

RECEIVED
SUPREME COURT
STATE OF WASHINGTON
15th 5:00 PM
2008 SEP 16 A.S.T.O

9-15-08
2008 P 5:00
By R. Carpenter
CLERK LT.

BY RONALD R. CARPENTER
United States District Court
Western District of Washington No. C06-0794 RSL
CLERK

SUPREME COURT
OF THE STATE OF WASHINGTON

Glenn Hutton, et al., Plaintiffs,

v.

John McAdam, et al., Defendants,

and

F5 Networks, Inc., Nominal Defendant.

OPENING BRIEF OF NOMINAL DEFENDANT
F5 NETWORKS, INC.

Stellman Keehnel, WSBA No. 9309
Brian D. Buckley, WSBA No. 26423
Kit W. Roth, WSBA No. 33059

DLA PIPER LLP (US)
701 Fifth Avenue, Suite 7000
Seattle, WA 98104
Ph: 206-839-4800
Facsimile: 206-839-4801

Attorneys for Nominal Defendant
F5 Networks, Inc.

TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION AND RELIEF REQUESTED	1
II. QUESTIONS CERTIFIED.....	3
III. STATEMENT OF THE CASE.....	3
IV. AUTHORITY AND ANALYSIS	6
A. Demand Is A Fundamental And Essential Corporate Principle.....	6
B. Washington Does Not Recognize “Demand Futility”.....	9
1. Washington Courts Have Never Adopted Or Applied A “Futility” Exception To The Demand Requirement.....	9
2. Washington’s Statute And Civil Rule Are Procedural And Do Not Imply A Demand Futility Exception.....	15
C. Washington Should Affirm A “Universal Demand” Requirement.....	20
1. The Overwhelming National Trend Is To Adopt “Universal Demand” And Reject Demand Futility.....	20
a. Universal Demand Helps Prevent Improper Strike Suits.....	22
b. Universal Demand Permits Even An “Interested” Board To Take Proper Action.....	25

TABLE OF CONTENTS

(Continued)

c. Universal Demand Avoids
Expensive Litigation On Collateral
Issues.....27

2. Washington Should Follow The National Trend.....29

D. Washington Should Reject Delaware’s Demand Futility
Standard.....31

1. Washington Has Never Looked to Delaware For
Guidance On Derivative Issues.....32

2. Courts And Commentators Have Denounced
Delaware’s Unusual And Flawed Demand Futility
Standard.....35

3. The Court Could Recognize A Demand “Futility”
Notion But Still Reject Delaware’s Formulation.....39

E. *Maxim* Is A Dangerous Anomaly And Should Be
Rejected.....45

V. CONCLUSION.....50

APPENDIX

A:1 July 3, 2008 Order Certifying Question To The
Washington Supreme Court [Record No. 98]

A:2 May 20, 2008 Order To Show Cause [Record No. 92]

TABLE OF CONTENTS
(Continued)

- A:3 Dr. Reno Comolli et al., *Options Backdating: The Statistics of Luck*, NERA Economic Consulting (Securities/Finance Practice) (March 8, 2007) [Record No. 60, Ex. A]
- A:4 Nominal Defendant F5 Networks, Inc.'s Motion To Dismiss For Failure to Make Demand [Record No. 49]
- A:5 Nominal Defendant F5 Networks, Inc.'s Reply On F5 Networks, Inc.'s Motion To Dismiss For Failure To Make Demand [Record No. 59]
- A:6 Nominal Defendant F5 Networks, Inc.'s Motion to Dismiss Amended Complaint For Failure to Make Demand [Record No. 80]
- A:7 Reply In Support of Nominal Defendant F5 Networks, Inc.'s Motion To Dismiss Amended Complaint For Failure To Make Demand [Record No. 89]

TABLE OF AUTHORITIES

	Page(s)
CASES	
<i>Aronson v. Lewis</i> , 473 A.2d 805 (Del. 1984).....	passim
<i>Ballard Square Condo. Owners Ass'n v. Dynasty Constr. Co.</i> , 158 Wn.2d 603, 146 P.3d 914 (2006).....	15
<i>Boland v. Engle</i> , 113 F.3d 706 (7 th Cir. 1997).....	17, 24, 26, 41
<i>Casey v. Brennan</i> , 780 A.2d 553 (N.J. Super. 2001).....	32, 36
<i>Croy Const. Co. v. Whatcom-Skagit Crane Serv., Inc.</i> , 3 Wn. App. 222, 473 P.2d 438 (1970).....	6
<i>Cuker v. Mikalauskas</i> , 547 Pa. 600, 692 A.2d 1042 (1997).....	23
<i>Desimone v. Barrows</i> , 924 A.2d 908 (Del. Ch. 2007).....	50
<i>Elliott v. Puget Sound Wood Prod. Co.</i> , 52 Wash. 637, 101 P. 228 (1909).....	passim
<i>Equipto Div. Aurora Equip. Co. v. Yarmouth</i> , 134 Wn.2d 356, 950 P.2d 451 (1998).....	33
<i>Golconda Mining Corp. v. Hecla Mining Co.</i> , 80 Wn.2d 372, 494 P.2d 1365 (1972).....	33
<i>Goodman v. Darden, Doman & Stafford Assoc.</i> , 100 Wn.2d 476, 670 P.2d 648 (1983).....	33
<i>Goodwin v. Castleton</i> , 19 Wn.2d 748, 144 P.2d 725 (1944).....	7, 8

<i>Haberman v. Wash. Pub. Power Supply Sys.</i> , 109 Wn.2d 107, 744 P.2d 1032 (1987).....	7, 14, 39
<i>Hay v. Hay</i> , 38 Wn.2d 513, 230 P.2d 791 (1951).....	34
<i>Henry George & Sons, Inc. v. Cooper-George, Inc.</i> , 95 Wn.2d 944, 632 P.2d 512 (1981).....	33
<i>In re CNET Networks, Inc.</i> , 483 F. Supp. 2d 947 (N.D. Cal. 2007).....	52
<i>In re Cray</i> , 431 F. Supp. 2d 1114 (W.D. Wash. 2006)	5, 16, 31
<i>In re F5 Networks, Inc. Deriv. Litig.</i> , slip op., No. C06-794 RSL, 2007 WL 2476278 (W.D. Wash. Aug. 6, 2007).....	49, 49, 50
<i>In re Guidant S'holders Deriv. Litig.</i> , 841 N.E.2d 571 (Ind. 2006).....	passim
<i>Interlake Porsche & Audi, Inc. v. Buchholz</i> , 45 Wn. App. 502, 728 P.2d 597(1986).....	9
<i>Jones v. Reed</i> , 3 Wash. 57, 27 P. 1067 (1891)	7, 32
<i>Kamen v. Kemper Fin. Serv., Inc.</i> , 500 U.S. 90 (1991)	14, 17
<i>Kneeland Inv. Co. v. Berendes</i> , 81 Wash. 372, 142 P. 869 (1914)	13
<i>LaHue v. Keystone Inv. Co.</i> , 6 Wn. App. 765, 496 P.2d 343 (1972).....	passim
<i>Lang v. Hougan</i> , 136 Wn. App. 708, 150 P.3d 622 (2007).....	33
<i>McCormick v. Dunn & Black</i> , 140 Wn. App. 873, 167 P.3d 610 (2007).....	6, 33

<i>Nursing Home Bldg. Corp. v. DeHart</i> , 13 Wn. App. 489, 535 P.2d 137 (1975).....	6, 7, 26
<i>Peck v. Linney</i> , 97 Wash. 103, 165 P. 1080 (1917)	9
<i>Rabkin v. Philip A. Hunt Chem. Corp.</i> , 498 A.2d 1099 (Del. 1985).....	36
<i>RCL Northwest, Inc. v. Colorado Res., Inc.</i> , 72 Wn. App. 265, 864 P.2d 12 (1993).....	23, 30
<i>Reimel v. MacFarlane</i> , 9 F. Supp. 2d 1062 (D. Minn. 1998).....	47
<i>Ryan v. Gifford</i> , 918 A.2d 341 (Del. Ch. 2007)	passim
<i>Sanders v. E-Z Park, Inc.</i> , 57 Wn.2d 474, 358 P.2d 138 (1960).....	9
<i>Schwartzman v. McGavick</i> , slip op., No. C06-1080P, 2007 WL 1174697	5, 17
<i>Schwarzmann v. Ass'n of Apartment Owners</i> , 33 Wn. App. 397, 655 P.2d 1177 (1982).....	5, 6
<i>Seattle & N. Ry. Co. v. Bowman</i> , 53 Wash. 416, 102 P. 27 (1909)	8
<i>Seattle Trust & Sav. Bank v. McCarthy</i> , 94 Wn.2d 605, 617 P.2d 1023 (1980).....	34
<i>Sound Infinity v. Snyder</i> , 186 P.3d 1107 --- Wn. App. --- (June 23, 2008)	33
<i>Starrels v. First Nat. Bank of Chicago</i> , 870 F.2d 1168 (7 th Cir. 1989) (Easterbrook, J., concurring)	passim
<i>Sternberg v. O'Neil</i> , 550 A.2d 1105 (Del. 1988).....	36

<i>Washington Equip. Mfg. Co. v. Concrete Placing Co.</i> , 85 Wn. App. 240, 931 P.2d 170 (1997).....	34
<i>Wayne Pike Co. v. Hammons</i> , 27 N.E. 487 (Ind. 1891).....	41
<i>Werbowsky v. Collomb</i> , 766 A.2d 123 (Md. 2001).....	21, 28, 47
<i>Williams v. Erie Mountain Consol. Min. Co.</i> , 47 Wash. 360, 91 P. 1091 (1907).....	passim

STATUTES

8 Del. C. § 144.....	34
8 Del. C. § 170.....	34
8 Del. C. § 203.....	34
8 Del. C. § 211.....	34
8 Del. C. § 228.....	34
8 Del. C. § 242.....	34
8 Del. C. § 262.....	34
8 Del. C. § 271.....	34
Ariz. Rev. Stat. Annot. § 10-742.....	22
Conn. Gen. Stat. Annot. § 33-722.....	22
County Law.....	24
County Law. 34, 37 (2004).....	21
Fla. Stat. Annot. § 607.07401.....	22
Ga. Code Annot. § 14-2-742.....	22

Haw. Rev. Stat. § 414-173.....	22
Idaho Code Ann. § 30-1-742	22
Iowa Code § 490.742.....	22
Mass. Gen. Laws ch. 156D, § 7.42.....	22
Me. Rev. Stat. Ann. tit. 13-C, § 753	22
Mich. Comp. Laws § 450.1493a.....	22
Miss. Code Annot. § 79-4-7.42	22
Mont. Code Annot. § 35-1-543	22
N.C. Gen. Stat. § 55-7-42	22
Neb. Rev. Stat. § 21-2072.....	22
R.I. Gen. Laws § 7-1.2-711	22
RCW 23B.06.400	34
RCW 23B.07.020	34
RCW 23B.07.040	34
RCW 23B.07.260	34
RCW 23B.07.400	passim
RCW 23B.08.010	6
RCW 23B.08.250	25, 30
RCW 23B.08.700-720	34
RCW 23B.10.010-030	34
RCW 23B.11.030	34
RCW 23B.12.020	34

RCW 23B.13.020	34
RCW 23B.13.220	34
RCW 23B.19.020	34
RCW 23B.19.040	34
S.D. Codified Laws § 47-1A-742	23
Stat. Annot. § 293-A:7.42.....	23
Tex. Bus. Orgs. Code Ann. § 21.553.....	23
Utah Code Ann. § 16-10a-740(3).....	23
Va. Code Annot. § 13.1-672.1.....	23
Wis. Stat. Annot. § 180.0742.....	23
Wyo. Stat. Ann. § 17-16-742.....	23

OTHER AUTHORITIES

American Law Institute, <i>Principles of Corporate Governance: Analysis and Recommendations</i> , § 7.03 (1994).....	passim
Block & Prussin, <i>Termination of Derivative Suits Against Directors on Business Judgment Grounds: From Zapata to Aronson</i> , 39 Bus. Law. 1503, 1506 (1984).....	54
Bradley T. Ferrell, <i>A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation</i> , 60 Ohio St. L.J. 241 (1999)	23, 24, 28
Brian L. Levine, <i>Delaware Raises The Bar For Pleading Stock Option Manipulation</i> Bus. L. Today 65 (Sept./Oct. 2007).....	53

Bryan Stanfield, <i>For Better or For Worse?: Marriage of the Texas and Model Business Corporation Act's Derivative Action Statutes and What it Means for Corporations</i> , 35 Tex. Tech L. Rev. 347 (2004)	23
Carol B. Swanson, <i>Juggling Shareholder Rights and Strike Suits in Derivative Litigation</i> , 77 Minn. L. Rev. 1339 (1993)	passim
Civil Rule 23.1	passim
Corporate Act Revision Committee Analysis and Comments to the New Washington Business Corporation Act, RCW 23B.07.400, (1990).....	16
Delaware Chancery Rule 23.1	32
Federal Rule of Civil Procedure 23.1	passim
Dr. Reno Comolli et al., <i>Options Backdating: The Statistics of Luck, NERA Economic Consulting (Securities/Finance Practice) March 8, 2007</i>	47
Jeffrey S. Facter, <i>Fashioning a Coherent Demand Rule for Derivative Litigation in California</i> , 40 Santa Clara L. Rev. 379, 400-01 (2000)	passim
John C. Coffee, <i>New Myths and Old Realities: The American Law Institute Faces the Derivative Action</i> , 48 Bus. Law. 1407 (1993).....	37, 54
Justice Jack B. Jacobs, <i>The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay</i> , 41 Suffolk U. L. Rev. 1 (2007).....	39
Mary Siegel, <i>Changes in the Model Business Corporation Act – Amendments Pertaining to Derivative Proceedings</i> , 44 Bus. Law. 543 (1998)	21, 23, 28, 30
OFFICIAL LEGISLATIVE HISTORY, Senate Journal 51st Leg., App. A, 3030 (1989).....	16, 18
Peter M. Stone & Jay C. Gandhi, <i>The “Clone” Derivative Lawsuit</i> , 46-JUL Orange County Law. 34 (2004).....	20, 22

RAP 16.16(e)(1) 1

I. INTRODUCTION AND RELIEF REQUESTED

This proceeding is before the Court as the result of an Order Certifying Question To The Washington State Supreme Court, issued by the United States District Court for the Western District of Washington (Hon. R. Lasnik) on July 3, 2008 (“Certification Order”) [Record No. 98; Appendix (App.) No. 1]. F5 Networks, Inc. (“F5”) respectfully submits this opening brief addressing the certified issues.¹

This certification proceeding will conclusively establish a fundamental and pivotal element of Washington corporate law. At issue are shareholder derivative proceedings and the precise contours of the rule that a shareholder must make demand on corporate management before attempting to sue on the corporation’s behalf. The Court’s holdings will determine whether Washington remains a state where decisions regarding corporate affairs are properly reserved for corporate management, or becomes a disfavored state of incorporation because the derivative mechanism is expanded to usurp normal corporate governance.

The Court is called upon here to consider one core issue and two subsidiary issues, all currently unaddressed by Washington law. The core issue is this: When a corporate shareholder seeks to commence derivative litigation on behalf of a corporation, does Washington require the shareholder to first make demand on corporate management as a prerequisite to bringing suit (referred to as the “universal demand” requirement), or does Washington excuse a shareholder from making

¹ In the Certification Order, the District Court designated F5 — which is the nominal defendant in the underlying putative derivative action pending in the District Court — as the party to file the opening and reply briefs in this proceeding, pursuant to RAP 16.16(e)(1). *See* Certification Order at 3.

demand where such demand would be effectively “futile” (referred to as the “demand futility” exception)? This basic debate — whether to recognize demand futility or instead require universal demand — has been playing out across the nation for over two decades. The overwhelming national trend, well-recognized by courts and commentators alike, is to reject the notion of demand futility and embrace universal demand. The justifications supporting a universal demand requirement, discussed in detail in this opening brief, are compelling. Moreover, those justifications advance the fundamental principle of Washington corporate governance that decisions on corporate affairs — including whether to pursue litigation — are reserved for duly elected corporate directors. For that basic reason, derivative proceedings in Washington have always been highly disfavored, and the Court should continue to tightly circumscribe the circumstances in which a single shareholder is permitted to hijack the proper role of corporate management.

If the Court declines to affirm a universal demand requirement, the two subsidiary issues before the Court are these: Does Washington follow Delaware’s standard for evaluating “demand futility”? If Washington *does* follow Delaware law, does Washington also adopt the reasoning of a specific Delaware trial court opinion: *Ryan v. Gifford* (or “*Maxim*”? As to the first question, there is no reason for Washington to adopt Delaware’s “demand futility” standards. Washington has never previously looked to Delaware for guidance on issues related to derivative proceedings; Washington does not routinely hew to Delaware law on corporate matters; and Delaware’s “demand futility” standards have been vigorously criticized by commentators and courts across the country.

As to the second question, even if the Court were generally to look to Delaware for guidance on demand futility, the Court should reject the *Maxim* decision because it is based on grossly flawed reasoning and it undermines the core precepts of Washington law on corporate governance.

F5 respectfully urges the Court to affirm a standard universally requiring a shareholder to make demand on corporate management as a prerequisite to commencing derivative proceedings, except in those rare instances where making demand would cause “irreparable injury” to the corporation or demand would be objectively impossible to effectuate.

II. QUESTIONS CERTIFIED

In the Certification Order, the District Court certified the following questions to this Court for resolution:

What test does Washington apply to determine whether allegations made pursuant to RCW 23B.07.400(2) by a shareholder seeking to initiate derivative litigation on behalf of a Washington corporation excuse that shareholder from first making demand on the board of directors to bring that litigation on behalf of the corporation?; and

If Washington follows Delaware’s demand futility standard, does it also follow the reasoning of Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) in cases where the improper backdating of stock options has been alleged?

Certification Order at 2.²

III. STATEMENT OF THE CASE

This lawsuit is part of the wave of options “backdating” litigation that flooded the nation’s courts in 2006. “Backdating” is the practice of fraudulently selecting, with the benefit of hindsight, an exercise price for

² The District Court also stated: “The Court does not intend its framing of the question to restrict the Washington State Supreme Court’s consideration of any issues that it determines are relevant. If the Washington State Supreme Court decides to consider the certified question, it may in its discretion reformulate the question.” *Id.* at 2-3.

stock options that is below fair market value, thereby artificially rendering the options “in-the-money” and bestowing a financial benefit on the option recipient. The focus on options “backdating” was sparked by a March 18, 2006 article in *The Wall Street Journal*, and subsequent studies conducted by Merrill Lynch and others, which purported to identify “abnormal” and “improbable” options patterns by U.S. public companies, where option grants tended to coincide with low points in a company’s stock price.

In June and July 2006, F5 was sued as a nominal defendant in six putative shareholder derivative actions in Washington, based on alleged fraudulent “backdating” of stock options. In *none* of the putative derivative actions did the plaintiff shareholders make demand on the F5 Board of Directors. Three of the derivative actions were consolidated in the United States District Court for the Western District of Washington, before the Hon. Robert Lasnik. It is that consolidated action from which this certification issued. *See* District Court’s May 20, 2008 Order To Show Cause (“Show Cause Order”) at 2 [Record No. 92; App. No. 2].³

In February 2007, F5 moved to dismiss the consolidated complaint in the federal action, on the grounds that plaintiffs had failed to make demand on the F5 Board before attempting to proceed derivatively on the Company’s behalf. In their consolidated complaint, and in opposition to F5’s dismissal motion, plaintiffs argued that their failure to make demand should be excused because demand would have been “futile.” In analyzing demand futility issues, the parties relied on Delaware law, because prior District Court cases had done so. *See* Show Cause Order

³ The remaining three derivative actions were consolidated in the Superior Court of Washington for King County, before the Hon. William Downing. On April 3, 2007, Judge Downing stayed the consolidated state court action in favor of the federal action.

at 5 (citing *In re Cray*, 431 F. Supp. 2d 1114, 1120 (W.D. Wash. 2006); *Schwartzman v. McGavick*, slip op., No. C06-1080P, 2007 WL 1174697, *4, Fed. Sec. L. Rep. P 94,310 (W.D. Wash. April 19, 2007)).

On February 6, 2007, three weeks before F5's initial dismissal motion was filed, the Delaware Chancery Court (Chancellor Chandler) issued an order in the Maxim Integrated Products derivative litigation — which also involves alleged “backdating” of stock options — referred to herein as the *Maxim* opinion (*Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007)). As discussed further in Section IV(E) below, the *Maxim* decision establishes an unreasonably low threshold for would-be derivative plaintiffs to plead demand futility. In opposition to F5's motion, plaintiffs relied entirely on *Maxim* in arguing that demand on the F5 Board was “futile.” F5 argued that the *Maxim* decision was inconsistent with decades of corporate law and wrongly decided, and that the District Court should decline to follow *Maxim*. On August 6, 2007, the District Court granted F5's dismissal motion and dismissed plaintiffs' initial consolidated complaint with leave to amend. Judge Lasnik implicitly rejected the *Maxim* reasoning and held plaintiffs to a much higher standard for pleading demand futility. *See* Show Cause Order at 5-6.

On September 14, 2007, plaintiffs filed an amended consolidated complaint. In November 2007, F5 filed a motion to dismiss the amended complaint, on the grounds that plaintiffs still had not established that demand on F5's Board would have been futile. On May 20, 2008, while F5's motion to dismiss the amended complaint remained pending, the District Court issued the Show Cause Order. Judge Lasnik noted that there is no Washington state law addressing whether Washington

recognizes a “futility” exception to the demand requirement, and observed that the District Court’s assumption that a Washington court would apply Delaware law to corporate matters involving a Washington corporation was pure “speculation.” Show Cause Order at 5-6.

On July 3, 2008, (over plaintiffs’ objection) the District Court issued the Certification Order, which led to this proceeding.

IV. AUTHORITY AND ANALYSIS

A. Demand Is A Fundamental And Essential Corporate Principle.

Underpinning and informing every element of the analysis the Court must undertake in this proceeding is one bedrock principle of corporate governance: a corporation’s affairs are overseen, managed, and controlled by its directors and officers. *McCormick v. Dunn & Black*, 140 Wn. App. 873, 895, 167 P.3d 610 (2007); *Croy Const. Co. v. Whatcom-Skagit Crane Serv., Inc.*, 3 Wn. App. 222, 224, 473 P.2d 438 (1970); *see also* RCW 23B.08.010(2). All decisions regarding corporate operations are entrusted to the discretion of duly elected corporate management. *Id.* Because that discretion is so fundamental to the orderly conduct of corporate activities, Washington courts are extremely reluctant to second-guess or invalidate decisions made by corporate directors or officers within the scope of their authority. *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”); *Nursing Home Bldg. Corp. v. DeHart*, 13 Wn. App. 489, 498, 535 P.2d 137 (1975).

The exclusive authority of corporate management to govern corporate affairs — and the appropriate reticence of Washington courts to interfere

with or supplant the judgment of corporate directors and officers — necessarily encompasses whether the corporation should commence or proceed with litigation. *Goodwin v. Castleton*, 19 Wn.2d 748, 763, 144 P.2d 725 (1944). Derivative proceedings thwart these bedrock principles of corporate governance because, by suing derivatively, a single shareholder usurps the role of corporate management to determine whether litigation is in the best interests of the corporation and all its shareholders. Consequently, “[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) (citing *LaHue v. Keystone Inv. Co.*, 6 Wn. App. 765, 777, 496 P.2d 343 (1972)). Because it goes to the heart of the Court’s analysis here, the point bears repeating: derivative proceedings are the *rare and disfavored exception* to fundamental rules of corporate governance.

In Washington, derivative litigation is a judicial creation, grounded in equity and first recognized by Washington courts over a century ago. See, e.g., *Jones v. Reed*, 3 Wash. 57, 27 P. 1067 (1891); *Elliott v. Puget Sound Wood Prod. Co.*, 52 Wash. 637, 101 P. 228 (1909). A shareholder’s ability to proceed derivatively has always been treated as an extraordinary carve-out from the general authority of corporate management to control corporate affairs. As such, from the very inception of the derivative mechanism, Washington courts have required a would-be derivative plaintiff to first make demand on corporate management to take the desired action:

[I]t is manifest that corporations which do their business through the officers of the corporation, in the absence of fraud or oppression, must be allowed to transact their own business and

settle their own difficulties; the duty of the stockholder being to bow to the will of the majority as expressed through their agents. ... *[B]efore the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show, to the satisfaction of the court, that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He 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, 52 Wash. at 641-43 (emphasis added). In short, *the rule is that a shareholder must first make demand*, for compelling reasons:

The mere fact that a corporation has a cause of action for an injury does not always make it incumbent upon it to sue, any more than in the case of an individual. *If, in the opinion of the directors or a majority of the stockholders, the best interests of the company do not require it to sue, it need not do so. ... The exercise of such discretion by the directors will not be lightly set aside by the court* [O]therwise, by this [derivative] device the corporation, its officers, and directors, and the majority stockholders would at once be conclusively shorn of their powers of management and discretion in the conduct of those affairs which are of vital concern to the corporation and all its stockholders.

Goodwin, 19 Wn.2d at 762-63 (internal quotations omitted; emphasis added).⁴ See also *Seattle & N. Ry. Co. v. Bowman*, 53 Wash. 416, 420, 102 P. 27 (1909) (“The management of corporate affairs is properly vested in a board of directors, and it is against the policy of the law to permit stockholders as such to usurp their functions. ... They should not be permitted to resort to the courts in their capacity as stockholders, unless

⁴ The Washington requirement that a would-be derivative plaintiff, as a prerequisite to bringing suit, make demand on corporate management is hardly novel or unique. Every state in the country requires such demand as a general matter. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03, Comment (a) at 54 (1994). The question (and the crux of this proceeding) is the degree, if any, to which a particular state will recognize demand as being *excused*.

the remedies thus sought are denied them by the officers and directors of the corporation itself").⁵

In summary, in Washington, the entire concept of derivative litigation is grounded in the common law (as opposed to statute or court rule, as in some states). Washington courts view the derivative concept skeptically and with disfavor because it undermines fundamental corporate governance principles. And, for a century, Washington has consistently required a shareholder to make demand on corporate management before attempting to proceed derivatively on the corporation's behalf.⁶

B. Washington Does Not Recognize "Demand Futility."

1. Washington Courts Have Never Adopted Or Applied A "Futility" Exception To The Demand Requirement.

Plaintiffs may argue that, in the early stages of the development of Washington's jurisprudence regarding shareholder derivative litigation, Washington courts allowed that a would-be derivative plaintiff might be

⁵ *Accord Williams v. Erie Mountain Consol. Min. Co.*, 47 Wash. 360, 361-62, 91 P. 1091 (1907) ("It may be admitted that as a general rule, before a stockholder can be permitted to sue or defend on behalf of a corporation, he must show that he has exhausted all means within his reach to obtain within the corporation itself the redress of his grievances ..."); *see also Sanders v. E-Z Park, Inc.*, 57 Wn.2d 474, 476, 358 P.2d 138 (1960) (same); *Peck v. Linney*, 97 Wash. 103, 106, 165 P. 1080 (1917) (same); *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wn. App. 502, 506, 728 P.2d 597(1986) (same).

⁶ In its Show Cause Order, the District Court made the erroneous statement that the Washington courts have not "adopted a substantive demand requirement." Show Cause Order at 4. As is clear from the cases above, Washington has recognized and enforced a substantive demand requirement for at least a century. F5 respectfully submits that the District Court intended to state that Washington has never adopted a substantive demand futility *exception* to the substantive demand requirement. That conclusion is bolstered by the District Court's reference to a statement made by F5's counsel at oral argument, noting "the absence of Washington law concerning the substantive standard for when demand is *excused*." Show Cause Order at 4 n.1 (emphasis added). The District Court is correct that the Washington courts do not recognize a demand futility exception to the demand requirement. But it is beyond legitimate dispute that demand is a prerequisite to derivative litigation in Washington (as it is, as a threshold matter, in every state).

excused from making demand on corporate management if such demand would be “futile” or “useless.” But a careful analysis of the Washington cases reveals that Washington did *not* ultimately adopt, but in fact rejected, a “futility” exception to the demand requirement. Moreover, even if the early Washington cases *had* recognized the possibility of demand futility, that doctrine has not carried through to Washington’s modern law of corporate governance and should have no remaining vitality in light of prevailing trends in the law of derivative litigation.

Plaintiffs are likely to rely upon this Court’s 1907 decision in *Williams v. Erie Mountain Consolidated Mining Co.* In *Williams*, shareholders of a mining company brought a derivative action against certain officers of the company, alleging that the officers had engaged in an elaborate scheme to fraudulently divert the company’s assets for their own gain. 47 Wash. at 360. The defendants sought dismissal of the action on the grounds, in part, that the plaintiff shareholders had failed to make demand on the corporation to bring suit, which precluded the plaintiffs from proceeding derivatively. The Court affirmed the general demand requirement, *i.e.*, that “before a stockholder can be permitted to sue or defend on behalf of a corporation, *he must show that he has exhausted all means within his reach to obtain within the corporation itself the redress of his grievances, or action in conformity to his wishes*, and that the managing body of the corporation has refused to sue or defend, as the case may be.” *Id.* at 361 (emphasis added).

The Court declined to dismiss the derivative action, but on specific grounds: “It seems to us that the complaint in this case shows a state of facts that is *equivalent to a showing that the corporate authorities or*

those in control refuse to act.” 47 Wash. at 362 (emphasis added). The Court noted that the plaintiffs and their counsel had repeatedly demanded access to the corporate books and records — in an attempt to unravel the twisted financial condition of the company — and the defendants had steadfastly refused to grant such access. *Id.* at 362-63. Because the defendants were actively thwarting the shareholders’ affirmative efforts to seek redress, the plaintiffs were “practically helpless so far as any action within the corporation is concerned.” *Id.* at 363. In short, based on the specific facts of that case, the *Williams* Court apparently concluded that demand had been made on the corporation and constructively rejected.

In discussing the general demand requirement standards, the *Williams* Court quoted a treatise acknowledging a form of futility exception: “In the state courts it is generally held that a stockholder may excuse a failure to demand corporate action by showing that the persons charged with the wrongdoing, and who would be parties defendant to the action, are still in control of the corporation as directors, or that the wrongdoers control a majority of the board of directors, or by proof of any other facts which clearly show that a demand for corporate action would have been useless.” 47 Wash. at 363 (quoting 26 Am. & Eng. Enc. of Law, at 978 (2d ed. 1904)). But the Court did *not* expressly adopt that exception, nor apply it to the facts of the case. Instead, the Court proceeded to quote from a different treatise having nothing to do with demand futility, but addressing the specific instances in which a derivative action is appropriate. *Id.* (quoting 10 Cyclopaedia of Law and Procedure, 967 (1904)). The Court then sustained the complaint on the grounds that the plaintiffs had adequately pled “that the assets of the corporation have been fraudulently

diverted into the hands of individual shareholders, and that the officers are not acting in any faithful discharge of their duties” *Id.* at 364. In other words, the Court denied dismissal because the plaintiffs had stated a cause of action sufficient to unwind the corporate actions at issue. There was no further discussion of the theoretical demand futility exception, because the Court assumed there had been a *de facto* refusal of the shareholders’ demand; thus, the reference to the futility exception was merely dictum.

Any doubt regarding whether the *Williams* decision recognized a futility exception to the demand requirement was resolved by this Court’s 1909 decision in *Elliott v. Puget Sound Wood Products Co.* Reminiscent of *Williams*, in *Elliott*, shareholders of a lumber company filed a derivative action against certain officers of the company, alleging that the officers had executed a complicated scheme to fraudulently transfer ownership and assets of the company to themselves. 52 Wash. at 638. The Court, on its own initiative, invoked the demand requirement, affirming that “a bill by one or more shareholders ...*cannot be maintained* unless it shows that the plaintiffs have *exhausted every means of putting the corporation in motion.*” *Id.* at 641 (emphasis added). The Court referenced certain non-Washington cases, relied upon by the plaintiffs, standing for the proposition that “the stockholder is permitted to appeal to the courts without first seeking redress from the corporation itself, for instance, where the facts stated conclusively show that an application to the corporation would be useless.” *Id.* But the Court refused to adopt or apply any such exception and strictly enforced the demand requirement, noting that the requirement “is founded on general principles of justice and of necessity in the transaction of corporate business.” *Id.*

The *Elliott* Court also rejected the plaintiffs' argument that demand should be excused because the corporate officers were the alleged wrongdoers "and therefore a court of equity will interfere at the suit of a shareholder without any proof or allegation of a demand upon such agents, for a demand would ordinarily be nugatory under these circumstances." 52 Wash. at 642. (This is the same principle quoted, though not expressly adopted, by the Court in *Williams*, *i.e.*, that demand is excused where the defendants are the same individuals upon whom demand would be made.) In rejecting that argument, the *Elliott* Court observed that "every grievance in a corporation may arise from the acts of its agents or directors, and that, if the position of the appellants is tenable, the general rule [requiring demand] would be destroyed." *Id.* In short, on facts materially identical to *Williams*, the *Elliott* Court rejected any notion of a demand futility exception and affirmed the duty of a would-be derivative plaintiff to "make an earnest not a simulated effort with the managing body of the corporation to induce remedial action on their part."⁷ *Id.* at 643 (quoting *Hawes v. Oakland*, 104 U. S. 450, 26 L. Ed. 827 (1881)).⁸

⁷ Note that four of the six Justices who decided *Elliott* also decided *Williams*, and Justice Dunbar wrote both opinions. That overlap confirms that the *Williams* Court did not intend to adopt the futility exception (quoted as dictum in the opinion), because the *Elliott* Court rejected the exception less than two years later on materially identical facts.

⁸ In *Kneeland Investment Co. v. Berendes*, 81 Wash. 372, 376, 142 P. 869 (1914), the Court stated that "where it appears from the allegations and proofs that the making of a request upon the officers of the corporation to bring the appropriate action would be useless, the requirement is dispensed with." But that observation was pure dictum because the Court had concluded that the action was not a derivative proceeding, as the plaintiffs were not shareholders. *Id.* The Court cited *no* authority for the notion that demand is excused where "useless," nor analyzed what "useless" means in this context. Moreover, under the convoluted facts of *Kneeland*, the Court noted that it was clear from the evidence that demand would have been denied, and apparently deemed demand to have been constructively rejected (as the Court did in *Williams*). The dictum in *Kneeland* does not vitiate the Court's analysis in *Elliott* rejecting any demand futility exception.

The only relatively modern Washington case discussing a possible futility exception to the demand requirement in the context of shareholder derivative actions is *LaHue v. Keystone Investment Co.* In *LaHue*, the Court noted that the plaintiff's derivative complaint failed to comply with the technical requirements of Civil Rule 23.1 because "there is a failure to allege that [plaintiff] was a stockholder at the time of the breaches; or of demand by [plaintiff] upon and refusal by [the corporation] to sue defendants; or that such a demand by her would have been futile." 6 Wn. App. at 774. But the Court went on to note that "the corporation had no assets and had ceased functioning," and "for all practical purposes had ceased to exist." *Id.* at 775. Thus, the Court concluded that demand would have been "futile" because "the corporation had no funds with which to sue or had ceased to function." *Id.* In other words, though it inaptly chose the word "futile," the Court clearly found that demand would have been not futile but *impossible*, given that there was effectively no corporation left to receive or act upon any demand. As discussed further below, the Court may affirm a universal demand requirement yet still allow for circumstances where demand is excused as impossible.⁹

In summary, Washington courts have not adopted or applied a "futility" exception to the well-established shareholder demand requirement. In fact, in *Elliott*, this Court affirmatively *rejected* such an exception. And the few early cases that imply the validity of a futility

⁹ In *Haberman*, while the Court did discuss demand "futility," it did so in the context of bondholder indentures, rather than shareholder derivative proceedings, and the Court cited by analogy to the *federal* common law of demand futility, which was subsequently abrogated by the U.S. Supreme Court in *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90 (1991). 109 Wn.2d at 153-54. As such, *Haberman* is inapposite on whether Washington recognizes a demand futility exception in the shareholder derivative context.

exception in Washington are, at best, confusing and inconclusive. Given that there is no Washington precedent recognizing a demand futility exception, the Court is free to follow the clear national trend (as discussed further below) and affirm a strict requirement that putative derivative plaintiffs make demand prior to filing suit.

2. **Washington's Statute And Civil Rule Are Procedural And Do Not Imply A Demand Futility Exception.**

Plaintiffs may also argue that Washington's statute and court rule governing derivative proceedings imply the existence of a demand futility exception. That argument fails under scrutiny because Washington's statutory and civil rules provisions are merely procedural, and neither create nor supplement the substantive standards governing derivative litigation (which, as discussed, are purely products of the common law).

Washington's Business Corporation Act (WBCA), Title 23B RCW, sets out the basic procedural requirements for a shareholder seeking to initiate derivative litigation:

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 the demand was refused or ignored or why a demand was not made.

RCW 23B.07.400(2). Enacted in 1989, RCW 23B.07.400 adopted language from the 1984 Revised Model Business Corporation Act (MBCA), promulgated by the American Bar Association (ABA). *See Corporate Act Revision Committee Analysis and Comments to the New Washington Business Corporation Act*, RCW 23B.07.400, 7-31 (1990) ("Proposed section 7.40 is identical in substance to [MBCA] § 7.40"); *see also Ballard Square Condo. Owners Ass'n v. Dynasty Constr. Co.*, 158

Wn.2d 603, 621, 146 P.3d 914 (2006). In adopting RCW 23B.07.400, the Washington Legislature stated that “[p]roposed section 7.40 [now RCW 23B.07.400] deals with the *procedural* requirements applicable to derivative suits.” OFFICIAL LEGISLATIVE HISTORY, Senate Journal 51st Leg., App. A, 3030 (1989) (emphasis added). (Indeed, RCW 23B.07.400 is titled “Derivative proceedings procedure.”) Although this Court has not spoken to the issue, the federal District Court has repeatedly recognized that RCW 23B.07.400 is merely a procedural framework for derivative proceedings that does not create or abridge any substantive derivative standards. See Show Cause Order at 4; *Cray*, 431 F. Supp. 2d at 1119.

In addition to RCW 23B.07.400, Washington Superior Court Civil Rule (CR) 23.1 also addresses the procedural requirements a would-be derivative plaintiff must observe:

The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

CR 23.1. The Washington Legislature has expressly recognized that CR 23.1 is merely procedural. Senate Journal 51st Leg., at 3030 (“Fed. R. Civ. P. 23.1, and Wash. R. Civ. P. 23.1, also impose *procedural* requirements on derivative litigation brought in federal and state courts, respectively”) (emphasis added). In 1967, Washington’s Rule 23.1 was copied verbatim from Federal Rule of Civil Procedure (FRCP) 23.1. *LaHue*, 6 Wn. App. at 776; compare CR 23.1 (1967) with FRCP 23.1

(1966).¹⁰ It is well-established that FRCP 23.1 sets forth procedural obligations but does not delineate any substantive rights or standards. *See, e.g., Kamen*, 500 U.S. at 96-97 (“[A]lthough [FRCP] 23.1 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. On its face, Rule 23.1 speaks only to the adequacy of the shareholder representative’s pleadings. ... Rule 23.1 cannot be understood to ‘abridge, enlarge or modify any substantive right’”); *Boland v. Engle*, 113 F.3d 706, 710 (7th Cir. 1997) (FRCP 23.1 “neither requires a plaintiff to make demand nor governs what excuses are acceptable for failing to make demand”). The District Court has recognized that, like FRCP 23.1, Washington’s CR 23.1 does not establish any substantive derivative standards. *See Schwartzman*, 2007 WL 1174697, at *4 (“Neither Rule 23.1 nor RCW 23B.07.400 spell out substantive demand requirements”).

It cannot reasonably be argued that either RCW 23B.07.400 or CR 23.1 contemplates a “futility” exception to the requirement that a putative derivative plaintiff make demand on corporate management. Neither source contains any language regarding “futility.” In fact, neither source addresses or establishes *any* exception whatsoever to the demand requirement. RCW 23B.07.400 and CR 23.1 merely require a shareholder plaintiff to include enough detail in the complaint for a court to determine whether the demand requirement has been satisfied. That detail must include an explanation if the shareholder has failed to properly make

¹⁰ FRCP 23.1 has since undergone certain stylistic, non-substantive amendments, but the language of Washington’s CR 23.1 and FRCP 23.1 remains materially identical. *Compare* CR 23.1 (2008) *with* FRCP 23.1 (2008).

demand. RCW 23B.07.400 (“A complaint [must] ... allege with particularity ... why a demand was not made”); CR 23.1 (“The complaint shall also allege with particularity ... the reasons for his failure to obtain the action or for not making the effort”).¹¹ But neither source addresses the consequences if the shareholder has failed to satisfy the demand requirement. By their plain language, the statute and rule deal only with the adequacy of a would-be derivative plaintiff’s pleadings. It is left to the Washington courts to determine the substantive contours of the demand requirement, which is appropriate given that Washington’s derivative procedure is judicially created and wholly a product of the common law.

Plaintiffs might also contend that the provisions in RCW 23B.07.400 and CR 23.1 directing a derivative plaintiff to explain his failure to make demand would be a nullity if Washington does not recognize a futility exception to the demand requirement. Not so. As discussed above, there are circumstances where making demand is literally impossible, for example, where the corporation has ceased to exist. *See LaHue*, 6 Wn. App. at 775. In addition, a putative derivative plaintiff could file suit in Washington on behalf of a company incorporated in another state, such as Delaware, that *does* recognize demand futility. Again, Washington’s

¹¹ Plaintiffs will undoubtedly note that the legislative history for RCW 23B.07.400 states: “On the other hand, there may be circumstances showing that a demand on the board of directors would be useless, and in those circumstances it should be sufficient to allege the reasons why the plaintiff did not make the demand.” Senate Journal 51st Leg., at 3031. As an initial matter, that language was simply lifted verbatim from the commentary to the 1984 MBCA. The comment does not change the fact that RCW 23B.07.400 is procedural; it merely recognizes that a court *might* choose to excuse demand where it would be “useless.” Nor does the comment define what “useless” means in this context; as discussed, Washington courts have excused demand only where it is objectively *impossible*. *LaHue*, 6 Wn. App. at 775. Importantly, the term “futility” does not appear anywhere in the MBCA or WBCA commentary on derivative procedures (nor does any citation to Delaware law).

statute and rule merely set forth a general procedural framework for derivative proceedings, on which the courts must overlay the substantive standards (some of which might be governed by non-Washington law). The point is that RCW 23B.07.400 and CR 23.1 do not address whether there are any acceptable justifications for failing to make demand; instead, those sources merely require a plaintiff to plead the factual circumstances with sufficient particularity for a court to make that determination.

In summary, as the District Court correctly concluded, there is an “absence of Washington law concerning the substantive standard for when demand is excused.” Show Cause Order at 4 n.1. Washington courts have always recognized and strictly enforced the demand requirement, but have not adopted a “futility” exception to that fundamental requirement. Nor do the Washington statutes or court rules inform, let alone dictate, whether Washington should recognize demand futility.

More to the point, even if the early Washington derivative jurisprudence could plausibly support the existence of a demand futility exception, there is *no* Washington authority maintaining that doctrine into the modern age of corporate governance. As discussed at length in Section IV(C) below, there has been significant evolution in the policies and principles that underpin shareholder derivative proceedings. The clear trend in the law is to recognize some form of “universal” demand requirement and to reject exceptions to that fundamental requirement, including the futility exception. Thus, even if there were an existing demand futility exception in Washington, that doctrine should have no remaining vitality and should be abandoned in favor of more sound corporate governance principles.

C. Washington Should Affirm A “Universal Demand” Requirement.

1. The Overwhelming National Trend Is To Adopt “Universal Demand” And Reject Demand Futility.

It is well-recognized, by courts and commentators alike, that there is an existing and expanding national trend to eliminate the “demand futility” concept and require a shareholder to make demand, as a prerequisite to proceeding derivatively, in essentially all circumstances. This modern prevailing standard, which strictly requires shareholder demand, is referred to as “universal demand.”¹² See, e.g., Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation*, 77 Minn. L. Rev. 1339, 1353, 1386-87 (1993) (“In light of the recurring dissatisfaction with the futility exception’s unnecessary prominence in shareholder derivative suits, the modern trend has been decidedly towards requiring pre-suit demand in virtually every instance. Commentators have almost unanimously supported such a move for many years. ... The universal demand approach is now supplanting the futility doctrine, after decades of struggle over the exception’s application and interpretation”).¹³

¹² The term “universal demand” is a slight misnomer, because the standard *does* recognize that demand may be excused in certain extremely limited circumstances. For example, as discussed further below, demand may be *temporarily* excused if “irreparable injury” to the corporation would result from a delay in filing suit, but the shareholder must still make demand after the emergency is averted. The critical point is that universal demand rejects any notion of demand futility.

¹³ See also Jeffrey S. Facter, *Fashioning a Coherent Demand Rule for Derivative Litigation in California*, 40 Santa Clara L. Rev. 379, 400-01 (2000) (“The clear trend of recent decisions has been toward requiring pre-suit demand, even when earlier precedents might have excused it”) (internal quotation omitted); Peter M. Stone & Jay C. Gandhi, *The “Clone” Derivative Lawsuit*, 46-JUL Orange County Law. 34, 37 (2004) (“[R]easoning that litigating the issue of demand futility is often costly and unproductive and that a clearer, unified standard would advance judicial review, a growing number of states have altogether abolished demand futility. In those states, demand on the board of directors is required in virtually every case, unless irreparable injury would result”); *Werbowsky v. Collomb*, 766 A.2d 123, 137 (Md. 2001) (“[T]he trend since [1968] has been to enforce more strictly the requirement of pre-suit demand and at least to circumscribe, if not effectively eliminate, the futility exception”).

In the most recent version of the MBCA (1989), the ABA advocated rejection of the demand futility exception and championed “universal demand” as a superior approach. See Mary Siegel, *Changes in the Model Business Corporation Act – Amendments Pertaining to Derivative Proceedings* (the “ABA Amendments”), 44 Bus. Law. 543 (1998). Under the 1989 MBCA, a shareholder is absolutely precluded from commencing a derivative proceeding until the shareholder makes demand on corporate management to take action. MBCA § 7.42(1), 44 Bus. Law. at 547. After demand is made, the shareholder must then wait 90 days to file a derivative lawsuit, “unless irreparable injury to the corporation would result by waiting for the expiration of the ninety-day period.” § 7.42(2). The Official Comment confirms that § 7.42 “*requires a written demand on the corporation in all cases.*” 44 Bus. Law. at 547. The exception for “irreparable injury” applies only to the 90-day period, and may excuse a shareholder from waiting the full 90 days to file a derivative action, but “irreparable injury” does *not* excuse a shareholder from making demand.

In 1978, the American Law Institute (ALI) — the same entity responsible for promulgating the Restatements of the Law, which are routinely cited and adopted by courts nationwide — commenced its Project on the Structure and Governance of Corporations. In 1992, the ALI published its comprehensive *Principles of Corporate Governance: Analysis and Recommendations* (the “ALI Principles”). In that document, as the ABA had done, the ALI identified serious shortcomings and inefficiencies inherent in the demand futility concept, and advocated adoption of a “universal demand” standard to cure those defects. Under the ALI formulation, demand on the corporate board of directors is always

required as a prerequisite to commencing derivative litigation, unless “irreparable injury to the corporation would otherwise result.” *ALI Principles*, § 7.03(a), (b). Critically, even in those truly emergent instances where demand is temporarily excused, “demand should be made promptly after commencement of the action.” *Id.*, § 7.03(b). Thus, even under the ALI formulation, demand is never truly “excused,” just delayed.

To date, twenty three states have expressly adopted “universal demand,” either by statute or court decision.¹⁴ Many of those states did so by adopting the 1989 MBCA provisions, meaning that those states apply the most stringent demand requirement of “a written demand on the corporation *in all cases*.” See Show Cause Order at 9 (“[T]he majority of states that have considered the issue have adopted, either by statute or by judicial decision, what has been described as the ‘universal demand’ requirement from the Model Business Corporation Act”). The prevailing trend abandoning the demand futility concept and embracing universal demand is based on many compelling justifications, discussed below.

a. Universal Demand Helps Prevent Improper Strike Suits.

Shareholder derivative lawsuits are dramatically on the rise. Stone & Gandhi, 46-JUL Orange County Law. at 34 (2004). According to one

¹⁴ Arizona (Ariz. Rev. Stat. Annot. § 10-742); Connecticut (Conn. Gen. Stat. Annot. § 33-722); Florida (Fla. Stat. Annot. § 607.07401); Georgia (Ga. Code Annot. § 14-2-742); Hawaii (Haw. Rev. Stat. § 414-173); Idaho (Idaho Code Ann. § 30-1-742); Iowa (Iowa Code § 490.742); Maine (Me. Rev. Stat. Ann. tit. 13-C, § 753); Massachusetts (Mass. Gen. Laws ch. 156D, § 7.42); Michigan (Mich. Comp. Laws § 450.1493a); Mississippi (Miss. Code Annot. § 79-4-7.42); Montana (Mont. Code Annot. § 35-1-543); Nebraska (Neb. Rev. Stat. § 21-2072); New Hampshire (N.H. Rev. Stat. Annot. § 293-A:7.42); North Carolina (N.C. Gen. Stat. § 55-7-42); Pennsylvania (*Cuker v. Mikalauskas*, 547 Pa. 600, 613, 692 A.2d 1042 (1997)); Rhode Island (R.I. Gen. Laws § 7-1.2-711); South Dakota (S.D. Codified Laws § 47-1A-742); Texas (Tex. Bus. Orgs. Code Ann. § 21.553); Utah (Utah Code Ann. § 16-10a-740(3)); Virginia (Va. Code Annot. § 13.1-672.1); Wisconsin (Wis. Stat. Annot. § 180.0742); Wyoming (Wyo. Stat. Ann. § 17-16-742).

source, “from 2000 to 2001 the number of derivative action suits filed increased by 130%, an increase of almost 330% from 1996.” Bryan Stanfield, *For Better or For Worse?: Marriage of the Texas and Model Business Corporation Act's Derivative Action Statutes and What it Means for Corporations*, 35 Tex. Tech L. Rev. 347, 348 (2004). One reason for the recent surge in derivative litigation is Congress’s enactment of the Private Securities Litigation Reform Act (PSLRA) and the Securities Litigation Uniform Standards Act (SLUSA) to curb improper “strike suits.”¹⁵ The enactment of those statutes had the effect of prompting more meritless derivative lawsuits. Facter, 40 Santa Clara L. Rev. at 380 (“The increase in derivative litigation is a by-product of the enactment by the United States Congress of the Private Securities Litigation Reform Act”). Derivative litigation has therefore become increasingly susceptible to abuse as a means for bringing strike suits and extorting undeserved settlements. *See ABA Amendments*, 44 Bus. Law. at 544 (“[I]t has long been recognized that the derivative suit may be instituted more with a view to obtaining a settlement resulting in fees to the plaintiff’s attorney than with a view to righting a wrong to the corporation”).¹⁶

¹⁵ A so-called “strike suit” is one prompted by enterprising plaintiffs’ counsel for the purpose of forcing a quick settlement or generating potentially reimbursable legal fees, rather than for the legitimate purpose of addressing some harm done to the corporation. *See ABA Amendments*, 44 Bus. Law. at 544; *RCL Northwest, Inc. v. Colorado Res., Inc.*, 72 Wn. App. 265, 270-71 n.5, 864 P.2d 12 (1993) (“Strike suits are brought by persons who make charges without regard to their truth so as to coerce corporate managers to settle worthless claims”).

¹⁶ *See also* Bradley T. Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 Ohio St. L.J. 241, 244 (1999) (“[T]he derivative suit can lend itself to abuse by allowing opportunistic shareholders and attorneys to impede the actual best interests of the corporation by filing frivolous and unfounded strike suits”); Facter, 40 Santa Clara L. Rev. at 384-85 (“Derivative litigation has historically been notorious as a vehicle for bringing strike suits” (footnotes omitted)).

It is widely recognized that a universal demand requirement is the most effective method for deterring and preventing abuse of derivative proceedings. *See, e.g.*, Ferrell, 60 Ohio St. L.J. at 271 (“Universal demand serves the initial gate-keeping role. It provides a fairly strict standard to sift out the frivolous strike suits that are filed, but not a standard that is so strict that even plaintiff-shareholders with valid claims have no chance of surviving a corporation’s rejection of demand”).¹⁷ If the corporation has truly suffered some cognizable harm, corporate management should be afforded the opportunity, in the first instance, to assess and, if appropriate, seek redress for that harm.¹⁸ Consequently, a shareholder concerned first-and-foremost with the best interests of the corporation should have no reason to take issue with a universal demand requirement. If demand is properly made and refused, a shareholder who still earnestly believes that an injury to the corporation requires redress may challenge the corporation’s refusal to act. Thus, weeding out meritless strike suits is one of the key benefits to be derived from universal demand.

¹⁷ *See* Factor, 40 Santa Clara L. Rev. at 385 (“By performing this ‘gatekeeper’ function, the demand rule empowers a board of directors to protect the corporation from the heavy cost of strike suits, which, by definition, seek to drive up a corporation’s costs for the sole purpose of extracting a settlement. The demand requirement can be an effective gatekeeper ... only if the exceptions to the rule are clearly defined and narrowly drawn”).

¹⁸ *See* Factor, 40 Santa Clara L. Rev. at 394-95 (“[T]he demand requirement can serve a useful function both with respect to meritorious and non-meritorious claims. ... The demand rule simply puts into play a requirement of exhausting ‘intracorporate’ remedies that are cost-free, both to the shareholder and to the courts”); *Boland*, 113 F.3d at 712 (“[W]hether a corporation should pursue a right of action is a complicated business question on which courts need assistance. ... [H]ard-nosed business acumen will be a better judge of whether corporate norms have been violated and whether litigation would be worth the costs to the corporation. ... *Requiring demand thus serves as a valuable screen of potential lawsuits, both by giving corporations a crack at resolving shareholder complaints before litigation and by giving courts more information on which to decide the merits of those suits that remain after demand*”)(emphasis added).

b. **Universal Demand Permits Even An “Interested” Board To Take Proper Action.**

The shareholder demand requirement honors the essential tenet that decisions regarding corporate affairs, including whether to pursue litigation, are vested in corporate management. The futility exception is rooted in the notion that making demand on the same individuals who are charged with the alleged wrongdoing is a meaningless act, because the result — *i.e.*, rejection of the demand on the alleged perpetrators to sue themselves — is somehow preordained. Facter, 40 Santa Clara L. Rev. at 389. But even where a board is arguably “interested” — by having benefited from or participated in a challenged decision or transaction — it is not accurate to summarily conclude that demand would be “futile.” Even a purportedly “interested” board has options for responding to a shareholder demand that can provide tangible benefits to the corporation. That is particularly true where the board is empowered to appoint a special committee of disinterested directors to investigate alleged wrongdoing or evaluate a shareholder demand. *See, e.g., In re Guidant S’holders Deriv. Litig.*, 841 N.E.2d 571, 576 (Ind. 2006) (“Recent developments that improve corporate responsibility and accountability suggest the viability of the disinterested committee as an alternative to derivative suits”).¹⁹

In advocating for universal demand, the ALI pointedly exposed the central fallacy that underpins the concept of demand futility:

[D]emand may sometimes induce the board to consider issues or take corrective action that either moots or permits the early resolution of the action. Requiring demand thus permits “a form of

¹⁹ Washington, like most other states, empowers a corporate board of directors to appoint a special committee to take any authorized board action, including investigating alleged corporate errors or misconduct, considering possible litigation, and evaluating a shareholder demand. *See* RCW 23B.08.250.

alternative dispute resolution” that spares the corporation expense and may eliminate some litigation. ... *Although requiring demand when a majority of the board is clearly interested in the challenged transaction has struck some courts as an exercise in futility, this view misconceives the range of options still open to the board.* Even in such a case, the board as a whole can appoint ... a special committee, which can consider the demand In the extreme case in which all directors are implicated in the transaction, the board can still expand its size and appoint new directors to staff such a committee, or it can request the appointment of a special panel *Thus, the majority rule, which excuses demand only when a majority of the board is implicated, appears to be founded on a fallacy: namely, that the corporation is powerless to act when a majority of its members are implicated.*

ALI Principles, § 7.03, Comment (c) at 55, Comment (e) at 58-59 (emphasis added); *accord ABA Amendments*, 44 Bus. Law. at 547 (“[E]ven though no director may be independent, the demand will give the board of directors the opportunity to reexamine the act complained of in the light of a potential lawsuit and take corrective action”).²⁰

The demand futility doctrine also takes an irrationally dim view of the motives and integrity of the average corporate director. Not all corporate missteps are the result of intentional or nefarious conduct. Indeed, Washington’s law of corporate governance incorporates the opposite notion, *i.e.*, that duly elected directors operate in good faith and with the best interests of the corporation at heart (even when their decisions are questionable or even negligent). *See, e.g., DeHart*, 13 Wn. App. at 499. Why would a Washington court assume that the average director,

²⁰ *See also Boland*, 113 F.3d at 711 (“[O]lder cases] suggest that the general reason behind excusing demand is that it would be silly to require shareholders to take useless actions. Uselessness, however, depends on context”; holding that demand on even an interested board is not “futile”); *Swanson*, 77 Minn. L. Rev. at n.92 (“Even in circumstances in which the board is arguably disqualified due to interest, the corporation still possesses a possibly beneficial range of options when faced with demand”).

confronted with an erroneous corporate act or omission, would refuse to take reasonable steps to correct the error? The universal demand requirement properly assumes that corporate management will act responsibly in response to a shareholder demand, including appointing a disinterested special committee (if necessary) and initiating litigation when the best interests of the corporation so require.²¹

c. Universal Demand Avoids Expensive Litigation On Collateral Issues.

In addition to the above justifications for adopting universal demand, courts and commentators have also noted that the demand futility exception requires extended litigation regarding the board's independence, an issue entirely collateral to the merits of the litigation. The futility phase of derivative litigation is often lengthy and expensive. Those significant ancillary costs are, of course, borne by the corporation, the entity the plaintiff shareholder is purportedly acting to protect.

In advocating universal demand, the ALI recognized that "a universal demand rule eliminates much of the threshold litigation, collateral to the merits of the action, that today slows the pace and increases the cost of derivative actions. Under [universal demand], courts would not need to

²¹ In this case, F5's board of directors voluntarily undertook significant efforts to investigate and address the allegations of improper options "backdating" at F5, beginning weeks before plaintiffs filed their derivative lawsuits. F5 appointed a Special Committee of disinterested outside directors, including one newly appointed director, to conduct the investigation. The Special Committee retained independent counsel and experts, and ultimately incurred over *\$7 million* in investigative expenses. After over five months of inquiry, the Company announced that certain option measurement dates should not be relied upon for accounting purposes, and that the Company would restate its financials. F5 also announced the adoption of a range of remedial measures, including new equity compensation and corporate documentation policies, and the resignation and replacement of F5's General Counsel. Despite the Company's extensive efforts to properly evaluate and respond to alleged errors and wrongdoing, the plaintiffs *still* failed to make demand on the F5 Board, arguing that demand would be "futile." The Court need look no further for a vivid illustration of the core fallacy underlying the demand "futility" concept.

resolve the often complex, but ultimately peripheral, issue whether demand was necessary” *ALI Principles*, § 7.03, Comment (e) at 57. In revising the MBCA to require demand “in all cases,” the ABA noted: “The drafters believe that this provision will eliminate the needless time and expense for both litigants and the court in litigating the question whether demand is required but that it will not unduly restrict the filing of a legitimate derivative suit.” *ABA Amendments*, 44 Bus. Law. at 544.²²

Balanced against the high costs of litigating ancillary futility issues, the burden on shareholders of making demand on corporate management is negligible. *See, e.g., ALI Principles*, § 7.03, Comment (e) at 57 (“[B]ecause making demand on the board is a relatively costless step, imposing this requirement places little burden on the plaintiff”); Ferrell, 60 Ohio St. L.J. at 273 (“Demand is a relatively low-cost procedure for shareholders. Therefore, the benefits that demand creates, such as providing the corporation with notice of the allegations and potentially allowing it to conduct intracorporate dispute resolution that will save substantial judicial resources, clearly outweigh any slight financial burden that demand places on the shareholder. Moreover, the slight costs of making demand are much less than the substantial costs and waste of

²² The ALI and ABA are by no means alone in criticizing the demand futility notion for substantially and needlessly multiplying the time and expense of derivative litigation. *See, e.g., Werbowski*, 766 A.2d at 144 (“[The futility exception] virtually assures extensive and expensive judicial wrangling over a peripheral issue that may result in preliminary determinations regarding director culpability that, after trial on the merits, turn out to be unsupportable”); Swanson, 77 Minn. L. Rev. at 1353, 1387 (“The volume of shareholder derivative suits clogging court dockets has been surprisingly high, especially during the 1980s. Distressingly, most of these actions turned on the definition of futility rather than on a substantive examination of the alleged wrongdoing. ... Important issues of corporate governance have hinged on the procedural questions of whether the shareholder first made an appropriate demand and, if not, whether that demand was excused” (footnotes omitted)); Facter, 40 Santa Clara L. Rev. at 397 (same).

judicial resources that are caused by the vast amount of collateral litigation that arises under the Delaware approach” (footnotes omitted)).

In short, a universal demand requirement focuses the court’s inquiry in a derivative proceeding on the merits of the dispute. It also eliminates a long, complicated additional phase of derivative litigation that provides no ultimate benefit to the corporation — because the inquiry answers *only* the question of *who* may pursue a corporate claim — but subjects the corporation to substantial expense.²³ Streamlining the derivative process honors the fact that a derivative action is intended to protect the company.

2. Washington Should Follow The National Trend.

This Court should affirm that Washington universally requires demand as a prerequisite to a shareholder commencing derivative proceedings. The well-reasoned considerations supporting universal demand discussed above apply with particular force in Washington. That is so, in part, because Washington’s law on derivative proceedings has, from its genesis, strictly required demand and rejected any futility exception. Thus, although the Court has never *expressly* addressed the issue of universal demand, Washington law already embodies the national trend.

Moreover, the key justifications for universal demand align perfectly with the core principle underlying Washington’s law of corporate

²³ In this case, plaintiffs first filed their derivative actions in June 2006. For over *two years*, the parties have engaged in extensive briefing and argument before the District Court regarding whether F5’s Board was sufficiently “disinterested” to consider remedial measures for alleged “backdating” of stock options (measures that the Board already voluntarily implemented). In addition to the federal actions, there are stayed consolidated actions pending against F5 in King County Superior Court. If the federal actions are dismissed based on the federal plaintiffs’ failure to make demand, the state plaintiffs have made known that they will insist on litigating the very same demand futility issues before the state court. Thus, even if F5 is ultimately successful in dismissing the state court actions as well, the Company will have spent years and millions of dollars litigating *only* the collateral issue of whether a majority of F5’s Directors are “disinterested.”

governance, *i.e.*, that corporate affairs must be overseen, managed, and controlled by the corporation's directors and officers. First, Washington obviously has an interest in preventing shareholders from pursuing their own interests, at the expense of the corporation, through improper strike suits. *Colorado Res.*, 72 Wn. App. at 270. Second, Washington empowers even an allegedly "interested" corporate board to appoint a clearly disinterested special committee to investigate potential wrongdoing, evaluate a shareholder demand, and consider litigation. See RCW 23B.08.250. Third, simplifying derivative litigation procedures in a manner that alleviates the burden and expense on the corporation advances Washington's fundamental precept that derivative proceedings are highly disfavored.

It is not necessary for the Court to adopt the ABA's bright-line approach requiring demand "in all cases" without exception (though many states have seen fit to do so). The ALI standard — which *temporarily* suspends the demand requirement where "irreparable injury" would result from delay — is reasonable. The key, however, is that demand must still be made after the emergent circumstances have abated. And, in those instances where demand is deferred due to the risk of "irreparable injury," the derivative proceeding should be stayed as soon as demand is made.

It is also reasonable for the Court to continue to recognize that demand is excused in those rare circumstances where demand would be literally *impossible*. In *LaHue*, for example, "the corporation had no assets and had ceased functioning," and "for all practical purposes had ceased to exist." 6 Wn. App. at 775. Requiring a shareholder to make demand when there is no one at the corporation to receive or consider the demand

would make little sense. Without excusing demand because a would-be derivative plaintiff asserts that demand is *subjectively* “futile,” the Court may still opt to excuse demand that is *objectively* impossible to effectuate.

A universal demand standard in Washington that requires demand in all cases, unless “irreparable injury” to the corporation would result from delay or demand is objectively impossible, both honors Washington’s existing standards of corporate governance and brings Washington in line with the prevailing and well-reasoned national trend.

D. Washington Should Reject Delaware’s Demand Futility Standard.

In answer to the first part of the District Court’s certified question to this Court — *i.e.*, what test does Washington apply to determine whether a would-be derivative plaintiff is ever excused from making demand on the board — the Court should follow the national trend and affirm a universal demand requirement. In the second part of its certified question, the District Court asked this Court whether Washington follows Delaware’s demand futility standard. Certification Order at 2.²⁴ If the Court adopts a universal demand requirement, obviously the Court will implicitly reject Delaware’s doctrine of demand futility. Even if the Court felt compelled, however, to recognize some form of “futility” exception to the demand requirement, there is no logical or compelling rationale for the Court to adopt Delaware’s standard. Under those circumstances, as discussed in detail below, the Court should reject Delaware’s demand futility standard and fashion a more reasoned, clear, and functional measure of futility.

²⁴ Before the District Court entered its Show Cause Order, all parties proceeded as if Delaware’s demand futility standards were applicable to this suit. But the parties did so because prior District Court opinions had applied Delaware’s demand futility law, on the assumption (without analysis) that Washington would follow Delaware. *See, e.g., Cray*, 431 F. Supp. 2d at 1120. As Judge Lasnik noted, that assumption was sheer speculation.

1. **Washington Has Never Looked To Delaware For Guidance On Derivative Issues.**

As an initial matter, if the Court were now to look to Delaware for guidance in establishing Washington's law on derivative suits, it would be the first time the Court has ever done so. In Washington, derivative proceedings are a purely judicial creation, recognized by Washington courts beginning over a century ago. See *Elliott*, 52 Wash. at 637 (1909); *Jones*, 3 Wash. at 57 (1891). Nowhere in Washington's jurisprudence authorizing shareholders, in extremely rare circumstances, to proceed derivatively on the corporation's behalf — and establishing the strict requirement that shareholders make demand on the corporation before commencing derivative litigation — is there *any* reference to, or reliance on, Delaware law.²⁵ In other words, under existing Washington law governing derivative proceedings, there is no more reason for Washington to seek guidance from Delaware than from any other state or source.

In developing Washington's corporate law, Washington courts do not generally turn to Delaware for guidance. It is true that some states look to Delaware on corporate governance issues because Delaware has deliberately positioned itself as a preferred locale for incorporation and has developed an attendant body of law on corporate issues. See, e.g., *Casey v. Brennan*, 780 A.2d 553, 567 (N.J. Super. 2001) (“When considering issues of first impression in New Jersey regarding corporate

²⁵ Nor are Washington's *procedural* provisions governing derivative proceedings based on Delaware's procedures. RCW 23B.07.400 was an adoption of the MBCA. Delaware, by contrast, has not adopted the MBCA; in fact, there is no Delaware statutory analog to RCW 23B.07.400 that addresses derivative litigation procedures. Washington's CR 23.1 was derived verbatim from FRCP 23.1. *LaHue*, 6 Wn. App. at 776. Delaware's Rule 23.1 was not. Compare FRCP 23.1 (1966) with Delaware Chancery Rule 23.1 (1967). In short, *no* aspect of Washington's law governing derivative proceedings, either substantive or procedural, is derived from Delaware law.

law, we frequently look to Delaware for guidance or assistance”). But Washington is *not* one of the states swimming in Delaware’s wake. Indeed, Washington has regularly decided novel issues of Washington corporate law without any reference to Delaware law.²⁶

Washington courts have also expressly *rejected* Delaware’s approach on certain corporate issues, in favor of Washington’s own standards. For example, in *Sound Infiniti, Inc. v. Snyder*, the Washington Court of Appeals recently held that the appraisal remedy in the WBCA’s dissenters rights provisions is the exclusive remedy for shareholders dissenting from fundamental corporate changes (absent a showing of actual fraud). 186 P.3d 1107, 1115, --- Wn. App. --- (June 23, 2008). The *Sound Infiniti* Court expressly rejected Delaware’s contrary doctrine that a dissenting shareholder is *not* limited to the appraisal remedy, but may bring separate claims for breaches of fiduciary duty. *Id.* at 1113 n.3²⁷ (rejecting *Rabkin*

²⁶ See, e.g., *Equipto Div. Aurora Equip. Co. v. Yarmouth*, 134 Wn.2d 356, 364-70, 950 P.2d 451 (1998) (analyzing post-dissolution individual liability for acts taken on behalf of dissolved Washington corporation); *Goodman v. Darden, Doman & Stafford Assoc.*, 100 Wn.2d 476, 478-83, 670 P.2d 648 (1983) (considering exception to promoter liability for pre-incorporation contracts intended to benefit later-formed corporation); *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wn.2d 944, 945-53, 632 P.2d 512 (1981) (deciding whether failure of shareholders of Washington corporation to elect new directors is, by itself, sufficient grounds for dissolution of corporation); *Golconda Mining Corp. v. Hecla Mining Co.*, 80 Wn.2d 372, 373-81, 494 P.2d 1365 (1972) (resolving issues of shareholder cumulative voting rights and renewal of corporate charter for Washington corporation); *McCormick v. Dunn & Black, P.S.*, 140 Wn. App. 873, 890-94, 167 P.3d 610 (2007) (analyzing and deciding issues of departing law firm member’s entitlement to buyout of shares of Washington legal corporation and “ethical and confidential obligations” of member if he remained a shareholder post-termination); *Lang v. Hougan*, 136 Wn. App. 708, 718-19, 150 P.3d 622 (2007) (determining whether solicitation of customers by dissolving Washington corporation’s officer/director breached fiduciary duties to corporation).

²⁷ Notably, the Court refused to adopt the Delaware standard despite the fact that, according to the WBCA legislative history, Washington’s dissenters rights provisions were originally based, in part, on a Delaware case. Though Delaware’s standard subsequently evolved, the *Sound Infiniti* Court declined to follow Delaware’s lead. *Id.*

v. *Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1103-04 (Del. 1985)). Similarly, in *Washington Equipment Manufacturing Co. v. Concrete Placing Co.*, the Washington Court of Appeals rejected the Delaware Supreme Court's holding that a foreign corporation consents to general jurisdiction of Delaware courts by registering to do business in Delaware and appointing an agent in Delaware to accept service. 85 Wn. App. 240, 244-46, 931 P.2d 170 (1997) (rejecting *Sternberg v. O'Neil*, 550 A.2d 1105, 1109 (Del. 1988)). In contrast to Delaware law, the *Concrete Placing* Court held that, in Washington, "[a] certificate of authority to do business and appointment of a registered agent do not ... confer general jurisdiction over a foreign corporation." *Id.* at 246.²⁸

On other corporate issues, Washington does not reference Delaware authority with any more frequency than authority from other states. *See, e.g., Seattle Trust & Sav. Bank v. McCarthy*, 94 Wn.2d 605, 611-12, 617 P.2d 1023 (1980) (citing Delaware opinion — along with opinions from Oregon, Alaska, Wisconsin, and New York — holding minority shareholders' preemptive rights extinguishable); *Hay v. Hay*, 38 Wn.2d 513, 518-19, 230 P.2d 791 (1951) (citing Delaware opinions — along with opinions from Georgia, Massachusetts, Virginia, California, Pennsylvania,

²⁸ Washington courts' express rejection of Delaware's approach on certain issues of corporate law is not surprising, given that Washington's body of corporate law is materially different from Delaware's corporate law in many significant respects. *Compare, e.g.,* RCW 23B.10.010-030 with 8 Del. C. § 242 (amending articles of incorporation); RCW 23B.19.040 and 23B.19.020 with 8 Del. C. § 203 (anti-takeover provisions); RCW 23B.11.030, 23B.12.020 with 8 Del. C. §§ 251, 271 (mergers and corporate dissolution); RCW 23B.07.040 with 8 Del. C. § 228 (shareholder action without a meeting); RCW 23B.07.260 with 8 Del. C. § 242 (authorization of class of shares, voting rights); RCW 23B.08.700-720 with 8 Del. C. § 144 (corporate transactions with interested directors or officers); RCW 23B.13.020 and 23B.13.220 with 8 Del. C. § 262 (dissenting shareholders' rights); RCW 23B.06.400 with 8 Del. C. § 170 (dividend distributions); RCW 23B.07.020 with 8 Del. C. § 211 (special shareholder meeting).

North Dakota, Kentucky, Texas, and Illinois — holding that preferred stockholders of dissolving corporation were entitled to payment of accrued dividends from corporate assets before common stockholders).²⁹

In short, Washington has no history of hewing to Delaware authority on corporate governance issues. More often, Washington ignores or departs from Delaware's approach and either fashions Washington's own standards or seeks guidance from other sources. It would be particularly inappropriate for this Court to now follow Delaware on derivative proceeding standards because, as discussed below, Delaware's unique demand futility concepts have been repeatedly criticized and rejected.

2. **Courts And Commentators Have Denounced Delaware's Unusual And Flawed Demand Futility Standard.**

In Delaware, a shareholder who seeks to proceed derivatively on behalf of a corporation is excused from making demand on corporate management if "a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). That standard sets an unreasonably low bar for would-be derivative plaintiffs to clear in order to circumvent fundamental corporate procedures and usurp the proper role of corporate management. It is easy to imagine (or concoct) reasons that a corporate director theoretically might not be "disinterested" in alleged

²⁹ There are three areas where Washington has opted to follow Delaware's approach: the corporate opportunity doctrine; valuing the shares of dissenting shareholders in dissenters rights proceedings; and the power of corporations to repurchase their own stock (under a Washington statute copied nearly verbatim from a Delaware statute). None of those issues relates to, or has any bearing on, derivative proceedings. More to the point, no Washington court has *ever* held that Washington generally looks to Delaware law for guidance, and the cases discussed above soundly refute that notion.

wrongdoing that occurred on that director's watch. In order to establish demand futility in Delaware, that theoretical basis to doubt a director's disinterestedness need only be "reasonable," *i.e.*, not frivolous, foolish, or patently unreasonable. Reasonable minds may differ on a great many things; in essence, therefore, Delaware's test validates any doubt that is not arbitrary or clearly spurious. *Starrels v. First Nat. Bank of Chicago*, 870 F.2d 1168, 1175 (7th Cir. 1989) (Easterbrook, J., concurring).

Reasonable doubt is a familiar concept in criminal proceedings. Criminal defense attorneys rely, as a matter of course, on the "reasonable doubt" standard to argue that *any* modicum, or "shred," of doubt that is within the realm of reason — even when balanced against an abiding sense that the truth lies elsewhere — is sufficient to exonerate. That is a wholly inappropriate standard for measuring a shareholder's right to pursue derivative litigation, which is intended to be a rare and disfavored *exception* to the general rules of corporate governance. As the ALI noted:

The Delaware law on demand and its excuse seems in particular to invite collateral litigation by adopting the ambiguous "reasonable doubt" standard. ... Even if a "reasonable doubt" standard may arguably make sense as a screening mechanism to determine which actions should proceed further to the stage where the board must conduct a fuller inquiry and where discovery may be appropriate, its dual use as a standard to determine also when demand is excused may result in demand being excused too frequently, thereby unduly diminishing the role of the board.

ALI Principles, § 7.03, Reporter's Note 5 at 66-67.³⁰

³⁰ See also *Starrels*, 870 F.2d at 1175 (Easterbrook, J., concurring) ("If 'reasonable doubt' in the *Aronson* formula means the same thing as 'reasonable doubt' in criminal law, then demand is excused whenever there is a 10% chance that the original transaction is not protected by the business judgment-rule. Why should demand be excused on such a slight showing? Surely not because courts want shareholders to file suit whenever there is an 11% likelihood that the business judgment rule will not protect a transaction"); Factor, 40 Santa Clara L. Rev. at 396-97 (cataloguing sources critical of Delaware).

In addition to the critique that a “reasonable doubt” notion sets an unreasonably low bar for would-be derivative plaintiffs, Delaware’s demand futility standard has been variously criticized as “exceedingly complicated,” “irrational,” “subjective,” “confusing,” “unpredictable,” and susceptible to widely disparate applications. As the ALI observed in advocating rejection of Delaware’s demand futility doctrine:

[T]he Delaware rule on demand futility has a special complexity. ... [P]hrased in terms of a “reasonable doubt” test, it seems to inject a substantial measure of subjective judicial discretion into the decision whether to excuse demand. Indeed, some recent federal court decisions applying Delaware law ... have liberally interpreted this standard and found a “reasonable doubt” about the board’s performance on facts that might not have sufficed in Delaware.

ALI Principles, § 7.03 at 57 (citations omitted).³¹ In fact, Delaware’s demand futility test has been criticized as virtually amounting to no test at all: “[T]he *Aronson* test ultimately is an empty one that seldom dictates the result in a specific case. *A strong judge usually can manipulate a ‘reasonable doubt’ standard to reach the out-come that he or she desires.*” Coffee, 48 *Bus. Law.* at 1413 (emphasis added).³²

³¹ See also John C. Coffee, *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 *Bus. Law.* 1407, 1412-13 (1993) (“[Delaware’s demand futility doctrine] is susceptible to highly variant interpretation and application. 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 — as recent cases have indicated. In particular, the meaning of the term *reasonable doubt* and the quantum of particularization necessary to rebut the presumption in favor of the board are undefined and invite inherently subjective responses from other courts. ... Indeed, federal courts applying *Aronson* recently excused demand in cases where little board involvement was shown” (footnotes omitted)).

³² See also Factor, 40 *Santa Clara L. Rev.* at 379-88 (“Delaware’s demand futility rule is costly to apply and counterproductive. ... Any test that routinely embroils a corporation in protracted, costly litigation just to determine whether a shareholder must first pursue an intracorporate resolution defeats the purpose of the demand rule. ... Delaware law is antithetical to the purposes of the demand requirement because it involves the courts and parties in complex, difficult, and costly threshold litigation regarding excusing demand”).

One commentator has aptly condemned Delaware's demand futility doctrine as "irrational because it makes the demand requirement turn on the court's uninformed prediction of how the case will turn out on the merits, rather than on whether the purposes of the demand rule could be achieved in a particular case." Facter, 40 Santa Clara L. Rev. at 393. Whether demand is excused under the first *Aronson* prong depends "on an educated guess as to the likelihood of director liability made by the trial court at the outset of a case. That educated guess is based on the pleadings alone, not on any evidence." *Id.* at 389. Likewise, determining whether demand is excused under the second *Aronson* prong — *i.e.*, whether there is a reasonable doubt that the challenged transaction was "the product of a valid exercise of business judgment" — requires a merits-related analysis, but for a wholly collateral purpose and based only on the pleadings without the benefit of discovery. *Id.* at 392-95; accord *ALI Principles*, § 7.03, at 56-57.³³ Not only does that test place the court in an awkward position, it also "cuts even a disinterested board out of the process whenever there is a serious question about the status of the challenged conduct, denying the firm the initial opportunity to make a business decision whether to pursue litigation although there may be no reason to doubt the integrity of the board's decision." *Starrels*, 870 F.2d at 1174.³⁴

³³ As Facter notes: "There is perhaps no other place in the law where statutory rights — both the board's right to manage the corporation's litigation and the majority shareholders' rights to have the corporation's affairs managed by their elected board members — can be divested prior to discovery and without any factual showing." 40 Santa Clara L. Rev. at 394.

³⁴ The ALI has also noted that Delaware's standards chill shareholder attempts to seek redress of complaints through intra-corporate mechanisms. In Delaware, any demand made by a shareholder is deemed to concede the board's independence, which dissuades a shareholder from sending even written protests or requests for information to the board, for fear the act will be deemed a demand. *ALI Principles*, § 7.03, at 67.

Ultimately, Delaware's convoluted and imprecise demand futility doctrine results only in unpredictable, unnecessary, and extended litigation over the doctrine's application, rather than furthering the central purpose of the demand requirement, *i.e.*, to protect corporate management's ability and right to govern corporate affairs.³⁵ Moreover, Delaware's standard is subject to interpretations that turn on its head the bedrock principle that underlies Washington's law of corporate governance: corporate affairs must be directed and controlled by corporate management. As the ALI presaged, if putative derivative plaintiffs need only conjure up "reasonable doubt" regarding the disinterestedness of the board, derivative litigation will become routine, rather than a highly "disfavored" proceeding permitted only "in exceptional circumstances." *Haberman*, 109 Wn.2d at 147. Even if this Court were inclined to forego "universal demand" and adopt wholesale another state's approach to demand futility, Delaware would be a wholly inappropriate state for Washington to emulate.³⁶

3. The Court Could Recognize A Demand "Futility" Notion But Still Reject Delaware's Formulation.

As noted above, 23 states have, either implicitly or explicitly, rejected Delaware's flawed approach to derivative proceedings and instead adopted

³⁵ Justice Jacobs of the Delaware Supreme Court admitted as much, concluding that *Aronson's* demand futility test "generates other issues that in turn will require additional complex and expensive litigation to resolve." Justice Jack B. Jacobs, *The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay*, 41 Suffolk U. L. Rev. 1, 5, 14 (2007) (noting that *Aronson's* demand futility standard "spawned new motion practices that resulted in additional delay and expense"); *see also Starrels*, 870 F.2d at 1173 ("As a way to curtail litigation, the demand rule is a flop").

³⁶ The risks inherent in Delaware's confusing demand futility standard are manifest in the *Maxim* decision (discussed in Section IV(E) below). In *Maxim*, the pendulum has swung to its maximum distance from the principles that underlie Washington's corporate law. If *Maxim* survives as the law in Delaware — a result open to serious doubt because *Maxim* undermines even the *Aronson* standards — the burden will have shifted entirely to the corporation to demonstrate why derivative litigation should *not* proceed.

“universal” demand. But even in states where the courts felt constrained to recognize some form of “futility” exception to the demand requirement, courts have chosen to depart from Delaware’s standards.

Particularly instructive is *In re Guidant Shareholders Derivative Litigation*. The procedural posture in *Guidant* was the same as in this proceeding: presiding over a putative derivative action under Indiana law, and faced with the shareholder plaintiffs’ failure to make demand on the board, the U.S. District Court for the Southern District of Indiana certified to the Indiana Supreme Court the following question:

Under [Indiana Business Corporation Law], regarding futility, by what legal standard should a court evaluate a shareholder’s decision not to make demand to a public corporation’s board of directors before filing a derivative suit?

841 N.E.2d at 572. As a starting point, the *Guidant* Court noted that Indiana follows the universal rule that “a shareholder wishing to file a derivative lawsuit to pursue a corporation’s rights must first demand that the board of directors take action.” *Id.* at 572. But the Court also noted that, since as early as 1891, Indiana has recognized, as a matter of common law, that demand may be excused “where the shareholder alleges with particularity in a verified complaint that a majority of the board of directors are either the tortfeasors and/or interested in the transaction at issue.” *Id.* In 1986, the Indiana Legislature adopted the 1984 MBCA provision (§ 7.40) requiring a derivative plaintiff to allege with particularity “either that the demand [on the board] was refused or ignored or why the shareholder did not make the demand.” *Id.* at 573. The Indiana Legislature also adopted a provision authorizing a corporation “to form a disinterested committee to determine whether the corporation

should pursue a possible claim.” *Id.* Against that legal backdrop, the Court considered whether to retain, eliminate, or modify the futility exception to the shareholder demand requirement.

The *Guidant* corporate defendants argued that Indiana should reject demand futility and adopt “universal demand,” and the Court acknowledged the clear national trend toward adopting universal demand. 841 N.E.2d at 574. The Court also noted that the Seventh Circuit had predicted, nearly a decade before, “that the highest court in Indiana would today be persuaded by the general trend in the law towards narrowing, if not eliminating, the exceptions from the demand requirement.” *Id.* (citing *Boland*, 113 F.3d at 712). Notwithstanding that national trend, which the *Guidant* Court appeared to cite with favor, the Court ultimately felt constrained to retain some vestige of the demand futility exception, but for one critical reason: “We think the doctrine of futility is *sufficiently implanted in the interpretation and operation of Indiana corporate law* that we should not deem it cast aside by indirect statutory hint.” *Id.* (emphasis added).³⁷

Despite tipping its hat to the futility exception — which the Court felt obligated to do, in light of Indiana’s “implanted” common law — the *Guidant* Court nevertheless limited the exception to an extent that drained

³⁷ Of course, this is the key way in which the corporate law of Indiana and the corporate law of Washington differ. Since 1891, Indiana’s common law has stated that it would be a “farce” to “require those who are charged with a conversion of the assets to bring suit in the name of the corporation against themselves, and to furnish the proof to sustain the charge.” *Wayne Pike Co. v. Hammons*, 27 N.E. 487, 489-90 (Ind. 1891). Unlike Indiana’s “long-standing” and “consistent” recognition of the demand futility exception (*Guidant*, 841 N.E.2d at 572-73), as discussed above, Washington courts have never adopted the futility exception, but have instead rejected it. It is evident from the *Guidant* decision that, absent the entrenchment of the futility exception in Indiana’s common law (which Washington does not share), the Indiana Supreme Court would have rejected demand futility and adopted universal demand.

demand futility of any practical effect.³⁸ Citing Indiana's statute that authorizes a board to appoint a special committee to assess the wisdom of the corporation pursuing litigation, the *Guidant* defendants argued that the statute "so significantly narrows the situations where demand would be excused as futile, that it virtually eliminates the need for any doctrine defining what adequately excuses making a demand." 841 N.E.2d at 574. The Supreme Court effectively agreed. *Id.* at 575 ("We conclude [the defendants] are pretty close to being right about this"). The Court observed that "[r]ecent developments that improve corporate responsibility and accountability suggest the viability of the disinterested committee as an alternative to derivative suits." *Id.* at 576. Thus, although the Court purportedly preserved demand futility, it held:

Once a corporation establishes a disinterested committee (which it can do even after a suit is filed without a demand according to [Indiana Business Corporation Law] section 23-1-32-2) ***demand futility is no longer an issue***. There is no need at that point for a court to determine if demand would be futile on traditional grounds, for example, such as when a majority of the board of directors have an interest in the transaction. This is because the decision of the disinterested directors or other disinterested persons is presumed to be conclusive

Id. at 575 (emphasis added).

In operation, the *Guidant* Court's ruling guts the futility exception and effectively results in a "universal" demand standard. Where a corporation

³⁸ In preserving vestiges of demand futility, the *Guidant* Court also noted that the Indiana Legislature had not expressly adopted a universal demand standard, despite several opportunities to do so. But the Court obviously did not believe that the Legislature's failure to act limited the Supreme Court's ability to fashion its own standard. The *Guidant* Court went on to significantly limit the futility exception, despite the lack of direct guidance from the Legislature. Here, Washington's Legislature has adopted a purely procedural statute (RCW 23B.07.400), but left to the Washington courts the task of delineating the substantive standards to accompany that procedure.

has already appointed a special committee, demand is required and futility is inapplicable (though the Court adopted the ALI concept that the risk of “irreparable injury” may still excuse demand). *Id.* at 575 n.3. And where a committee has *not* yet been appointed and a derivative suit is commenced, the corporation may still appoint a committee at that stage and, again, futility is moot. (It is difficult to imagine that a rational Indiana board would *not* appoint a disinterested special committee in order to prevent or halt ill-advised derivative litigation.) In short, Indiana has preserved the demand futility exception in name only.

Conspicuously absent from the *Guidant* Court’s consideration of demand futility is *any* discussion of Delaware’s standards. In *Boland*, the would-be derivative plaintiff argued to the Seventh Circuit that Indiana would adopt Delaware law on demand futility. 113 F.3d at 712. The Seventh Circuit disagreed — despite the fact that Indiana courts have favorably cited Delaware law on other topics — and predicted that Indiana would instead adopt universal demand. *Id.* It is telling that, in opting to retain some form of futility exception (at least in a technical sense), Indiana’s Supreme Court deemed it unnecessary to even address Delaware’s aberrant and problematic approach to demand futility.

In *Werbowsky v. Collomb*, the Maryland Court of Appeals similarly considered whether to adopt a universal demand standard or to retain the futility exception. Like Indiana, Maryland has recognized demand futility for well over a century. 766 A.2d at 135-36. The Court engaged in a thorough analysis of the genesis and history of the demand futility concept, and acknowledged the clear national trend away from futility and toward universal demand. *Id.* at 137-38. The Court also

specifically discussed Delaware's doctrine of demand futility and its myriad weaknesses. *Id.* at 138-39. Ultimately, the Court declined "to adopt in full the Delaware approach," noting that "*few, if any, States have abandoned their existing law in favor of that approach.*" *Id.* at 143 (emphasis added). Apparently because the demand futility notion was already firmly ingrained in Maryland's common law, the *Werbowsky* Court chose to retain the concept. The Court adopted, however, a standard considerably more exacting than Delaware's, requiring a "very particular" showing that directors are "so personally and directly conflicted" that they are incapable of acting in good faith or exercising business judgment. *Id.* at 144. That standard properly places on putative derivative plaintiffs the heavy burden of establishing a clear disabling interest.³⁹

In summary, Washington should, for all the compelling reasons discussed above, adopt universal demand. If, however, the Court is inclined to recognize some form of demand futility, it should fashion a standard that honors the fundamental precepts underpinning Washington corporate law on derivative proceedings and eschew Delaware's flawed standards. At a minimum, like Indiana, Washington should only entertain a demand futility argument where the corporation has failed to take *any* steps — such as the appointment of a special committee — to avoid the risk of "interested" decision-making. And if the corporation takes such prophylactic measures after derivative litigation is commenced, the derivative proceeding should automatically halt until demand is made.

³⁹ See also *Reimel v. MacFarlane*, 9 F. Supp. 2d 1062, 1067 (D. Minn. 1998) ("Finally, the Court refuses to adopt blindly Delaware's test for futility. ... There is no reason to engage in a mechanical application of Delaware law (and likely find that demand is futile) where the realities of this case suggest that the board's response to a shareholder demand is not preordained"; rejecting that Minnesota would follow Delaware).

In those rare instances where the corporation fails to take appropriate steps to permit disinterested decision-making, any test of demand futility must place the burden squarely on a would-be derivative plaintiff to prove, with particularized facts and evidence, that the individuals on whom demand would be made are *incapable* of acting in good faith. The test for judging demand futility should set the highest possible pleading bar.⁴⁰ Anything short of such an exacting standard would eviscerate the fundamental principles on which Washington's corporate law relies.

E. *Maxim* Is A Dangerous Anomaly And Should Be Rejected.

In light of the issues discussed above — in particular, Washington's history of deference to the decision-making of corporate management, the lack of *any* nexus between Washington law and Delaware law, and the vigorous and expanding condemnation of Delaware's demand futility standards — it is odd to be analyzing whether the Washington Supreme Court would follow a Delaware trial court opinion (*Maxim*), particularly where that trial court opinion not only abandons a century of corporate governance principles, but has not yet been tested on appeal. Because plaintiffs' claims hinge entirely on whether *Maxim's* reasoning applies, the District Court ostensibly felt compelled to certify the issue. For multiple reasons, the Court should disregard *Maxim*.

The *Maxim* opinion, issued on February 6, 2007, was one of the first published decisions to grapple with demand futility in the context of

⁴⁰ This discussion points up one of the core deficiencies in the demand futility doctrine: it is extremely difficult to formulate a coherent definition of demand "futility" that properly balances and respects the fundamental corporate principles on which derivative proceedings are based. Anything other than the simple bright-line standard of universal demand provides little practical guidance to Washington courts, and introduces an undesirable level of confusion and subjectivity into the derivative analysis.

alleged options “backdating.” *Maxim* involved allegations that Maxim’s directors had systematically “backdated” stock options, in violation of the company’s option plans. “Backdating,” as Chancellor Chandler employed the term, “involves a company issuing stock options to an executive on one date while providing *fraudulent* documentation asserting that the options were actually issued earlier. These options may provide a windfall for executives because the *falsely* dated stock option grants often coincide with market lows.” 918 A.2d at 345 (emphasis added). In short, “backdating” is *fraud*.⁴¹ See *In re F5 Networks, Inc. Deriv. Litig.*, slip op., No. C06-794 RSL, 2007 WL 2476278, *7 n.3 (W.D. Wash. Aug. 6, 2007). The *Maxim* Court concluded that a derivative plaintiff may establish demand futility by merely alleging that (1) options were “backdated,” (2) in violation of a company’s stock option plans, and (3) a majority of the directors “approved” the “backdated” options. 918 A.2d at 355-57.

The overarching failing of the *Maxim* opinion is that it sets the bar *much* too low for a would-be derivative plaintiff to plead demand futility (and thereby usurp the fundamental role of corporate management). *Maxim*’s reasoning adopts an unreasonably (and illogically) lenient standard in two respects. First, Chancellor Chandler did not require the plaintiffs to adduce *any* evidence that fraudulent “backdating” actually occurred. Despite the Court purporting to require “well-pleaded allegations” of fraudulent conduct (918 A.2d at 358), the *only* allegation supporting the plaintiffs’ “backdating” accusation was the Merrill Lynch

⁴¹ Note that “[t]he practice of granting ‘in the money options’ is not improper, in and of itself, provided it is: 1) fully disclosed to necessary parties ... ; 2) properly accounted for ... in the company’s financial disclosures ... ; 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.” *F5 Networks*, 2007 WL 2476278, *7 n.3.

study that suggested Maxim's option grant pattern was "extraordinarily lucky." *Id.* at 354-55. But the Merrill Lynch statistical analysis is fatally flawed and effectively meaningless. The basic conclusion of that study — *i.e.*, that it is highly unlikely, through the operation of random chance, that a particular company's option grants would repeatedly or consistently coincide with low-points in the company's stock price — is simply wrong. As the well-respected firm NERA Economic Consulting has noted, if option grants were entirely random, it is a virtual *certainty* that at least some of the many thousands of U.S. companies granting options would, purely by chance, have grant patterns that coincide with stock low-points and appear unreasonably "lucky."⁴² In any normal probability distribution (the common "bell curve"), there will always be "outliers," *i.e.*, instances at either extreme of the curve that appear to be highly improbable, but that are just as likely to occur as any instance in the center of the curve.⁴³ Thus, the key conclusion in *Maxim* that the company's grant pattern "seems too fortuitous to be mere coincidence" (*id.* at 355) is false.⁴⁴

⁴² See Dr. Reno Comolli et al., *Options Backdating: The Statistics of Luck*, NERA Economic Consulting (Securities/Finance Practice) (March 8, 2007) at 4 [Record No. 60; App. No. 3] ("Speculation has been rampant about companies that have been very lucky; yet nobody has been paying any attention to companies that have been very unlucky").

⁴³ NERA cites the example of the New Jersey woman who won the state lottery twice in a four-month period. Despite the seeming impossibility of such a thing occurring as a result of random chance, it is actually better than even odds that, over a seven-year period, *someone* in the U.S. will be a double lottery winner. NERA Study at 4. Under the Merrill Lynch reasoning — which was regrettably swallowed whole by Chancellor Chandler — a plaintiff could accuse any lottery winner of *fraud*, simply because the odds of winning are so low. But people routinely win the lottery *non-fraudulently*.

⁴⁴ There are myriad flaws in the Merrill Lynch study, and other studies like it, which are frequently compounded by would-be derivative plaintiffs. For example, the statistical "backdating" studies are all based on a "sample selection bias," because those studies seek out stock option grants that were followed by large gains in stock price, but ignore grants that were followed by large *declines* in stock price. NERA Study at 3. Plaintiffs also use an artificial 20-day window following an option grant to measure price gains,

More to the point, even if the Merrill Lynch analysis were beyond reproach, statistical probabilities alone should *never* be sufficient to establish fraud. Chancellor Chandler admitted that Merrill Lynch did not “take a position on whether Maxim actually backdated,” 918 A.2d at 347, but the Court nevertheless concluded that the Merrill Lynch study was “empirical evidence” of backdating. Not true. Without *some* actual evidence of “backdating” (*i.e.*, fraud), there is no basis to conclude that any company accused of “backdating” is not simply the random statistical outlier, the double lottery winner.⁴⁵ And relying only on “probabilities” and conjecture is particularly inappropriate where a plaintiff is required to plead with *particularity*, as required by *Aronson* (which the *Maxim* opinion purports to apply). *Id.* at 352. Judge Lasnik properly rejected *Maxim*, and the notion that statistical inferences are sufficient to allege “backdating,” and instead engaged in a “searching inquiry into the individual option grants at issue.” Show Cause Order at 7; *F5 Networks*, 2007 WL 2476278, *8-14. Based on that “detailed, grant-specific analysis,” and notwithstanding an option grant pattern that plaintiffs claim is “wildly improbable,” Judge Lasnik concluded that plaintiffs had failed to adequately plead that any “backdating” occurred at F5. *Id.*

and ignore that many options are subject to vesting (which defeats any short-term profit). A full discussion of the fallacies underlying a statistical approach to “backdating” is beyond the scope of this opening brief, but the issues were briefed in depth to the District Court. Record 49; App. No. 4 (pp. 23-28); Record 59; App. No. 5 (pp. 3-18); Record 80; App. No. 6 (pp. 5-17); Record 89; App. No. 7 (pp. 7-12).

⁴⁵ Moreover, it is entirely possible for a company to erroneously, but *innocently*, select the grant date for an option. *See, e.g., In re CNET Networks, Inc.*, 483 F. Supp. 2d 947, 955 (N.D. Cal. 2007) (“The Chief Accountant’s Office of the SEC has identified a few instances where a company could use the wrong measurement date through sloppy accounting practices not rising to the level of fraud”). Thus, to establish “backdating,” a plaintiff must allege indicia of fraud, not merely a discrepancy between the option date and the proper grant date (which can occur as the result of innocent error).

The *Maxim* opinion establishes an unreasonably lenient pleading standard in a second important respect: according to *Maxim*, the conclusory allegation that a director “approved” a challenged option grant is sufficient to render that director “interested” under *Aronson*. 918 A.2d at 356. But *Aronson* establishes exactly the *opposite*. 473 A.2d at 814 (holding it is *not* the rule that “any board approval of a challenged transaction automatically connotes ‘hostile interest’ and ‘guilty participation’ by directors, or some other form of sterilizing influence upon them. Were that so, the demand requirements of our law would be meaningless ...”).⁴⁶ Judge Lasnik also held that a plaintiff must “plead particularized facts regarding the Director Defendant’s actual involvement in granting the options.” *F5 Networks*, 2007 WL 2476278, *14.

The *Maxim* decision fatally undermines Delaware’s demand futility standards, as set forth in *Aronson*. In *Aronson*, the Delaware Supreme Court was attempting to remedy an inappropriately lenient pleading standard applied by the trial court, because “demand futility becomes virtually automatic under such a test.” 473 A.2d at 814. In other words, *Aronson* intended to *raise* the bar a would-be derivative plaintiff must clear. *Id.* at 812 (“Thus, by promoting this form of alternative dispute resolution [demand], rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that

⁴⁶ Other Delaware courts have recognized *Maxim*’s standard as falling far short of the particularity required by *Aronson*. See, e.g., *Desimone v. Barrows*, 924 A.2d 908, 942-43 (Del. Ch. 2007) (requiring plaintiffs to plead with particularity “facts specific to each director” and concluding that the court could “infer nothing from the pled facts about whether and to what extent any director was involved in the mechanics by which the options were issued or the dates on which that administrative task was carried out”); see also Brian L. Levine, *Delaware Raises The Bar For Pleading Stock Option Manipulation*, 17-OCT Bus. L. Today 65 (Sept./Oct. 2007) (recognizing that *Desimone* rejects the too-lenient *Maxim* standard for pleading participation in alleged backdating).

directors manage the business and affairs of corporations”).⁴⁷ *Maxim* returns to the very evil *Aronson* sought to eliminate, a test where demand futility is “virtually automatic.” The *Maxim* plaintiffs pled *nothing* with particularity. They alleged a bare (and fallacious) statistical implication that Maxim’s option granting patterns were the result of something other than chance, and summarily concluded that the Maxim directors “approved” those grants. Chancellor Chandler deemed that skeletal notice pleading sufficient to excuse demand. But there is no reason to believe *Maxim* will survive an appeal, or reverse decades of Delaware law narrowing the circumstances when shareholders may proceed derivatively.

To bring this analysis full-circle, the reasoning and practical effect of *Maxim* are utterly inconsistent with the fundamental principles that underlie Washington’s law on derivative proceedings. In Washington, derivative litigation is highly disfavored and only permitted in the rarest circumstances. Consequently, even if this Court were inclined to follow Delaware’s general demand futility standards, the Court should reject *Maxim*, as it perverts well-established Delaware law and is antithetical to basic precepts of Washington corporate governance.

V. CONCLUSION

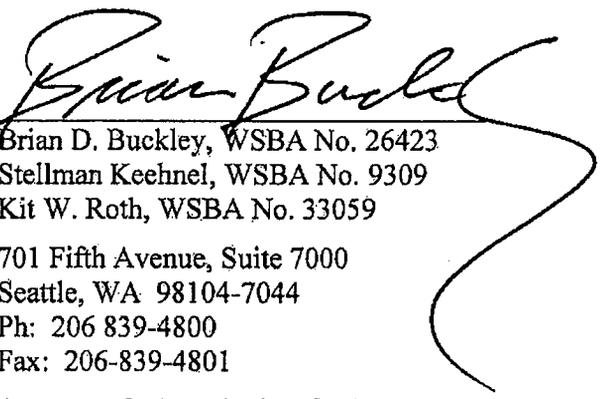
Based on the foregoing, the Court should recognize “universal demand” in Washington and reject any notion of “demand futility.”

⁴⁷ The *Aronson* decision was heralded as a “doctrinal shift,” establishing “a severe test, which rarely can be satisfied in the case of a publicly held corporation having a board with a majority of outside directors.” Coffee, 48 Bus. Law. at 1413. In fact, when *Aronson* issued, one commentator noted that the opinion would “make it very difficult to establish the futility of demand under Delaware law,” and predicted: “After *Aronson* there should be relatively few demand-excused cases” Block & Prussin, *Termination of Derivative Suits Against Directors on Business Judgment Grounds: From Zapata to Aronson*, 39 Bus. Law. 1503, 1506 (1984) (emphasis added).

RESPECTFULLY SUBMITTED this 15th day of September, 2008.

DLA PIPER LLP (US)

By:


Brian D. Buckley, WSBA No. 26423
Stellman Keehnel, WSBA No. 9309
Kit W. Roth, WSBA No. 33059

701 Fifth Avenue, Suite 7000
Seattle, WA 98104-7044
Ph: 206 839-4800
Fax: 206-839-4801

Attorneys for Nominal Defendant
F5 Networks, Inc.