received the backdated stock options at issue in this case, including at least 67,500 backdated options worth at least $972,900, and has sold at least 156,300 shares of his personal F5 stock, for unlawful insider trading proceeds of at least $6.6 million. Id.

Defendant Karl Guelich has been an F5 director since June 1999, and has also served as a member of F5's Audit and/or Compensation Committees since 1999. Id. at ¶29. Plaintiffs allege that as a director, Mr. Guelich authorized, approved and/or received the backdated stock options at issue in this case, including at least 67,500 backdated options worth at least $972,900, and has sold at least 70,880 shares of his personal F5 stock, for unlawful insider proceeds of at least $3.1 million. Id.

Defendant Keith Grinstein has been an F5 director since December 1999, and has also served as a member of F5's Audit and/or Compensation Committees since 1999. Id. at ¶30. Plaintiffs allege that as a director, Mr. Grinstein authorized, approved and/or received the backdated stock options at issue in this case, including at least 67,500 backdated options worth at least $972,900, and has sold at least 62,500 shares of his personal F5 stock, for unlawful insider proceeds of at least $2.8 million. Id.

Defendant Rich Malone has been an F5 director since August 2003. Id. at ¶31. Plaintiffs allege that as a director, Mr. Malone assisted in the preparation of F5's annual and quarterly reports, and reviewed, approved and helped to prepare each proxy statement issued since August 2003; and signed F5's annual financial reports for fiscal years 2003-2005, which must now be restated to correct for accounting irregularities caused by the backdated options at issue in this case. Id.

Defendant Gary Ames has been a director of F5 since July 2004, and has also served as a member of F5's Compensation Committee since 2004. Id. at ¶32. Plaintiffs allege that as a director, Mr. Ames assisted in the preparation of F5's annual and quarterly reports, and reviewed, approved and helped to prepare each proxy statement issued since July 2004; and signed F5's annual financial reports for fiscal year 2004-2005, which must now be restated to correct for accounting irregularities caused by the backdated options at issue in this case. Id. Plaintiffs further allege that Mr. Ames has sold at least 10,000 shares of his personal F5 stock, for unlawful insider trading proceeds of at least $548,800. Id.

b. F5's Officers

The following defendants were F5 officers as of the time the complaint was filed:

Defendant Joann Reiter served as Vice President of F5 since 2000, Corporate Secretary since July 1999, and as General Counsel since 1998. Id. at ¶33. Plaintiffs allege that Ms. Reiter resigned on or about November 8, 2006 following disclosures of the issues in this case. Id. Plaintiffs also allege that as an executive, Ms. Reiter authorized, approved and/or received the backdated stock options at issue in this case, including at least 177,916 backdated options worth at least $2.6 million, and has sold at least 226,491 shares of her personal F5 stock, for unlawful insider proceeds of at least $8.4 million. Id.

Defendant Tom Hull has been F5's Senior Vice President of Worldwide Sales since October 2003. Id. at ¶38. Plaintiffs allege that as an executive of F5, Mr. Hull authorized, approved and/or received the backdated options at issue in this case, including 40,000 backdated options worth at least $1.01 million, and has sold at least 50,000 shares of his F5 stock, for unlawful insider trading proceeds of at least $892,000. Id.

Defendant Edward Eames has been F5's Senior Vice President of Business Operations since January 2001 and served as Vice President of Professional Services from October 2000 to January 2001. Id. at ¶40. Plaintiffs allege that as an executive of F5, Mr. Eames authorized, approved and/or received the backdated options at issue in this case, including 165,000 backdated options worth at least $1.9 million, and sold at least 386,146 shares of his F5 stock, for unlawful insider trading proceeds of at least $16.6 million. Id.

Defendant Andy Reinland has been F5's Senior Vice President and Chief Financial Officer since October 25, 2005, and previously served as Vice President of Finance. Id. at ¶41. Plaintiffs allege that as an executive of F5, Mr. Reinland authorized, approved and/or received the backdated stock options at issue in this case, and sold at least 18,933 shares of his personal F5 stock, for unlawful insider trading proceeds of at least $1.1 million. Id.

Defendant John Rodriguez has been F5's Senior Vice President and Chief Accounting Officer since October 25, 2005 and Controller since 2001. Id. at ¶43. Plaintiff alleges that as an executive, Mr. Rodriguez authorized, approved and/or received the backdated stock options at issue in this case, and sold at least 10,287 shares of his personal F5 stock, for unlawful insider trading proceeds of at least $595,564. Id.

c. F5's Former Officers and Directors

The following defendants are former F5 officers and directors:

Defendant Carlton Amdahl served as an F5 director from at least May 1998 to January 2001, and also as Chief Technical Officer from at least February 2000 to January 2001. Id. at ¶34. Plaintiffs allege as a director, Mr. Amdahl authorized, approved and/or received the backdated stock options at issue in this case, including 487,500 backdated options worth at least $35.5 million, and has sold at least 10,000 shares of his F5 stock, for unlawful insider trading proceeds of at least $520,300. Id.

Defendant Steven Goldman served as F5's Senior Vice President of Sales and Services from July 1997 to July 1999. Id. at ¶35. Plaintiffs allege that as an executive, Mr. Goldman authorized, approved and/or received the backdated stock options at issue in this case, including 215,000 backdated options worth at least $2.3 million, and has sold at least 352,500 shares of his F5 stock, for unlawful insider trading proceeds of at least $10.5 million. Id.

Defendant Brett Helsel served as F5's Vice President of Product Development and Chief Technology Officer from May 1998 to February 2000 and as Senior Vice President of Product Development from February 2000 until his resignation. Id. at ¶36. Plaintiffs allege that as an executive, Mr. Helsel authorized, approved and/or received the backdated stock options at issue in this case, including 80,000 backdated options worth at least $660,000, and has sold at least 289,703 shares of his F5 stock, for unlawful insider trading proceeds of at least $8.2 million. Id.

Defendant Jeff Pancottine served as F5's Senior Vice President and General Manager since 2004 and as Senior Vice President of Marketing and Business Development since October 2000. Id. at ¶37. Plaintiffs allege that as an executive, Mr. Pancottine authorized, approved and/or received the backdated stock options at issue in this case, including 265,000 backdated options worth at least $3.4 million, and has sold at least 475,878 shares of his F5 stock, for unlawful insider trading proceeds of at least $19.1 million. Id.

Defendant Steven Coburn served as F5's Vice President of Finance and Chief Financial Officer from May 2001 to 2005. Id. at ¶39. Plaintiffs allege that as an executive, Mr. Coburn authorized, approved and/or received the backdated options at issue in this case, including 165,000 backdated options worth at least $2.6 million, and sold at least 365,000 shares of his F5 stock, for unlawful insider trading proceeds of at least $14.9 million. Id.

Defendant Jeffrey Hussey served as F5's Chairman from 1996 to 2002, and as CEO from

January 1996 to July 2000. Id. at ¶42. Plaintiffs allege that as a director and executive, Mr. Hussey authorized, approved and/or received the backdated stock options at issue in this case, including 70,000 backdated options worth at least $490,000, and sold at least 478,000 shares of his F5 stock, for unlawful insider trading proceeds of at least $25.8 million. Id.

B. Analysis

1. The demand futility standard

The purpose of a derivative action is to "place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of faithless directors and managers." Kamen v. Kemper Fin. Serv., Inc., 500 U.S. 90, 95 (1991) (quotation marks and citation omitted). To prevent abuse of this remedy, however, shareholder derivative complaints are governed by the pleading requirements of Fed. R. Civ. P. 23.1, which states, in part: "[t]he 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 the reasons for the plaintiff's failure to obtain the action or for not making the effort." Id. In this case, plaintiffs do not allege that they made a demand on F5's board of directors. Instead, plaintiffs claim that demand was excused because it would have been futile. See Dkt. #39 at ¶154 ("A pre-filing demand would be a useless and futile act").

"[A] court that is entertaining a derivative action . . . must apply the demand futility exception as it is defined by the law of the State of incorporation." Kamen, 500 U.S. at 108-109; In re Silicon Graphics Inc. Securities Litig., 183 F.3d 970, 990 (9th Cir. 1999) ("For [demand futility] standards, we turn to the law of the state of incorporation"). F5 was incorporated in Washington State, so Washington law applies on this issue. Washington has a procedural demand requirement set forth in RCW 23B.07.400(2), "Derivative proceedings procedure," which states:

> A complaint in a proceeding brought in the right of a corporation must be verified and allege with particularity the demand made, if any, to obtain action by the board of directors and either that demand was refused or ignored or why a demand

> was not made. Whether or not a demand for action was made, if the corporation commences an investigation of the charges made in the demand or complaint, the court may stay any proceeding until the investigation is complete.

Although RCW 23B.07.400(2) sets forth the procedural demand requirement, Washington courts have neither interpreted this provision nor adopted a substantive demand requirement. See Kamen, 500 U.S. at 96 ("[T]he demand doctrine . . . clearly is a matter of 'substance' not 'procedure.'"). But, it is clear under Washington law that "[d]erivative suits are disfavored and may be brought only in exceptional circumstances." Haberman v. Wash. Pub. Power Supply Sys., 109 Wn.2d 107, 147 (1987).

In the absence of Washington substantive law on demand futility, Judge Zilly of this Court previously concluded that "the Washington State Supreme Court would likely adopt the substantive demand requirement and apply a similar, if not the same, exception for futility as that employed in Delaware." See In re Cray, 431 F. Supp. 2d 1114, 1120 (W.D. Wash. 2006); accord Schwartzman v. McGavick, 2007 U.S. Dist. Lexis 28962, at *12 (W.D. Wash. April 19, 2007) (citing In re Cray, 431 F. Supp. 2d at 1120 and following Delaware law given the parties' agreement); Fernandes v. Bianco, 2006 U.S. Dist. Lexis. 42048, at *7 (W.D. Wash. June 22, 2006) (same).

Following In re Cray, the parties agree that Delaware's substantive demand requirement is persuasive authority here. See Motion at 10 ("In Aronson, the Delaware Supreme Court created a two-pronged test for analyzing a claim of demand futility (a test that this Court adopted in Cray, 431 F. Supp. 2d at 1121)."); Response at 9 ("In determining the futility of demand, Washington State courts apply Delaware law.") (citing In re Cray, 431 F. Supp. 2d at 1119).

Delaware law has two tests for demand futility. Under the first test announced in Aronson v. Lewis, 473 A.2d 805 (Del. 1984), if a derivative suit challenges a decision made by the board of directors, then demand is excused if plaintiffs "allege particularized facts creating a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." In re Silicon Graphics Inc. Sec. Litig., 183 F.3d at 989 (citing Aronson, 473 A.2d at 814); In re CNET Networks, Inc. S'holder Derivative Litig., 483 F. Supp. 2d 947, 954 (N.D. Cal. 2007). A second test under Rales v. Blasband, 634 A.2d 927 (Del. 1993), applies where the directors did not make a decision: "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." In re CNET, 483 F. Supp. 2d at 954 (quoting Rales, 634 A.2d at 934). Plaintiffs' core allegations in this case are based on the directors' actions, such as receiving backdated options, preparing and signing proxy statements, and falsely reporting financial statements. Therefore, the Aronson v. Lewis test for demand futility applies here.

The Aronson test has two parts: the first part examines whether directors are disinterested and independent, and the second part examines whether the transaction at issue was a valid exercise of the board's business judgment. See Aronson, 473 A.2d at 814. In the first part of the test, disinterestedness and independence must be examined separately, because a lack of independence by a majority of the board may by itself excuse a derivative plaintiff from making demand. See Rales, 634 A.2d at 936. Accordingly, in the analysis below, the Court examines separately whether plaintiffs have established reasonable doubt that: (1) the directors are disinterested; (2) the directors are independent; and (3) whether the transactions at issue were valid exercises of business judgment.

But, before turning to the Aronson test, the Court highlights the fact that its determination of whether or not demand is excused as futile is determined as of the time the complaint was filed. See Rales, 634 A.2d at 934 ("Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt . . . as of the time the complaint is filed[.]") (emphasis added). At the time the Complaint was filed on June 8, 2006,[2] the F5 Board consisted of six directors: (1) John McAdam, (2) Alan Higginson, (3) Karl Guelich, (4) Keith Grinstein, (5) Rich Malone, and (6) Gary Ames. (hereinafter referred to as the "Director Defendants"). If plaintiff shows that three of these Director Defendants are not independent or disinterested, demand is excused as futile. See Beam v. Stewart, 845 A.2d 1040, 1046 n.8 (Del. 2004) ("If three directors of a six person board are not independent and three directors are independent, there is not a majority of independent directors and demand would be futile." (citing Beneville v. York, 769 A.2d 80, 85-86 (Del. Ch. 2000) (holding that demand is excused where a board is evenly divided between interested and disinterested directors)).

2. Is there reasonable doubt that F5's Director Defendants are disinterested?

Plaintiffs allege that F5 executives impermissibly "backdated" stock option grants. A stock option gives the holder the right, but not the requirement, to purchase stock at a certain price – the "strike" or "exercise" price. When the strike price of an option is set at the stock's closing price on the date of the option grant, the option is "at the money," or has no immediate value on the grant date, because the exercise price and the stock price are the same.

The crux of this case is plaintiffs' claim that defendants did not set the strike price on the same day the options were granted. Instead, plaintiffs allege that defendants engaged in a "backdating scheme" by looking back with 20/20 hindsight to link strike prices to dates when F5's stock closed at relative lows. If this allegation is proven true, the stock options at issue would have been "in the money" and had immediate value to defendants subject to any vesting requirements, because the strike price was known to be below the then-current price of F5's stock. While there is nothing per se impermissible with "in the money options,"[3] "[i]ntentionally

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[2] The Hutton v. McAdam, et al. complaint was filed on June 8, 2006. See C06-794RSL at Dkt. #1.

[3] See In re Computer Sci. Corp. Derivative Litig., 2007 U.S. Dist. Lexis 25414, at *7 (C.D. Cal. Mar. 27, 2007) ("[T]he practice [of granting "in the money options"] is not improper, in and of itself,

employing hindsight to adjust the grant date to an advantageously low price, or 'backdating,' is fraud.". In re CNET Networks, Inc., 483 F. Supp. 2d at 956.

To succeed on their backdating theory at trial, plaintiffs will have to show that the stock options at issue were in fact "backdated." Here, however, the case is at the pleading stage on defendant's motion to dismiss, so in response to defendant's motion, plaintiffs only have to present particularized facts creating reasonable doubt that the directors are disinterested. Plaintiffs' core contentions on this point are that the Director Defendants are not disinterested because they received backdated options. See Complaint at ¶153; Response at 24.

Plaintiffs allege that grants made on twelve dates between 1999 and 2004 were backdated: (1) October 1, 1999; (2) February 10, 2000; (3) July 24, 2000; (4) January 1, 2001; (5) March 16, 2001; (6) April 20, 2001; (7) April 27, 2001; (8) May 6, 2002; (9) February 13, 2003; (10) May 8, 2003; (11) April 29, 2004; and (12) April 30, 2004. See Complaint at ¶9. At the time the Complaint was filed, F5's board of directors consisted of Messrs. McAdam, Higginson, Guelich, Grinstein, Malone, and Ames.

Of the twelve grants plaintiffs allege were backdated, at least three of these Director Defendants received grants dated: (1) January 1, 2001; (2) April 20, 2001; (3) May 6, 2002; (4) February 13, 2003; and (5) April 29, 2004.[4] Directors are considered interested for purposes of

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provided it is: 1) fully disclosed to necessary parties, including securities and tax authorities, corporate directors and shareholders; 2) properly accounted for under Generally Accepted Accounting Principles ('GAAP') in the company's financial disclosures to shareholders, the SEC and other regulatory agencies; 3) correctly taxed at both the company and grantee levels; and 4) permitted under the company's bylaws and/or shareholder-approved stock option plans.").

[4] Plaintiffs allege that John McAdam received backdated options in grants dated July 24, 2000; January 1, 2001; March 16, 2001; April 27, 2001; May 6, 2002; May 8, 2003; and April 30, 2004. See Complaint at ¶9. Plaintiffs allege that Alan Higginson received backdated options in grants dated: January 1, 2001; April 20, 2001; May 6, 2002; February 13, 2003; and April 29, 2004. Id. Plaintiffs allege that Karl Guelich received backdated options in grants dated: January 1, 2001; April 20, 2001; May 6, 2002; February 13, 2003; and April 29, 2004. Id. Plaintiffs allege that Keith Grinstein received backdated options on grants dated: January 1, 2001; April 20, 2001; May 6, 2002; February 13, 2003;

determining demand futility when they "appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." Aronson, 473 A.2d at 812. If plaintiffs plead with particularity that the option grants on any of these five days were backdated, a majority of the board would not be considered disinterested because they would have received a personal benefit not equally shared by the stockholders, and demand on F5 would be excused as futile. See Beam, 845 A.2d at 1049 ("A director's interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision."). Therefore, the Court examines whether plaintiffs have pleaded facts with particularity creating reasonable doubt at the pleading stage that the Director Defendants are not disinterested because they received backdated option grants.

a. Option grants dated January 1, 2001

Plaintiffs allege that directors Higginson, Geulich, and Grinstein were granted 7,500 options, and director McAdam was granted 100,000 options dated January 1, 2001 at an exercise price of $9.50. See Complaint at ¶65.[5] For directors Higginson, Geulich, and Grinstein, 100% of the options vested immediately.[6] See Dkt. #60, Ex. F.[7] Directors Higginson, Geulich, and

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and April 29, 2004. Plaintiffs have not alleged that Rich Malone or Gary Ames received the backdated options at issue in this case. Id.

[5] Plaintiffs also allege that defendants Goldman, Helsel, Pancottine, and Reiter received options dated January 1, 2001. See Complaint at ¶65.

[6] In its reply, defendant asserts that "it can reasonably be argued that vesting requirements effectively defeat any incentive to 'backdate' because those requirements negate the ability to guarantee a profit to option recipients." See Reply at 12 (emphasis in original). The Court does not need to reach the merits of this argument because the options received by directors Higginson, Geulich, and Grinstein vested 100% on the grant dated and therefore could be "immediately exercised and the 'windfall' captured." Id. at 11; Dkt. #60, Exs. F, H, J, K, M.

[7] Defendant McAdam's January 1, 2001 options vested 50% after one year from the grant date and 50% after the second year. See Dkt. #60, Ex. F.

Grinstein filed Form 4's for the January 1, 2001 grants with the SEC on March 5, 2001. Id. On this March 5, 2001 disclosure date, F5's stock closed at $6.81, which was $2.69 lower than the stock price on the grant date. Id., Ex. B. In fact, F5's stock closed lower than the $9.50 strike price in the eight trading dates leading up to March 5, 2001, when directors Higginson, Geulich, and Grinstein filed their Form 4's with the SEC. Id. Therefore, by the time the grants dated January 1, 2001 were reported to the SEC, the options were significantly "out of the money." If the directors were attempting to backdate their options as plaintiffs allege, it is extremely unlikely that the directors would have looked into the past with 20/20 hindsight and chosen January 1, 2001 as a grant date when the price was $2.69 higher than March 5, 2001, the day on which the options were recorded with the SEC. This decrease between the grant date and the SEC filing date undermines plaintiffs' allegations that the January 1, 2001 grants were backdated.

b. Option grants dated April 20, 2001

Plaintiffs allege that directors Higginson, Geulich, and Grinstein were granted 15,000 options dated April 20, 2001 at an exercise price of $8.10. See Complaint at ¶67. These options vested immediately. See Dkt. #60, Ex. H. Directors Higginson, Geulich, and Grinstein filed their Form 4's for the April 20, 2001 grants with the SEC on May 3, 2001. There were eight trading days between April 20, 2001 and May 3, 2001. See Dkt. #60, Ex. B. On seven out of eight of these trading days, F5's stock closed lower than the April 20, 2001 grants' strike price. Id. In fact, on April 25, 2001 and April 27, 2001, F5's stock closed at $7.00, $1.10 lower than the April 20, 2001 option price. Id. In support of their claim that the grant dated April 20, 2001 was backdated, plaintiffs assert in the Complaint that: "[t]he [$8.10] exercise price was one of the lowest closing prices for the month of April 2001." Complaint at ¶32 (emphasis in original). This allegation by plaintiffs, however, is a complete misrepresentation of the facts. The April 20, 2001 closing price of $8.10 was the second highest closing price for the month of April

2001.[8] Only on April 19, 2001 when the stock closed at $8.55, did F5's stock close higher during the month of April 2001. Had the directors truly backdated their options during this time as plaintiffs suggest, the directors would have likely chosen April 4, 2001 as a grant date, when F5's stock closed at only $3.75 a share, or any of the seven days between April 20 and May 3, 2001 when F5's stock closed below $8.10. Id. Accordingly, plaintiffs have not pleaded particularized facts showing that the April 20, 2001 grants were backdated.

c. Option grants dated May 6, 2002

Plaintiffs allege that directors Higginson, Guelich, and Grinstein were granted 15,000 options each, and director McAdam was granted 100,000 options, dated May 6, 2002 with an exercise price of $11.12. See Complaint at ¶69. These options vested immediately. See Dkt. #60, Ex. J. Directors McAdam, Higginson, Geulich, and Grinstein filed Form 4's for the May 6, 2002 grants with the SEC on June 4, 2002. Id. On the day of the Form 4 filing, F5's stock closed at $11.93, which plaintiffs allege represents a 7.2% cumulative return based on the exercise price. See id. at Ex. B; Complaint at ¶69. Plaintiffs also allege that "[j]ust three days after the grant, the stock price soared to $11.77 per share, a 5.8% increase" and that "the exercise price was the lowest closing price for the stock in the month of May 2002." Id. (emphasis in original).

In response to these allegations, defendant asserts that the grants dated May 6, 2002 were issued under F5's "1998 Equity Incentive Plan" and this plan allows for grants of "in the money" options. See Dkt. #60, ¶18 and Ex. Q; see also Complaint at ¶90 (quoting F5's 2003

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[8] Plaintiffs are admonished for their misrepresentation of F5's April 20, 2001 stock price in the chart on page 33 of the Complaint. Based on the location of the arrow in this chart purportedly indicating the April 20, 2001 grant, it appears as if the April 20, 2001 grant was at a significant trough in price and suggests F5's stock closed below $7.50 on April 20th. In fact, F5's stock closed at $8.10 on April 20, 2001 and was not a relative low point at all. F5's stock actually closed lower in the 7 trading days following April 20, 2001. Had the arrow indicating the April 20, 2001 grant been properly located on the chart, it would show that the April 20, 2001 closing price was actually on a "peak" in the graph, not a valley as the chart misrepresents.

Proxy Statement indicating that the May 2002 grants were issued pursuant to the 1998 Equity Incentive Plan). Paragraph 6(c) of the 1998 Equity Incentive Plan, states:

> Exercise Price of a Nonstatutory Stock Option. Subject to the provisions of subsection 5(b) regarding Ten Percent Shareholders, the exercise price of each Nonstatutory Stock Option granted prior to the Listing Date shall be not less than eighty-five percent (85%) of the Fair Market Value of the stock subject to the Option on the date the Option is granted. The exercise price of each Nonstatutory Stock Option granted on or after the Listing Date shall be not less than fifty percent (50%) of the Fair Market Value of the stock subject to the Option on the date the Option is granted. Notwithstanding the foregoing, a Nonstatutory Stock Option may be granted with an exercise price lower than that set forth in the preceeding sentence if such Option is granted pursuant to an assumption or substitution for another option in a manner satisfying the provisions of Section 424(a) of the Code.

See Dkt. #50, Ex. I. Given that the share price on June 4, 2002 was only 7.2% higher than on May 6, 2002, at the time the grant was recorded with the SEC, it was within the allowable percentage for "in the money" options under the 1998 Equity Incentive Plan.[9]

As discussed above and below, plaintiffs have failed to plead with particularity that the other four grants of options to the Director Defendants were backdated. In May 2002, there were 22 trading days. See Dkt. #60, Ex. B. Even if the May 6, 2002 strike price of $11.12 was the lowest closing price for F5's stock during the month of May 2002 as plaintiffs allege, this alone is not sufficient to show with particularity that the option was backdated. By granting an option in May of 2002, there was a 1 in 22 chance of the grant falling on May 6, 2002. Furthermore, given the volatility of F5's stock during 2002, which closed at a low of $6.78 on October 10, 2002 and at a high of $26.21 on March 18, 2002, the relatively modest 7.2% increase in the price is not analogous to the extreme increases where courts have found a particularized showing of backdating. See, e.g., In re CNET, 484 F. Supp. 2d at 959-61 (finding that plaintiffs pleaded facts supporting an inference of backdating where there were 115.1%, 66.2%, and 49.7% increases in CNET's stock 20 trading days after the grants); Dkt. #60, Ex. B.

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[9] The SEC filing for this grant indicates that it was a Non-Qualified Stock Option grant. See Dkt. #60, Ex. J.

Having determined that plaintiffs have not pleaded particularized facts indicating that the grants dated January 1, 2001, and May 6, 2002 were backdated, the Court now turns to the remaining grants dated February 13, 2003 and April 29, 2004.

The February 13, 2003 and April 29, 2004 grants issued after the effective date of the Sarbanes-Oxley Act of 2002. <u>See</u> 15 U.S.C. § 78p(a)(4). Under Sarbanes-Oxley, directors and officers transacting in their company's stock are required to file a Form 4 by the close of business the second day following the transaction. <u>See</u> <u>id.</u> at § 78p(a)(2)(c). "As this law was enacted, backdating became more difficult to pull off. Options grants had to be recorded with the SEC within two days of the grant date. This severely curtailed the ability to go back in time and change the grant date." <u>In re CNET</u>, 483 F. Supp. 2d at 961. In <u>In re Zoran Corp. Derivative Litig.</u>, 2007 U.S. Dist. Lexis 43402, *35-36 (N.D. Cal. June 5, 2007), Judge Alsup discussed the post-Sarbanes-Oxley Form 4 timing requirement in the context of backdating claims:

> This is not to say that backdating is completely impossible within a [Form 4] two-day window (particularly when there are intervening holidays), but only to say that on any given business day, the range of phony dates is restricted to only two for those who file <u>on time</u>. In order to reach back to even earlier phony dates, the Form 4 filer must submit the form late. Therefore, a late-filed Form 4 is a red flag. Particularly where there is no other indication that the grant was publically disclosed before it was reported to the SEC, a late-filed Form 4 is a warning indicator of backdating.

<u>Id.</u> (emphasis in original).

d. Option grants dated February 13, 2003

Plaintiffs allege that on February 13, 2003, 15,000 options each were granted to directors Higginson, Guelich, and Grinstein at an exercise price of $12.79. <u>See</u> Complaint at ¶70. February 13, 2003 was a Thursday. Under 15 U.S.C. § 78p(a)(2)(c), a Form 4 for options granted on February 13, 2003 should have been filed with the SEC by the close of business on February 17, 2003. Mr. Grinstein filed his Form 4 over a week late, on February 23, 2003. <u>See</u> Dkt. #60, Ex. K. Mr. Guelich filed his Form 4 a day late on February 18, 2003. <u>Id.</u> Mr.

Higginson, however, timely filed his Form 4 on February 15, 2003. Id. Given the fact that Mr. Higginson filed his Form 4 on time, plaintiffs have not shown for demand futility purposes that a majority of the directors received backdated grants on February 13, 2003.

e. Option grants dated April 29, 2004

Finally, plaintiffs allege that on April 29, 2004, 15,000 options each were granted to directors Higginson, Guelich, and Grinstein. See Complaint at ¶72. April 29, 2004 was a Thursday. Under 15 U.S.C. § 78p(a)(2)(c), a Form 4 for options granted on April 29, 2004 should have been electronically filed with the SEC by the close of business on May 3, 2003. See 15 U.S.C. § 78p(a)(4) (requiring that after July 30, 2003 all statements under section (a)(2) must be filed electronically). All three directors filed their Form 4's late on Thursday, May 6, 2004, a week after the April 29, 2004 grant date. See Dkt. #60, Ex. M.

These late filings, however, become insignificant when reviewed with the trajectory of F5's stock price after April 29, 2004.[10] Plaintiffs allege that the exercise price for these options was $28.10, which was the closing price of F5's stock on April 29, 2004. See Complaint at ¶72; Dkt. #60, Ex. B. Notably, the closing price on May 6, 2004, the day the directors filed their Form 4's was $26.90, $1.20 lower than the grant date. Accordingly, their options were "underwater" at the time of the SEC filing. See Dkt. #60, Ex. B. In fact, F5's stock closed lower in every trading day between April 29, 2004 and May 6, 2006, meaning the options were underwater the entire time between the grant date and the Form 4 filing date. Id. If the directors were attempting to backdate their options as plaintiffs contend, it is extremely unlikely that the directors would have looked into the past and chosen a day on which the price closed higher

[10] Plaintiffs are admonished for their misrepresentation of F5's April 29, 2004 stock price in the chart on page 42 of the Complaint. Based on the location of the arrow in this chart purportedly indicating the April 29, 2004 grant, it appears as if the April 29, 2004 grant was at a significant trough in price and suggests F5's stock closed below $27.00 on April 29. In fact, F5's stock closed at $28.10 on April 29, 2004 and was not a relative low point at all. F5's stock actually closed lower in the 16 trading days following April 29, 2004. When plotted properly, the April 29 price is not in a valley as plaintiffs' chart incorrectly suggests.

than the day on which the grant was recorded with the SEC. This decrease between the grant date and the date on which the transaction was filed with the SEC undermines any allegations that the April 29, 2004 grants were backdated.

3. Is there reasonable doubt that F5's Director Defendants are independent?

Having found that plaintiffs have failed to establish reasonable doubt that the Director Defendants are disinterested based on receipt of backdated options, the Court turns to the issue of whether plaintiffs have raised reasonable doubt that the Director Defendants are independent under the first part of Aronson's test. See Aronson, 473 A.2d at 814. "The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences." Beam, 845 A.2d at 1049. In their Complaint, plaintiffs allege that "[i]n order to bring this action for breaching their fiduciary duties, the members of the F5 Board of Directors would have been required to sue themselves and/or their fellow directors and allies in the top ranks of the Company, who are their personal friends and with whom they have entangling financial alliances, interests and dependencies, which they would not do." See Complaint at ¶154(i) (emphasis added). Plaintiff also alleges that "[c]ertain directors are also dominated and controlled by other directors and cannot act independently of them." Id. at ¶154(b) (emphasis added). These types of generalized allegations in the Complaint, however, are insufficient to create reasonable doubt that F5's Director Defendants lacked independence:

> [S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. . . . Not all friendships, or even most of them, rise to this level and the Court cannot make a reasonable inference that a particular friendship does so without specific factual allegations to support such a conclusion.

Beam, 845 A.2d at 1050 (emphasis in original); see Aronson, 473 A.2d at 816 (concluding that "[t]he shorthand shibboleth of 'dominated and controlled directors' is insufficient" to support a showing that directors lack independence).

To excuse pre-suit demand, "the plaintiff has the burden to plead particularized facts that create reasonable doubt sufficient to rebut the presumption" that the Director Defendants acted independently. Beam, 845 A.2d at 1050. Plaintiffs have not met this burden based on the generalized allegations in the Complaint.

4. Is there reasonable doubt as to whether the challenged conduct is protected by the business judgment rule?

Under the second part of the Aronson test, plaintiffs can establish that demand was futile if they plead particularized facts creating reasonable doubt that the option grants at issue were "the product of a valid exercise of business judgment." Aronson, 473 A.2d at 814. Plaintiffs allege that they have created reasonable doubt on this issue because "F5's Compensation Committee members – Higginson, Guelich, Grinstein and Malone – awarded backdated option grants" and that "there is reasonable doubt that the issuance of false and misleading proxy statements and financial results was a valid exercise of business judgment." See Response at 18, 25. The Court also reviews here plaintiffs' contention that demand was futile because the Director Defendants Higginson, Guelich, Grinstein, and Malone "face a substantial likelihood of liability" as members of F5's Compensation Committee and defendants Higginson, Guelich and Grinstein "face a substantial likelihood of liability based on their conduct as members of the Audit Committee." See Response at 20-24. Plaintiffs also contend that demand is excused because "[i]n order to properly prosecute this lawsuit, it would be necessary for the directors to sue themselves and . . . [t]his they will not do." See Complaint at ¶154(g).

The Court finds that plaintiffs have failed to plead particularized facts creating reasonable doubt whether the decisions surrounding the option grants at issue were a valid exercise of business judgment. First, "[i]t is no answer to say that demand is necessarily futile because (a) the directors 'would have to sue themselves, thereby placing the conduct of the litigation in hostile hands,' or (b) that they approved the underlying transaction." Brehm v. Eisner, 746 A.2d 244, 257 n.34 (Del. 2000) (quoting Aronson, 473 A.2d at 817-18). Second, plaintiffs provide no particularized allegations showing that Director Defendants Higginson, Guelich, Grinstein, and Malone chose the date on which the allegedly backdated options were to be granted or that they knew a grant's true date. See In re CNET, 483 F. Supp. 2d at 965. Plaintiffs' allegations that because Director Defendants Higginson, Guelich, Grinstein, and Malone were on the Compensation Committee and Audit Committee, they must have known, "do not constitute particularized facts." Id. at 966. "[W]here plaintiffs merely allege that approval was given without more, the facts pleaded simply do not support the inference that . . . board members were not independent or disinterested or that their decisions were not protected by the business judgment rule." Id.

Furthermore, plaintiffs' allegations that demand is excused because the Director Defendants face a likelihood of liability fails, because in Aronson, the court held that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterested of the directors" Aronson, 473 A.2d at 815. Accordingly, a "plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves." In re Sagent Tech., Inc., Derivative Litig., 278 F. Supp. 2d 1079, 1089 (N.D. Cal. 2003) (citations omitted).

Finally, even if as plaintiffs allege: (1) the Director Defendants who were also members of the Compensation Committee awarded the option grants at issue; and (2) the Director Defendants who were also members of the Audit Committee reviewed and approved financial statements and disclosures that included information about the grants; and (3) the Director Defendants issued Proxy Statements and financial results that included information about the grants, all of these allegations challenging whether the actions of the Director Defendants represent exercises of valid business judgment must be viewed against the backdrop of plaintiffs' failure to make a particularized showing that options were in fact backdated.[11] See Response at 20, 22, and 25. As discussed in Section II.B.2 above, plaintiffs have failed to show that the five grants of options received by the Director Defendants were backdated. Given that these grants represent five of the twelve challenged grants, plaintiffs have failed to support their strident claim that F5's "astonishing multi-year pattern of stock option grants on dates with highly favorable exercise prices . . . indicates that the purported grant dates of stock options were not the actual dates on which the option grants were made [but] [r]ather, the pattern indicates that the grants were repeatedly backdated to dates with exceedingly low stock prices." See Complaint at ¶60 (emphasis added). On this point, Judge Chesney's opinion in In re Linear Tech. Corp. Derivative Litig., 2006 U.S. Dist. Lexis 90986, at *8-9 (N.D. Cal. 2006), is instructive:

> With respect to the allegation of "backdating," the only factual allegation offered by plaintiffs is that on seven occasions over a period of seven years, stock options were dated "just after a sharp drop" in Linear's stock and "just before a substantial rise," which, plaintiffs allege, constitutes a "striking pattern that could not have been the result of chance." Because plaintiffs provide no facts as to how often and at what times the Committee Defendants have granted stock options in the past, no "pattern," let alone a "striking" one, is apparent.

It is the same in this case. Although plaintiffs here claim that options granted on twelve dates were backdated, plaintiffs failed to plead any facts as to when any other options were granted, or under what circumstances they were issued. Nor do they plead any particularized facts regarding the Director Defendants' actual involvement in granting the options. In their response, plaintiffs contend that the Complaint adequately alleges stock option backdating because they "employed a statistical model that combined those used by various academic articles that have studied stock option granting practices." See Response at 14. The Complaint

[11] For this reason, plaintiffs' argument that demand is futile in this case because "defendants' illegal stock option backdating was an ultra vires act" also fails. See Response at 27.

on its face, however, does not appear to be based on any type of statistical model.[12] The only reference to a statistical review is plaintiffs' assertion that "11 of the 25 stock option grants to F5's directors and top officers came at monthly lows in F5's share price. The odds of that happening by change [sic] are less than 1 in 90 million." See Complaint at ¶2; see also ¶8 ("[M]any stock option grants to F5's directors and top officers came at monthly lows in F5's share price. The odds of that happening by chance are less than 1 in 90 million."). Significantly, the 1 in 90 million and the "11 of the 25 stock option grants" figures are not tied to, or harmonized with, the other allegations in the Complaint.[13] Adding further confusion is the different allegation presented by plaintiffs on August 1, 2007 at oral argument. Instead of tracking the allegation in the Complaint that "11 of the 25" stock option grants occurred at monthly lows, at oral argument, plaintiffs now contend that there are publically disclosed grants by F5 on 32 different days and that grants on 10 of these days[14] are backdated because they occurred on days of the month when F5's stock closed at a relative monthly low. This lack of

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[12] In the Complaint, plaintiffs rely on an examination of the "20-day cumulative return based on the exercise price" as a metric to support their contention that grants on twelve specific dates have been backdated. See Complaint at ¶¶ 62 - 73. While the 20-day analysis may have been used in the articles cited by plaintiffs in the Complaint, in this case, the fact that the options granted on eight of the twelve dates were reported to the SEC before 20 closing days passed, renders the 20-day cumulative return analysis meaningless for these grants. See Dkt. #60, Ex. D, G - I, K - N (Forms 4, and one Form 3, for grant dates February 10, 2000; March 16, 2001; April 20, 2001; April 27, 2001; February 13, 2003; May 8, 2003; April 29, 2004; and April 30, 2004); Response at n.9 ("Stated differently, the stock price 20 days after the option grant date is only relevant for purposes of plaintiffs' claims if the defendants looked back from that 20th trading day to pick the exercise price.").

[13] Plaintiffs expressly contest grants on twelve specific dates. See Complaint at ¶9. Based on plaintiffs' allegations, seven of these twelve dates were the lowest closing price for the month, not eleven. Id. Furthermore, it is unclear what the "25 stock option grants" refers to. In paragraph 9 of the Complaint, plaintiffs contest 48 individual grants on the twelve suspect dates. Other than the cursory reference to 25 grants in paragraph 2, there are no other allegations connecting the reference to "25 stock option grants" to the rest of the Complaint.

[14] At oral argument, plaintiffs represented that on 7 of the 32 days when publically disclosed options were granted, F5's stock closed at the monthly low. Plaintiffs also represented that on 3 of the 32 days, F5's stock closed at the second lowest price for the month.

consistency in plaintiffs' claims undermines any particularized showing.

For all of these reasons, plaintiffs have failed to plead particularized facts creating reasonable doubt that the option grants at issue were the product of a valid exercise of business judgment.

5. Demand is required for claims raised under §14(a)

In their response, plaintiffs contend that even if they have failed to show that demand was excused as futile, the claims for false or misleading annual proxy statements raised under § 14(a) of the Exchange Act must be allowed to proceed because these claims do not require pre-suit demand. See Response at 29 (citing Vides v. Amelio, 265 F. Supp. 2d 273 (S.D.N.Y. 2003), for the proposition that demand is not required for a derivative §14(a) claim). Although the Ninth Circuit has not yet considered this issue, the weight of authority, including recent authority from the same district that decided Vides, has disregarded this argument. See In re IAC/InterActiveCorp Sec. Litig., 478 F. Supp. 2d 574, 606 n.17 (S.D.N.Y 2007) ("Because derivative plaintiffs' claim pursuant to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), is premised on the same allegations of wrongdoing, it is also dismissed for failure to plead demand futility with adequate particularity."); In re CNET, 483 F. Supp. 2d at 966 ("The weight of the authority supports requiring plaintiffs to make a demand or plead that demand was futile in alleging a claim under Section 14(a)"). Accordingly, the Court rejects plaintiffs' contention that their §14(a) proxy statement claims should proceed even without a particularized showing of demand futility.

6. F5's formation of the Special Committee does not excuse demand

Plaintiffs also argue that demand is excused in this case because they claim that F5 delegated control of this litigation to a Special Committee and state: "[b]y delegating the decision to the Special Committee to act for the Board in responding to the backdated stock option litigation, F5's directors implicitly acknowledged that the complete Board cannot disinterestedly make such a determination and that a pre-suit demand is not required." See

Response at 29. Plaintiffs' generalized allegations regarding F5's formation of a Special Committee to conduct a review of the company's stock option practices, however, does not excuse demand.

"[A] disinterested board of directors does not waive its right to control derivative litigation merely by delegating that control to a special committee. For this Court to find that a board of directors conceded the futility of demand, a derivative plaintiff must allege particularized facts that support a factual finding that the board made the concession." Seminaris v. Landa, 662 A.2d 1350, 1353 (Del. Ch. 1995). In this case, F5's Special Committee was formed two weeks before the lawsuit was filed and, based on the disclosure in F5's 2005 Form 10-K/A, it had authority to "conduct a review of [F5's] stock option practices, including a review of [F5's] underlying stock option documentation and procedures"). See Dkt. #50, Ex. B. There has been no showing by plaintiffs that in forming this committee, the Director Defendants intended to concede the futility of demand.

Plaintiffs' reliance on Abbey v. Computer & Comm. Tech. Corp., 457 A.2d 368 (Del. Ch. 1983) is unavailing. In Abbey, the plaintiff made demand on the board and then filed suit claiming that demand was excused. Id. at 370. In response to the demand, the board established a one-man special litigation committee. Id. at 371. Here, plaintiffs did not make a demand, and F5's Special Committee was formed before the lawsuit was filed, not in the face of plaintiffs' lawsuit or a demand. See Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990) (rejecting the argument that "Abbey stands for the proposition that a board of directors, ipso facto, waives its right to challenge a shareholder plaintiff's allegation that demand is excused by the act of appointing a special litigation committee"). Furthermore in allowing the suit to proceed, the Abbey court distinguished a scenario where, as here, a board "appointed a committee to investigate the allegations and to report back to the board for whatever action the board might choose to take on the merits of the charges[.]" Abbey, 457 A.2d at 374.

The other cases cited by plaintiffs are also distinguishable. In Peller v. Southern Co., 911

F.2d 1532, 1537 (11th Cir. 1990), a committee was appointed after the lawsuit was filed and the board "delegated to it the sole authority to evaluate the merits of the suit and determine the Companies' response." Similarly, in In re FirstEnergy S'holder Derivative Litig., 320 F. Supp. 2d 621, 627 (N.D. Ohio 2004), an "independent committee" was formed after the complaint was filed. In this case, the Special Committee was in place to review F5's stock option practices before the lawsuit was filed, and there are no facts showing that the Committee was charged with evaluating the merits of the lawsuit after it was filed. Therefore, plaintiffs' argument that F5's formation of the Special Committee excused demand fails.

III. CONCLUSION

For all of the foregoing reasons, the Court finds that it would not have been futile for plaintiffs to make a demand on F5's directors. Accordingly, the Court GRANTS defendant "F5 Networks, Inc.'s Motion to Dismiss for Failure to Make Demand" (Dkt. #49). Plaintiffs are granted LEAVE TO AMEND their Complaint within twenty (20) days from the date of this order.

DATED this 6th day of August, 2007.

Robert S. Lasnik
United States District Judge