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CASE NO. 67979-1-1

COURT OF APPEALS, DIVISION I
STATE OF WASHINGTON

JOHN McKAY, A Washington Resident, GEORGE McKAY, a
Washington Resident, JOHN McKAY *ex rel.* SUNSET CARS OF
RENTON, INC., a Washington Corporation, and GEORGE McKAY *ex*
rel. SUNSET CARS OF RENTON, INC., a Washington Corporation,
Appellants,

vs.

MORRIS PROSZEK and "JANE DOE" PROSZEK, Husband and Wife
and the marital community Comprised thereof,
Respondent.

Brief of Respondent

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I. INTRODUCTION

Appellants John McKay and George McKay (together, “the McKays”) and Respondent Morris Proszek (“Proszek”) together own 100% of Sunset Cars of Renton, Inc. (“Sunset Cars”), a Washington corporation. Fife Commercial Bank (“Fife Commercial”) filed a lawsuit against Sunset Cars, John McKay, and Proszek, seeking replevin of vehicle inventory that Fife Commercial had financed and damages for breach of personal guaranties signed by Proszek and John McKay. The McKays filed a Third-Party Complaint against Proszek, which included a shareholder derivative claim against Proszek, as well as an “indemnification” claim asserted by John McKay against Proszek based on the guaranties.

Upon Proszek’s motion, the trial court dismissed the Third-Party Complaint. The McKays had failed to comply with the statutory prerequisites for a shareholder derivative suit, and the indemnification claim was without merit. The trial court dismissed the lawsuit with prejudice, which was appropriate because the McKays controlled Sunset Cars’ Board of Directors, and there was no reason to grant them leave to amend the Third-Party Complaint. The trial court also awarded Proszek attorney’s fees and costs he incurred due to the frivolous nature of the Third-Party Complaint, which was not well grounded in fact or law. Fife

Commercial recovered the vehicle inventory and dismissed its lawsuit with prejudice and without costs to either party.

II. COUNTERSTATEMENT OF ISSUES

A. Assignments of Error

1. Was the trial court correct when it dismissed the shareholder derivative suit with prejudice?

2. Was the trial court correct when it dismissed the indemnification claim with prejudice?

3. Was the trial court correct when it awarded attorney's fees and costs to Proszek pursuant to CR 11 and RCW 4.84.185?

B. Issues pertaining to Assignments of Error

1. Do shareholders lack standing to bring a shareholder derivative suit if they fail to comply with the substantive and procedural prerequisites for derivative suits mandated by statute and civil rule? [Assignment of Error No. 1]

2. Should a shareholder derivative suit that is dismissed be dismissed with prejudice where the shareholders who brought the action control the Board of Directors and a majority of the shares? [Assignment of Error No. 1]

3. Should an indemnification claim by a personal guarantor of a corporation's debt against a co-guarantor be dismissed with prejudice

when no special relationship or warranty between the two exists, other than their status as guarantors? [Assignment of Error No. 2]

4. Should a trial court's award of attorney's fees and costs be upheld where no abuse of discretion has been found? [Assignment of Error No. 3]

III. STATEMENT OF THE CASE

Sunset Cars was a licensed motor vehicle dealer that sold used cars in Renton, Washington. CP 106. It was incorporated in 2007 and owned by John McKay and Proszek. CP 19. According to the McKays' Third-Party Complaint, George McKay purchased an interest in the company in July 2010, and thereafter John and George McKay each owned 30% of Sunset Cars and Proszek owned 40%. CP 20.

On February 7, 2011, the McKays held a "Board of directors/ Shareholder vote", wherein Proszek was removed as President of Sunset Cars and fired from the company. CP 250. At that meeting, John McKay was voted the new President, George McKay was announced as Vice President and Director of Operations, and a majority of the board amended all company by-laws. CP 251. Proszek was also "instructed to refrain from entering the premises." CP 249.

The McKays held a subsequent Board of Directors meeting, either on April 16, 2011 or May 6, 2011¹, wherein Proszek was removed as director, officer, fiduciary, and signer from all corporate accounts of Sunset Cars. CP 279.

Sunset Cars obtained financing for its vehicle inventory (known as “flooring” in the industry) by obtaining loans through Fife Commercial Bank. CP 5 at ¶2.5. These loans were secured by personal guaranties signed by Proszek and John McKay. *Id.* at ¶2.7-2.8. Due to Sunset Cars’ default in making payments due, Fife Commercial brought a replevin action in King County Superior Court to recover possession of the inventory securing the loan. CP 1-13. Fife Commercial’s lawsuit also included claims against Proszek and John McKay for breach of their personal guaranties. CP 8-9.

Fife Commercial filed its action on April 22, 2011. CP 1. On May 5, the McKays filed an Answer and Affirmative Defenses to Complaint and Third-Party Complaint Against Morris Proszek (“Third Party Complaint”). CP 16-39. The Third Party Complaint named the McKays individually and in their representative capacity as shareholders of Sunset Cars. CP 16.² The Third Party Complaint alleged five claims, four of

¹ Compare CP 279 (“May 6”) with CP 280 (“April 16”).

² Although the Third Party Complaint listed George McKay in his individual capacity as well as a shareholder, he apparently never asserted any individual damages. CP 121:6-8.

which related to allegations that Sunset Cars incurred damages due to Proszek's conduct³ (collectively comprising the shareholder derivative action), and one claim that Proszek should indemnify John McKay for any damages John McKay incurred by virtue of the personal guaranty.⁴ CP 18-26; App. Br. at 5-10.

On July 27, Proszek filed a Motion to Dismiss, alleging, *inter alia*, that the McKays could not assert individual claims for injuries to the corporation; that the shareholder derivative suit was fatally flawed because the shareholders had made no demand on the Board of Directors, nor had they alternatively pled particular facts in the Third Party Complaint why such a demand would be futile; and that the indemnity claim was without merit. CP 105-14.

The McKays' response asserted that John McKay's indemnification claim was meritorious because Proszek knew that his representations to Fife Commercial would cause Fife Commercial to try

³ Although Proszek disputes the McKays' allegations about Proszek's conduct that they asserted in the Third Party Complaint and Appellate Brief, for purposes of the Motion to Dismiss as well as for this appeal, they are presumed to be true.

⁴ The Third Party Complaint alleged the following claims:

- (i) Breach of Fiduciary Duty;
- (ii) Conversion;
- (iii) Tortious Interference with Business Expectancies;
- (iv) Indemnification; and
- (v) Breach of Contract.

CP 22-25. Count (iv) is the indemnification claim for which John McKay is the only plaintiff allegedly injured, while the other four claims are for damages to Sunset Cars (*i.e.*, the shareholder derivative action). See CP 121:6-8.

and enforce his personal guaranties. CP 121-22. The McKays also argued that demanding action from the Board would have been futile and that failure to include the derivative pleading requirements found in RCW 23B.07.400 and CR 23.1 were merely technical defects for which the trial court should grant them leave to cure. CP 122-24.

The trial court granted Proszek's Motion to Dismiss, signing an Order in which the court found "the 3rd party Plaintiffs lack standing and fail to meet statutory prerequisites for Third Party action." CP 143.

The trial court denied the McKay's Motion for Reconsideration. CP 220. The court granted Proszek's subsequent Motion for Attorney's Fees and Costs, which Judgment found that the Third Party Complaint "was (i) frivolous and advanced without reasonable cause (RCW 4.84.185) and (ii) not well grounded in fact or warranted by existing law (CR 11)." CP 290.

After Sunset Cars returned the vehicles to Fife Commercial, Fife Commercial dismissed its Complaint with prejudice and without costs to either party. CP ___ (Supp. Clerk's Papers; *see* attached Appendix A (Order of Dismissal)). The McKays appealed both the order dismissing the Third Party Complaint and the order awarding Proszek attorney's fees and costs. CP 293.

IV. ARGUMENT

A. Dismissal of the shareholder derivative suit was proper because the McKays failed to make a demand upon the Board of Directors or plead with particularity the reasons such a demand would be futile.

The McKays claim that they had standing to bring a shareholder derivative action because they owned 60% of Sunset Cars' outstanding shares. App. Br. at 12. Although shareholder status is certainly a prerequisite to maintaining a shareholder derivative action under RCW §23B.07.400(1), that is not the reason the trial court dismissed the action, and is therefore not an issue before the Court.

The trial court dismissed the action because the McKays lacked standing and failed to meet statutory prerequisites. CP 143.⁵ The McKays failed to show whether a demand was made and refused or ignored by the board, or whether such a demand was futile. RCW 23B.07.400(2). Contrary to the McKays' assertion, this requirement is not merely a "procedural" formality, but a substantive prerequisite as well.

⁵ Because the Third Party Complaint named the Proszeks individually as well as in their shareholder capacity, Proszek's Motion to Dismiss included an argument that shareholders do not have standing to bring a claim for individual damages suffered as a result of simply being a shareholder, and any individual claims for such damages should be dismissed. CP 109-11. The McKays admitted they were not seeking damages outside of their role as shareholders. CP 120:22-23. Proszek asked the trial court to clarify that admission and dismiss each of them individually. CP 136:2-5.

Shareholders have the power to assert a corporation's rights on its behalf only when the corporation's officers and directors have failed to do so. In re F5 Networks, Inc., 166 Wn.2d 229, 236, 207 P.3d 433 (2009).

The complaint must verify that the shareholders have met the requirement to first get the corporation to pursue a claim, or that such a request is futile:

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) (emphasis added).

This demand requirement is also required by civil rule:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (a) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (b) that the action is not a collusive one to confer jurisdiction on a court of this state which it would not otherwise have. 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. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated

in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

CR 23.1 (emphasis added).

Thus, shareholders must do more than simply assert a corporation's rights. F5 Networks, 166 Wn.2d at 236. The shareholder must show that he has exhausted all means within his reach to obtain the desired action within the corporation, and that the managing body of the corporation has refused to sue. Id. (citation omitted). "Before bringing a shareholder's derivative action, shareholders must present their claims to the corporation and give the corporation an opportunity to pursue the case." Dreiling v. Jain, 151 Wn.2d 900, 904-05, 93 P.3d 861 (2004).

In F5 Networks, the Supreme Court determined that Washington follows the Delaware demand futility standard when determining whether allegations made pursuant to RCW 23B.07.400(2) excuse the shareholder from first making the demand on a board of directors. F5 Networks, 166 Wn.2d at 231. In other words, courts must look to the complaint to determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. F5 Networks,

166 Wn.2d at 237. Only if a demand would be futile will the court excuse the shareholder's requirement to make demand upon the board.

Ordinarily, a shareholder cannot sue for wrongs done to a corporation, because the corporation is viewed as a separate entity, and the shareholder's interest is too remote to meet the standing requirements. However, because of the possibility of abuse by the officers and directors of a corporation, a narrow exception has been created for shareholders to bring derivative suits on behalf of the corporation. CR 23.1 imposes four requirements upon a party who wishes to bring derivative actions: (1) he or she must be a shareholder at the time of the complained of transaction, (2) the action must not simply be collusive in order to confer jurisdiction on the court, (3) the complaint must allege what attempts the shareholder made to have the directors or corporation bring the suit, and (4) the shareholder bringing suit must fairly and adequately represent the interests of the class.

Gustafson v. Gustafson, 47 Wn. App. 272, 276-77, 734 P.2d 949 (1987).

By statute, civil rule, and caselaw, clearly a party must do more than simply assert a corporation's right to sue under a shareholder derivative action. The complaint must allege why a demand was not made. RCW §23B.07.400(2). This demand requirement is not just procedural, but is a substantive demand requirement. F5 Networks, 166 Wn.2d at 239 (finding that legislature has left it up to the court to develop the substantive standards of RCW 23B.07.400(2)); see also In re Cray, Inc., 431 F. Supp.2d 1114, 1120 (W.D. Wash. 2006) (concluding that substantive demand requirement exists within RCW 23B.07.400(2)).

The plaintiff in a derivative action must identify each of the directors and allege with particularity why each director is either interested or lacked independence, and cannot make generic and conclusory allegations. Cray, 431 F. Supp.2d at 1121 (noting that “demand is excused for futility only if a majority (five) of the members of Cray’s Board of Directors ... were either ‘interested’ or ‘lacked independence.’”). Furthermore, a plaintiff cannot “bootstrap” allegations of futility by pleading that the directors would be reluctant to sue themselves. Id. In Cray, the court examined each of the allegedly interested directors. Id. at 1117-18. The court found that the plaintiffs failed to show that a majority of the board was either interested in the alleged misconduct or lacked independence. Id. at 1128. As a result, the court granted the motion to dismiss. Id.

The complaint must allege “with particularity” the reasons for failing to make an effort to obtain action from the directors and shareholders. CR 23.1. The shareholder “must show that he has exhausted all means within his reach to obtain within the corporation ... action in conformity to his wishes, and that the managing body of the corporation has refused to sue or defend.” F5 Networks, 166 Wn.2d at 236 (citation omitted) (emphasis added).

In this case, the Third-Party Complaint wholly failed to allege with any particularity the reason for not making an effort to obtain action from the directors or shareholders. In their Appeal Brief, the McKays allege that they “pled facts sufficient to show that Proszek was one of two Board Members and that demanding action by the Board would have been futile.” App. Br. at 13. The McKays do not cite where in their Third-Party Complaint they pled such “sufficient facts” (*i.e.*, identification of the number or makeup of the Board of Directors for Sunset Cars and reasons for demand futility) and no such facts can be found.

That one member of the Board may oppose action is insufficient to demonstrate demand futility, especially where, as here, the majority of the board would support action. Not only did the McKays fail to plead demand futility in the Third Party Complaint, but the McKays did not face futility in approaching the Board of Directors of Sunset Cars because Proszek represented at most only 1/3 of the members of the Board. (It’s also worth noting that the McKays used their control of the Board to remove Proszek from the Board no later than May 6, 2011. CP 32 (Board minutes identifying Board of Directors members present (John and George McKay) and absent (Proszek) at Board meeting).)

Evidence submitted by the McKays proved that the Board of Directors consisted of three people – Mr. Proszek and both of the McKays.

The “Board of directors/Shareholder vote” minutes submitted by the McKays show the makeup of the Board on February 7:

Conclusion:

By a vote of 2-0, Mr. Proszek has been removed as President of Sunset Cars of Renton, Inc. and has been fired from the company. He is no longer an employee of Sunset Cars of Renton.

John McKay has been voted the new President of Sunset Cars of Renton, Inc. effective immediately. In addition, all by-laws have been amended by a majority of the board. Bylaw 6.3.

George McKay is Vice President and Director of Operations.

CP 276-77.

From the above minutes, it is apparent that as of February 7, there were at least two board members other than Mr. Proszek (“By a vote of 2-0...”; “all by-laws have been amended by a majority of the board.”). Moreover, if on February 7 the McKays could amend all bylaws of the corporation, remove Proszek as President and fire him from the company, vote John McKay as the new President, and appoint George McKay Vice President and Director of Operations, there is no reason why a demand upon the board for action in this matter would have been “futile.” Demand is excused only if it is demonstrated that a majority of the board members lacked independence. Cray, 431 F.Supp.2d at 1121. Clearly in this case the McKays were the majority of the board.

That the McKays both served on the Board of Directors is further supported by the facts alleged in the Third Party Complaint, which includes allegations that Proszek liquidated Sunset Cars' accounts "without the knowledge or consent of either John McKay or George McKay," CP 21 at ¶3.15, and that Proszek took title to 30 of Sunset Cars' vehicles "without John McKay or George McKay's knowledge and/or permission." Id. at ¶3.16. If George McKay was not a member of the Board of Directors, he would have no reason or authority to approve of the management of the corporation's business and affairs. See RCW 23B.08.010(2)(b) ("The business and affairs of the corporation shall be managed under the direction of its board of directors, which shall have exclusive authority as to substantive decisions concerning management of the corporation's business.").

In addition to their ability to compel action by the corporation as members of the board of directors, the McKays could compel action as majority shareholders of the corporation. The McKays allege that they owned 60% of Sunset Cars. App. Br. at 2; CP 20. As the McKays admitted in their response to Proszek's Motion to Dismiss, at the time of filing of the original Complaint, the McKays "were in the process of

having him removed as president.” CP 123:22.⁶ Even if the Board consisted of only Proszek and one other person (which quite obviously was not the case), the McKays could have used their shareholder voting power to compel action by the corporation.

The trial court correctly dismissed the Third Party Complaint. It failed to plead demand futility with particularity, a substantive requirement under RCW 23B.07.400(2). The facts pled in the Third Party Complaint as well as evidence submitted by the McKays in response to Proszek’s motions also demonstrated that there was no demand futility, as the McKays represented 2/3 of the Board, and Proszek only 1/3.

B. Dismissal of the shareholder derivative action with prejudice, and without leave to amend, was proper and was not an abuse of discretion.

The McKays argue that the trial court erred in dismissing the Third Party Complaint with prejudice, and should have dismissed it without prejudice or given them leave to amend. App. Br. at 16.

A trial court’s denial of leave to amend a complaint is reviewed for an abuse of discretion. Rodriguez v. Loudeye Corp., 144 Wn. App. 709, 728-29, 189 P.3d 168 (2008) (citation omitted). Denying a motion for leave to amend is not an abuse of discretion if the proposed amendment is

⁶ The McKays later recognized that they had already removed Proszek as President on February 7, 2011, months before they filed the Third Party Complaint. CP 276 (meeting minutes attached to John McKay declaration).

futile. Id. at 729. In Rodriguez, the trial court's dismissal of a shareholder derivative action without leave to amend the complaint was upheld, even though the trial court did not give an explanation for its denial of leave to amend, because an explicit explanation was not needed where it was apparent that an amendment would be futile. Id. at 729-30.

The substance of the McKays' argument is that the trial court should have granted them an opportunity to file an amended complaint "to show that reasonable doubt existed and that a pre-litigation demand would have been futile." App. Br. at 16. They cite the alleged actions by Proszek and the fact that he was a member of the Board at the time of filing to support their argument that a demand would have been futile. App. Br. at 15.

The McKays ignore the evidence that they themselves submitted (as did Proszek), which proves that Proszek was only one of three members of the Board. In addition, the McKays removed him from the Board no later than May 6, 2011, CP 132, so now the Board consists of only John and George McKay.

The demand futility standard that Washington follows looks to the complaint to determine if, "as of the time the complaint is filed," demand to the board of directors would have been futile. F5 Networks, 166 Wn.2d at 237 (citation omitted). Thus, the McKays essentially seek dismissal

without prejudice so they can refile a shareholder derivative action and assert that it would be futile to make a demand on the Board of Directors – a Board that was controlled by the McKays at the previous time of filing and that now consists of only the McKays. Because they control the Board, a shareholder derivative action is unnecessary. The trial court appropriately denied leave to amend, as it is apparent that amendment would be futile.

C. The trial court properly dismissed John McKay's implied indemnification claim against Proszek because he failed to show a special relationship between the two.

The Third-Party Complaint included an indemnification claim by John McKay against Proszek. CP 24-25. John McKay and Proszek each signed personal guaranties of the line of credit with Fife Commercial, and John McKay sought indemnification from Proszek for any actions that Fife Commercial took against John McKay's personal guarantee. *Id.*⁷

This issue is moot. On November 16, 2011, before the McKays perfected their appeal, the trial court signed an order dismissing Fife Commercial's claims against Proszek and McKay with prejudice and without costs to either party. CP ____ (Supp. Clerk's Papers; *see* attached Appendix A (Order of Dismissal)); see also CP 294 (Notice of Appeal submitted November 29). Thus, Fife Commercial will never take any

⁷ George McKay did not sign a personal guaranty and asserted no indemnification claim.

action against John McKay with respect to his personal guarantee, and the Court need not consider this matter. In re Silas, 135 Wn. App. 564, 568, 145 P.3d 1219 (Wn. App. 2006) (noting that courts generally do not consider a moot issue unless it involves continuing and substantial public interest).

In any event, John McKay had no right to assert an indemnification claim against Proszek. An implied indemnity claim is an equitable cause of action, which arises when one party incurs a liability the other should discharge by virtue of the nature of the relationship between the two parties. Fortune View Condominium Ass'n v. Fortune Star Dev. Co., 151 Wn.2d 534, 539, 90 P.3d 1062 (2004) (citation omitted).

For example, the courts have held that a contractual relationship under the UCC, with its implied warranties, provides sufficient basis for an implied indemnification claim. Central Wash. Refrigeration, Inc. v. Barbee, 133 Wn.2d 509, 516, 946 P.2d 760 (1997). In Barbee, the buyer of a product incurred liability to a third party injured by the defective product. Id. at 511. The Court upheld the buyer's implied indemnification claim against the seller, on the basis of the seller's implied warranties found in the UCC. Id. An implied indemnification claim may also arise by virtue of express warranties. Fortune View, 151 Wn.2d at 539-40. Fortune View held that express warranties created through

advertising can form the basis of an implied indemnification claim. Id. at 536.

Thus, in Fortune View and Barbee, a seller implicitly or explicitly warranted the condition of a product to a buyer and, when the product turned out to be defective, the buyer of the defective product could seek indemnification from the seller for injuries to a third party.

Where shareholders become sureties of a corporation, there is only a right of contribution as among themselves. See Brill v. Swanson, 36 Wn. App. 396, 398, 674 P.2d 211 (1984). In Washington State, co-guarantors must pay the guaranty equally, despite differing ownership interests. Brooke v. Boyd, 80 Wash. 213, 216-17, 141 P. 357 (1914). In Brooke, a corporation that developed marble quarries borrowed money from a bank. Id. at 214. The bank issued a promissory note, which was ultimately secured by five parties. Id. The corporation eventually became insolvent and failed to pay the note, which most of the guarantors collectively paid in full. Id. When the guarantors who paid the note sought contribution from the non-paying guarantor, the non-paying guarantor (Boyd) sought to avoid liability on the note by arguing, *inter alia*, that the trial court erred in holding him liable to contribute an equal share of the indebtedness, instead of holding him liable in proportion to his ownership share in the corporation. Id. at 216. The Court upheld the

trial court, noting that the rule in Washington is that cosureties are liable to make equal contributions, without regard to the relative amount of stock owned by each. Id. at 216-17; see also Sound Built Homes, Inc. v. Windermere Real Estate/South, Inc., 118 Wn. App. 617, 620, 72 P.3d 788 (2003) (holding that Sound Built Homes, which had paid entire judgment for which Sound Built Homes and Windermere were contractual co-obligors, was entitled to recover from Windermere half, but not all, of what it paid on the judgment).

In this case, John McKay sought complete indemnification from Proszek for any actions Fife Commercial may have taken on the guaranty. CP 24-25, at ¶4.18. John McKay alleges that he and Proszek had “established an interdependent relationship” in the governance and operations of Sunset Cars, which according to him gives rise to a claim for implied indemnification. App. Br. at 18. In reality, however, the only relevant relationship between the two is that they were both guarantors of Sunset Cars’ line of credit. John McKay cannot demonstrate how Proszek owed him any special duty of care or fiduciary duty, or that Proszek supplied any express or implied warranty to John McKay. At most, the relationship between the two possibly could have entitled John McKay to contribution from Proszek, not complete indemnification. The trial court did no err in dismissing that cause of action with prejudice.

D. The trial court's award of attorney's fees was not an abuse of discretion.

The Court reviews an award of sanctions under CR 11 or RCW §4.84.185 for an abuse of discretion. Biggs v. Vail, 124 Wn.2d 193, 197, 876 P.2d 448 (1994); Tiger Oil Corp. v. Dep't of Licensing, State of Wash., 88 Wn. App. 925, 937-38, 946 P.2d 1235 (1997). "A trial court abuses its discretion when its order is manifestly unreasonable or based on untenable grounds or reasons." In re Lasky, 54 Wn. App. 841, 854, 776 P.2d 695 (1989).

Although the McKays address the trial court's standard for granting attorney's fees under CR 11 and RCW 4.84.185, they fail to address the standard of review or explain how the trial court abused its discretion. The Court should deny their appeal of the attorney's fees award on that basis alone.

A lawsuit is "frivolous" and the prevailing party may recover attorney fees and costs under RCW 4.84.185⁸ when the lawsuit cannot be

⁸ RCW 4.84.185 provides as follows (emphasis added):

Prevailing party to receive expenses for opposing frivolous action or defense.

In any civil action, the court having jurisdiction may, upon written findings by the judge that the action, counterclaim, cross-claim, third party claim, or defense was frivolous and advanced without reasonable cause, require the nonprevailing party to pay the prevailing party the reasonable expenses, including fees of attorneys, incurred in opposing such action, counterclaim, cross-claim, third party claim, or defense. This determination shall be made upon motion by the prevailing party after a voluntary or involuntary order of dismissal, order on summary judgment, final judgment after trial, or other final order

supported by any rational argument on the law or facts. Tiger Oil Corp. v. Dep't of Licensing, State of Wash, 88 Wn. App. 925, 938, 946 P.2d 1235 (1997) (citation omitted). The reasonableness of the inquiry is evaluated by an objective standard. Harrington v. Pailthorp, 67 Wn. App. 901, 911-12, 841 P.2d 1258 (1992).

Civil Rule 11⁹ permits sanctions for attorney fees and costs incurred because a party filed pleadings that were not grounded in fact or warranted by law, or were for an improper purpose. Wood v. Battle

terminating the action as to the prevailing party. The judge shall consider all evidence presented at the time of the motion to determine whether the position of the nonprevailing party was frivolous and advanced without reasonable cause. In no event may such motion be filed more than thirty days after entry of the order.

The provisions of this section apply unless otherwise specifically provided by statute.

⁹ CR 11(a) provides as follows (emphasis added):

(a) Every pleading, motion, and legal memorandum of a party represented by an attorney shall be dated and signed by at least one attorney of record in the attorney's individual name, whose address and Washington State Bar Association membership number shall be stated. A party who is not represented by an attorney shall sign and date the party's pleading, motion, or legal memorandum and state the party's address. Petitions for dissolution of marriage, separation, declarations concerning the validity of a marriage, custody, and modification of decrees issued as a result of any of the foregoing petitions shall be verified. Other pleadings need not, but may be, verified or accompanied by affidavit. The signature of a party or of an attorney constitutes a certificate by the party or attorney that the party or attorney has read the pleading, motion, or legal memorandum; that to the best of the party's or attorney's knowledge, information, and belief, formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. If a pleading, motion, or legal memorandum is not signed, it shall be stricken unless it is signed promptly after the omission is called to the attention of the pleader or movant. If a pleading, motion, or legal memorandum is signed in violation of this rule, the court, upon motion or upon its own initiative, may impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, motion, or legal memorandum, including a reasonable attorney fee.

Ground Sch. Dist., 107 Wn. App. 550, 27 P.3d 1208 (2001). Trial courts apply an objective standard to determine whether sanctions are merited. The question for the trial court is whether a reasonable attorney in a like circumstance could believe his or her actions to be factually and legally justified. Bryant v. Joseph Tree, Inc., 119 Wn.2d 210, 220, 829 P.2d 1099 (1992). The purpose of the rule is to deter baseless filings and curb abuses of the judicial system. Biggs v. Vail, 124 Wn.2d 193, 197, 876 P.2d 448 (1994).

A court's decision to award attorney fees under the above legal standards is left to the trial court's discretion and will not be disturbed in the absence of a clear showing of abuse. Tiger Oil Corp., 88 Wn. App. at 937-38.

The trial court's judgment in this case decreed that the Third-Party Complaint against Proszek was "(i) frivolous and advanced without reasonable cause (RCW 4.84.185) and (ii) not well grounded in fact or warranted by existing law (CR 11)..." CP 290.

The McKays' assignment of error is that "The Trial Court erred when it granted Respondent an award of attorney fees based upon CR 11 and RCW §4.84.185 under the reasoning that Appellants' claims were not grounded in law or fact." App. Br. at 1. The assignment of error does not address the trial court's finding that the claim was "frivolous and

advanced without reasonable cause” under RCW §4.84.185. Unchallenged factual findings are verities on appeal. Harrington v. Pailthorp, 67 Wn. App. 901, 911, 841 P.2d 1258 (1992).

In this case, the Third-Party Complaint is not well grounded in fact. The McKays assert a shareholder derivative claim, despite the fact that they are majority shareholders of the corporation and occupied no less than two of three seats on the Board of Directors. CP 132, 276-79. The McKays exercised their power to amend all bylaws of the corporation, remove Proszek as President, director, officer, fiduciary, and signer on corporate accounts, as well as fire him from the company, vote John McKay as the new President, and appoint George McKay Vice President and Director of Operations. CP 276-79. Yet the McKays have the temerity to claim that the “Complaint sets forth reasonable doubt that the Board Members of this closely held corporation would initiate litigation against Proszek.” App. Br. at 15.

In addition to the fact that the shareholder derivative claim had no basis in law or fact, the McKays completely failed to follow the civil rule and statutory prerequisites for filing a shareholder derivative suit. Motion to Dismiss at 8-10. Shareholders must “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); see also CR 23.1. Even if the McKays' demand futility argument had some scintilla of merit (which it did not), their Third-Party Complaint lacked the necessary pleading details required by RCW 23B.07.400 and CR 23.1. The failure to comply with the substantive and procedural elements of a shareholder derivative suit warranted imposition of terms against the McKays.

The trial court's dismissal of John McKay's indemnification claims also warranted imposition of attorney's fees. He failed to demonstrate any facts or law that would support complete indemnification by Proszek of his personal guaranty.

E. The Court should award attorney's fees in favor of Proszek for the costs incurred in defending this appeal.

Pursuant to RAP 18.1, the Court should award Proszek the attorney's fees and costs he has incurred in responding to the McKays' appeal.

The appellate court may impose terms or compensatory damages against a party or counsel who files a frivolous appeal, uses the appellate rules for the purpose of delay, or fails to comply with the appellate rules. RAP 18.9. "An appeal is frivolous if no debatable issues are presented upon which reasonable minds might differ, and it is so devoid of merit that

no reasonable possibility of reversal exists.” Chapman v. Perera, 41 Wn. App. 444, 455-56, 704 P.2d 1224 (1985).

A court may also require the plaintiff in a shareholder derivative action to pay the defendant’s reasonable expenses, including attorney’s fees, incurred in defending against the proceeding if the court finds the proceeding was commenced without reasonable cause. RCW 23B.07.400(4).

The Court also has authority to impose sanctions against a party or the person signing the pleading for violating CR 11. Pursuant to RAP 18.7, CR 11’s certification requirement applies to appellate courts as well as superior courts. Bryant v. Joseph Tree, Inc., 119 Wn.2d 210, 223, 829 P.2d 1099 (1992). CR 11 requires that the party’s pleading or legal memorandum be “well grounded in fact and ... warranted by ... law” and that the filings are not interposed for “any improper purpose.” CR 11.

Here, the McKays continue to argue on appeal that their shareholder derivative action is justified because a demand to the Board would have been futile. Not only did the McKays completely fail to address demand futility in their Third-Party Complaint, their own evidence demonstrated such a demand would not have been futile because the McKays controlled the Board. The appellate brief is not well grounded in either law or fact. The McKays seek reversal of the trial court’s decision,

and believe that the court should have dismissed the claims without prejudice with leave to amend, despite the fact that the Board of Directors for the corporation now consists of only John and George McKay, and the corporation could sue on its own. The shareholder derivative action was commenced without reasonable cause, and the appeal is frivolous.

John McKay's implied indemnity action was without any merit as he failed to demonstrate any special relationship between himself and Proszek that justified indemnification. Because Fife Commercial dismissed its claims with prejudice and without costs prior to the appeal, his appeal of that moot issue is frivolous.

The shareholder derivative action was commenced without reasonable cause and the McKays' appeal was not well grounded in fact or law, and was frivolous. The Court should impose terms against the McKays and their counsel for the costs incurred by Proszek in defending against their appeal.

VI. CONCLUSION

The McKays filed a Third Party Complaint against Proszek, asserting a shareholder derivative action and an indemnification claim. The Third Party Complaint failed to allege with particularity any facts demonstrating that the shareholder plaintiffs had made a demand on the Board or that such a demand would have been futile. In fact, the Third

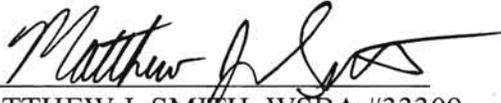
Party Complaint and the evidence submitted by the McKays shows that they controlled the Board of Directors, and such a demand would not have been futile. The implied indemnification claim was without basis in law, and not well grounded in fact, as John McKay failed to demonstrate any special relationship justifying indemnification by Proszek. Granting the McKays leave to file an amended complaint would be an exercise in futility, because they are the only Board members of Sunset Cars, and a demand could not possibly be futile. Fife Commercial dismissed its claims, so there is no reason for John McKay to assert an indemnification claim against Proszek. The trial court appropriately dismissed the Third Party Complaint with prejudice and awarded terms against the McKays.

The McKays' appeal is frivolous. They have not demonstrated how the Third Party Complaint complied with the substantive and procedural requirements of shareholder derivative claims. Nor have the McKays shown how the trial court abused its discretion in dismissing their claims without leave to amend or in imposing terms against them.

Because the shareholder derivative action was commenced without reasonable cause and because the McKays' appeal is frivolous, this Court should impose terms against them and their counsel for the costs incurred by Proszek in responding to the appeal.

Respectfully submitted this 19th day of March, 2012.

AIKEN LAW GROUP

A handwritten signature in black ink, appearing to read "Matthew J. Smith", written over a horizontal line.

MATTHEW J. SMITH, WSBA #33309
Attorneys for Respondent

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on the 19th day of March, 2012, I sent for delivery a true and correct copy of the foregoing Brief of Respondent by depositing in the mail of the United States of America, a properly stamped and addressed envelope via First Class Mail directed to:

James P. Ware, WSBA No. 36799
MDK Law Associates
10900 NE 4th Street, Suite 2030
Bellevue, WA 98004
(425) 455-9610

Court of Appeal – Division 1
One Union Square
600 University Street
Seattle, WA 98101-4170
(206) 464-7750

Dated this 19th day of March, 2012.


Kalani Igarta, Legal Assistant

APPENDIX A

Stipulation and Order of Dismissal with Prejudice

Entered with King County Superior Court on November 21, 2011

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Judge Monica Benton

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF KING

FIFE COMMERCIAL BANK, a Washington
banking corporation,

Plaintiff,

vs.

SUNSET CARS OF RENTON, INC., a
Washington Corporation, JOHN L. McKAY and
TINA McKAY, and the marital community
comprised thereof, and MORRIS D. PROSZEK
and "JANE DOE" PROSZEK, and the marital
community comprised thereof,

Defendants.

No. 11-2-14770-3KNT

**STIPULATION AND
ORDER OF
DISMISSAL WITH
PREJUDICE**

**(Clerk's Action
Required)**

STIPULATION

IT IS HEREBY STIPULATED between the parties, through their attorneys
undersigned, that the plaintiff's Complaint and causes of action therein stated may be

STIPULATION AND ORDER OF DISMISSAL WITH
PREJUDICE

Page 1 of 4

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1 forthwith dismissed with prejudice and without attorney fees or costs to any party, the
2 same having been fully and finally settled out of court. This stipulation and order of
3 dismissal does not dismiss defendants and third-party plaintiffs' claims against co-
4 defendants and/or third-party defendants.

5 DATED this ____ day of June, 2011.

6 **DAVIES PEARSON, P.C.**

7
8 By: _____
9 Brian M. King, WSB #29197
10 Attorney for Plaintiff

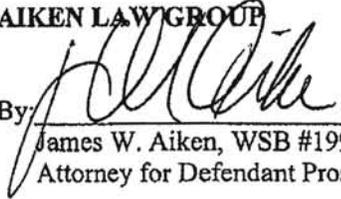
11 **MDK LAW ASSOCIATES**

SUNSET CARS OF RENTON, INC.

12
13 By: _____
14 James P. Ware, WSB# 36799
15 Attorney for Defendants John and
Tina McKay

13 By: _____
14 John L. McKay, Its President

16 **AIKEN LAW GROUP**

17
18 By: 
19 James W. Aiken, WSB #1993
Attorney for Defendant Proszek

21 **ORDER OF DISMISSAL**

22 Based upon the foregoing Stipulation, it is hereby,

23
24 **STIPULATION AND ORDER OF DISMISSAL WITH
PREJUDICE**

25 Page 2 of 4

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ORDERED, ADJUDGED AND DECREED that the plaintiffs' Complaint, and the causes of action against defendants stated therein, is hereby dismissed with prejudice and without attorney fees or costs to any party. This stipulation and order of dismissal does not dismiss defendants and third-party plaintiffs' claims against co-defendants and/or third-party defendants.

DONE IN OPEN COURT this 16 day of November, 2011.


JUDGE MONICA BENTON

Present by:

DAVIES PEARSON, P.C.

By: _____
Brian M. King, WSB#29197
Attorney for Plaintiff

Copy received, Approved as to Form,
Notice of Presentation Waived:

MDK LAW ASSOCIATES

SUNSET CARS OF RENTON, INC.

By: _____
James P. Ware, WSB# 36799
Attorney for Defendants John and
Tina McKay

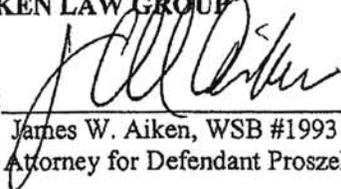
By: _____
John L. McKay, Its President

STIPULATION AND ORDER OF DISMISSAL WITH
PREJUDICE

Page 3 of 4
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1 AIKEN LAW GROUP

2
3 By: 

4 James W. Aiken, WSB #1993
Attorney for Defendant Proszek

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24 STIPULATION AND ORDER OF DISMISSAL WITH
PREJUDICE

25 Page 4 of 4

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In re Cray, Inc.
431 F. Supp.2d 114 (W.D. Wash. 2006)

Page 1114

431 F.Supp.2d 1114 (W.D.Wash. 2006)

In re CRAY INC. Derivative Litigation.

This document relates to All Actions.

No. C05-1016Z.

United States District Court, W.D. Washington, at Seattle.

April 28, 2006

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[Copyrighted Material Omitted]

Page 1116

Adam R. Gonnelli, Nadeem Faruqi, Faruqi & Faruqi, New York City, Clifford A. Cantor, Sammamish, WA, John G. Emerson, Emerson Poynter, Seattle, WA, Stuart W. Emmons, W. Todd Ver Weire, William B. Federman, Federman & Sherwood, Oklahoma City, OK, for Plaintiffs.

Alfred Arthur Day, Stoel Rives (WA), Christian N. Oldham, Rudy Albert Englund, Brian J. Meenaghan, Lane Powell PC (SEA), Seattle, WA, Lois Omenn Rosenbaum, Stoel Rives, Portland, OR, for Defendants.

ORDER

ZILLY, District Judge.

This matter comes before the Court on motions to dismiss by nominal Defendant Cray Incorporated ("Cray") pursuant to FED.R.CIV.P. 12(b)(6) for failure to comply with the pre-litigation demand requirement in RCW 23B.07.400, docket no. 18, and by the Individual Defendants [1] for failure to properly plead fraud pursuant to FED.R.CIV.P. 9(b) and failure to state claims upon which relief can be granted pursuant to FED.R.CIV.P. 12(b)(6), docket no. 16. [2] Having reviewed the motions to dismiss, Plaintiffs' opposition briefs, docket nos. 22 and 23, the reply briefs, docket nos. 25 and 27, and all supporting declarations and exhibits, and having heard argument on March 28, 2006, the Court now enters the following Order.

BACKGROUND

This shareholder derivative action brings claims for breach of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. Verified Amended Derivative Complaint

("VADC"), docket no. 9,

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¶ 1. Plaintiffs allege that these violations occurred from July 31, 2003, to the filing of the VADC on October 13, 2005 ("Relevant Period"). *Id.* ¶ 1. Plaintiffs are shareholders of Cray who owned, and continue to own, shares of Cray's common stock. *Id.* pp 11-12.

As alleged by Plaintiffs, "Cray is engaged in the design, development, marketing and support of high-performance computer systems, commonly known as supercomputers." *Id.* ¶ 2. Cray is incorporated and maintains its principal place of business in Washington State. *Id.* ¶ 13. Generally, Plaintiffs allege that Cray's officers and directors "knowingly misrepresented both the dynamics of Cray's business model and the Company's internal controls with regard to its financial reporting process." *Id.* ¶ 3. More specifically, Plaintiffs allege that "[o]n March 16, 2005, Cray revealed that, commensurate with its Sarbanes-Oxley activities, it expected to document material weaknesses in its system of internal controls and also expected to report that these controls were ineffective." *Id.* ¶ 5. As a result, Plaintiffs allege that on March 17, 2005, Cray's stock lost 25.9% of its value. *Id.* Finally, Plaintiffs allege that on May 9, 2005, Cray publicly revealed that it failed to include an auditor's opinion on management's assessment of internal control over financial reporting, and Cray reported revenue results that were adversely impacted by faulty internal controls and practices causing Cray's stock to drop another 35.6% by May 12, 2005. *Id.* ¶ 6.

Cray has a nine member Board of Directors. The Individual Defendants serving on the Board of Directors include Rottsolk, Smith, Kennedy, Kiely, Regis, Narodick, Richards, Lederman, and Jones. Plaintiffs bring claims against each member of Cray's Board for conduct during the Relevant Period. VADC ¶ 1. Plaintiffs also bring claims against Ungaro, Kiefer, Poteracki, and Johnson in their capacity as officers of Cray. VADC pp 16-19. Facts relevant to the Individual Defendants are as follows:

Rottsolk

Rottsolk is the Chairman and CEO of Cray and has been a member of the Board of Directors since Cray was founded in 1987. Rottsolk also served as Cray's President from March 2002 until March 7, 2005. Plaintiffs allege that Rottsolk knew of Cray's adverse nonpublic information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Rottsolk sold 79,980 shares of Cray stock for proceeds of \$960,710. *Id.* pp 14, 119(a).

Smith

Smith is a member of the Board of Directors and an employee of Cray. *Id.* pp 14, 119(d). Plaintiffs allege that Smith knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Smith sold 49,548 shares of Cray stock for proceeds of \$539,052. *Id.* ¶ 15.

Kennedy

Kennedy is a member of Cray's Board of Directors. Plaintiffs allege that Kennedy knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Kennedy sold 900 shares of Cray stock for proceeds of \$10,404. *Id.* ¶ 20. *Kiely*

Kiely is a member of Cray's Board of Directors. Plaintiffs allege that Kiely knew of Cray's adverse non-public information from internal documents and conversations with others and participated in

Page 1118

the issuance of false or misleading statements. *Id.* ¶ 21.

Regis

Regis is a member of Cray's Board of Directors. Plaintiffs allege that Regis knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Regis sold 31,999 shares of Cray stock for proceeds of \$212,185. *Id.* pp 22, 115.

Narodick

Narodick is a member of Cray's Board of Directors. Plaintiffs allege that Narodick knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 23.

Richards

Richards is a member of Cray's Board of Directors. Plaintiffs allege that Richards knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 24.

Lederman

Lederman is a member of Cray's Board of Directors. Plaintiffs allege that Lederman knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance

of false or misleading statements. *Id.* ¶ 25.

Jones

Jones is a member of Cray's Board of Directors. Plaintiffs allege that Jones knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 26.

Ungaro

Ungaro was President of Cray during the Relevant Period. Plaintiffs allege that Ungaro knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 16.

Kiefer

Kiefer was Sr. Vice President of Cray at times during the Relevant Period. Plaintiffs allege that Kiefer knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 17.

Poteracki

Poteracki was Sr. Vice President of Finance and Chief Financial Officer of Cray at times during the Relevant Period. Plaintiffs allege that Poteracki knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 18.

Johnson

Johnson was General Counsel, Secretary, and CFO of Cray at times during the Relevant Period. Plaintiffs allege that Johnson knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. *Id.* ¶ 19.

DISCUSSION

I. Cray's Motion to Dismiss for Failure to Comply with the Demand Requirement

A. Legal Standards

1. Motion to Dismiss

As with all motions to dismiss, allegations of material fact are taken as true and construed in the light most favorable to

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the nonmoving party. *Smith v. Jackson*, 84 F.3d 1213, 1217 (9th Cir.1996). However, conclusory allegations of

law and unwarranted inferences are insufficient to defeat a motion to dismiss. *Associated Gen. Contractors v. Metro. Water Dist. of So. Cal.*, 159 F.3d 1178, 1181 (9th Cir.1998).

2. Governing Law for Shareholder Demand Requirement

Shareholder derivative actions must comply with FED.R.CIV.P. 23.1, which states in relevant part as follows: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority ... and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Rule 23.1 is related to the substantive requirement that plaintiffs in shareholder derivative suits must first demand that the corporation take the action that the plaintiffs seek to enforce through the suit. *See Kamen v. Kemper Fin. Servs.*, 500 U.S. 90, 96, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991) (Rule 23.1 "clearly contemplates both the demand requirement and the possibility that demand may be excused, [but] it does not create a demand requirement of any particular dimension.").

Because the substantive demand requirement is established by state law, courts must apply the law of the forum state--in this case, Washington State. *See Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78, 58 S.Ct. 817, 82 L.Ed. 1188 (1938). Washington State sets forth its own procedural demand requirement for shareholder derivative actions in RCW 23B.07.400(2), which provides as follows:

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

(Emphasis added).

The parties in this case agree that Washington State courts have not interpreted or applied this *procedural* demand requirement, nor have they specifically adopted an underlying *substantive* demand requirement. As a result, both parties rely heavily on case law from other jurisdictions, including the relatively well-developed body of law from Delaware. [3] The "substantive" demand requirement for Delaware is found in Delaware's common law. "[T]he right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such

litigation." *Rales v. Blasband*, 634 A.2d 927, 932 (Del.1993) (noting the connection between this substantive requirement and the procedural requirement in Chancery Court Rule 23.1). The underlying purpose of this requirement is based on the fundamental principle that the "directors of a corporation and not its shareholders manage the

Page 1120

business and affairs of the corporation" and the "decision to bring a law suit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation." *Levine v. Smith*, 591 A.2d 194, 200 (Del.1991), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253 n. 13 (Del.2000).

Although relying heavily on Delaware law in their analysis, Plaintiffs suggest that the Court should not necessarily rely on such law but instead look to the plain language of RCW 23B.07.400(2) and a two-page unpublished case from the Middle District of Tennessee discussing Tennessee's procedural demand requirement statute, which is identical to the Washington State statute. *See In re Direct General Corp. Sec. Litig.*, 2005 WL 1895638 (M.D.Tenn. Aug. 3, 2005). The *Direct General* Court's analysis of the demand requirement was extremely limited, finding "that the allegations of the Verified Complaint are sufficient to excuse the demand otherwise required under Tennessee law" and that the plaintiffs had "shown that the decision-makers' interests and independence herein are sufficiently compromised by the actual allegations against them to excuse demand." *Id.* at *1. The single Tennessee state law case relied upon by *Direct General* cites extensively to Delaware demand requirement and business judgment rule cases. *See Lewis v. Boyd*, 838 S.W.2d 215, 222 (Tenn.App.1992), (citing *Aronson v. Lewis*, 473 A.2d 805, 814 (Del.1984) and *Levine*, 591 A.2d at 212, regarding interestedness and independence). Thus, *Direct General* does not provide support for Plaintiffs' contention that Washington State courts would deviate from the long-held corporate law standards of Delaware, nor does it provide any analysis that is useful in disposing of this motion to dismiss.

Rather than simply rely on *Direct General* as Plaintiffs suggest, this Court must attempt to "predict how the highest court of the state would decide the case if presented with the case today." *See Boland v. Engle*, 113 F.3d 706, 710 (7th Cir.1997). The *Boland* Court noted that this analysis may involve the consideration of relevant authority of other jurisdictions that have addressed the issue. *Id.* at 711-12 (noting that "Delaware corporate law is undoubtedly persuasive authority" but concluding that it is not necessarily dispositive). Ultimately, the *Boland* Court found the trend towards narrowing the exceptions to the demand requirement persuasive and held that *Boland's* failure to make a demand was not excused. *Id.* at 713-14. In this Case, RCW 23B.07.400(2) strongly implies the existence of a

substantive demand requirement in Washington State as does the underlying policy rationale (i.e., business decisions are within the province of the Board of Directors and a shareholder demand is a business decision). Accordingly, the Court concludes that the Washington State Supreme Court would likely adopt the substantive demand requirement and apply a similar, if not the same, exception for futility as that employed in Delaware.

B. Shareholder Demand Requirement and the Futility Exception

As described by the Supreme Court of Delaware, "the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation." *Rales v. Blasband*, 634 A.2d at 932. Plaintiffs acknowledge that no demand was submitted to Cray's Board of Directors in this case. VADC ¶ 119. Accordingly, dismissal is required unless Plaintiffs' failure to comply with the demand requirement was excused under the

Page 1121

so-called "futility" exception. *See Rales*, 634 A.2d at 933-34.

Where, as in this case, the plaintiffs in a derivative suit do not challenge any specific decision of the board, courts must "examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations." *Id.* at 934. [4] Courts must look to the complaint and determine "whether or not the *particularized factual allegations* of a derivative stockholder complaint create a *reasonable doubt* that, as of the time the complaint is filed, the board of directors could have properly exercised its *independent and disinterested* business judgment in responding to a demand." *Id.* (emphasis added). As one court described it, "the entire review is factual in nature." *In re Cendant Corp. Derivative Litig.*, 189 F.R.D. 117, 128 (D.N.J.1999) (citing *Aronson*, 473 A.2d at 814). The inquiry requires courts to look to the totality of the circumstances in assessing whether a complaint creates a "reasonable doubt" concerning the board's independence or disinterestedness:

Terms like reasonable doubt, for example, help guide judgment but, are not scientific. In making the required judgment no single factor--such as receipt of directorial compensation; family or social relationships; approval of the transaction attacked; or other relationships with the corporation (e.g., attorney or banker)--may itself be dispositive in any particular case. Rather the question is whether the accumulation of all factors creates the reasonable doubt to which *Aronson* refers.

Harris v. Carter, 582 A.2d 222, 229 (1990). "[T]he concept of reasonable doubt is akin to the concept that the stockholder has a 'reasonable belief' that the board lacks independence." *Grimes v. Donald*, 673 A.2d 1207, 1217 n. 17 (Del.1996), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253 n. 13 (Del.2000).

Based on these standards, Plaintiffs' failure to make a demand is excused for futility only if a majority (five) of the members of Cray's Board of Directors, as constituted at the time of filing the VADC, were either "interested" or "lacked independence." Although the Plaintiffs allege 16 separate reasons why a majority of the members of Cray's Board were either interested or lacked independence (meaning a demand on Cray would have been a "futile, wasteful and useless act"), Plaintiffs discuss only four of these allegations in their opposition to Defendants' demand requirement motion. *See* VADC ¶ 119(a), (c)-(e); Pls.' Opp., at 11-15. The Court limits its analysis of Plaintiffs' futility allegations to only those that Plaintiffs support with argument. [5]

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1. Interested Board Members

The *Rales* Court succinctly described the "interest" considerations as follows: "A director is considered interested where he or she will receive a personal financial benefit that is not equally shared by the stockholders. Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." 634 A.2d at 936. However, "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge ... [the] disinterestedness of directors." *In re Sagent Tech., Inc., Derivative Litig.*, 278 F.Supp.2d 1079, 1089 (N.D.Cal.2003) (quoting *Aronson*). In other words, "[a] plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves." *Id.* (citations omitted).

In *Sagent*, plaintiffs alleged that a demand was futile because three of the six board members were either interested or lacked independence. 278 F.Supp.2d 1079, 1088 (N.D.Cal.2003). One member, Zicker, was allegedly interested because he sold common stock for more than \$1.3 million in proceeds. *Id.* 1088-89. Plaintiffs alleged that Zicker did so while "in possession of material, adverse nonpublic information." *Id.* The *Sagent* Court concluded that this generic allegation was insufficient to demonstrate "a substantial likelihood" that Zicker would be liable for insider trading. *Id.* at 1089. Additionally, the plaintiffs in *Sagent* alleged that the members of *Sagent's* Audit Committee "failed to establish and maintain adequate internal accounting controls and to ensure that the company's financial statements were based on accurate information." *Id.* at 1084-85. However,

they apparently did not allege that this failure rendered the audit committee interested.

At the time Plaintiffs filed this derivative suit, the members of Cray's Board of Directors included Rottsoik, Smith, Jones, Kennedy, Kiely, Lederman, Narodick, Regis, and Richards. Plaintiffs' opposition brief relies on only two allegations to demonstrate interestedness: (1) Regis, Richards, Narodick, and Lederman are interested because they are members of Cray's Audit Committee ("Audit Committee Directors") (VADC ¶ 119(e)); and (2) Rottsoik, Smith, Kennedy, and Regis are interested because they sold Cray stock during the Relevant Period ("Selling Directors") (VADC ¶ 119(a)). [6] Pls.' Opp., docket no. 22, at 12-15. Because Plaintiffs must demonstrate that a total of five members were interested or lacked independence, the demand requirement is only excused if they establish that one group or the other is interested *and* there is at least one additional director who was either interested or who lacked independence (for a total of five). The Court turns now to an examination of the allegedly interested directors.

a. Audit Committee Directors

According to Cray's 2005 Proxy, Cray's Audit Committee "assists the Board of Directors in fulfilling its responsibility for oversight of" the following: "[1] the quality and integrity of [Cray's] accounting and financial reporting processes and the audits of [Cray's] financial statements; [2]

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the qualifications and independence of the public auditing firm engaged to issue an audit report on [Cray's] financial statements; [3] the performance of [Cray's] systems of internal controls, disclosure controls and internal audit functions, and [4] [Cray's] procedures for legal and regulatory compliance, risk assessment and business conduct standards." VADC ¶ 29(A). Plaintiffs allege that these duties required the Audit Committee to review and discuss financial reporting and accounting policies with management and auditors, review and approve SEC filings in advance, oversee disagreements between management and auditors, and recommend whether financial statements should be included in the 10-K Reports. *Id.*

In their opposition brief, Plaintiffs argue that three cases support their contention that Cray's Audit Committee Directors are interested under the *Rales* test. [7] *Cendant*, 189 F.R.D. 117; *In re Lernout & Hauspie Sec. Litig.*, 286 B.R. 33 (D.Mass.2002); *In re Oxford Health Plans, Inc. Sec. Litig.*, 192 F.R.D. 111 (S.D.N.Y.2000). First, Plaintiffs state that the *Cendant* Court "found demand to be futile in part because it was the Audit Committee's responsibility to catch and correct the accounting irregularities." Resp. Br. at 13. This interpretation of *Cendant* is mistaken. Plaintiffs cite the

"Background" section of the *Cendant* Court's Order, which noted that the Audit Committee was "specifically informed" that its income was overstated prior to the date *Cendant* publicly announced that information and, while in possession of this information, several members of the Audit Committee sold a total of 1.8 million shares of *Cendant* stock in the months before the announcement. 189 F.R.D. at 125; Pls.' Opp., at 13 n. 14. However, the "Demand" section of the *Cendant* Court's analysis is devoid of any suggestion that the Audit Committee members were interested merely because they were on the Audit Committee. *Id.* at 128-29 (citing instead the benefits directors received from transactions, the sale of millions of shares of stock by directors while in possession of adverse information, and the "significant personal liability" directors faced from a pending class action suit). In this case, the VADC alleges only that the Audit Committee "recommended that the Board include the improper financial statements and publish the improper and misleading press releases throughout the Relevant Period" and that such actions breached the Audit Committee's fiduciary duties. VADC ¶ 119(e). *Cendant* provides no helpful analysis as to these demand futility allegations.

Second, *Lernout* is inapposite as it provides no analysis of the demand requirement and addressed only a motion to dismiss for failure to allege facts sufficient to state claims for breach of fiduciary duties. *Lernout* did not apply the "interestedness" standard established in *Rales* and, in fact, involved class action claims under Section 10(b) of the Securities Exchange Act rather than a derivative action. 286 B.R. at 37-38.

Finally, the *Oxford* Court offered a lengthy recitation of the demand futility standards and proceeded to conclude demand was excused without any discussion of which specific directors were interested or lacked independence. 192 F.R.D. at 115-18 (concluding that it "appears unnecessary ... to address the issue of the

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independence or disinterestedness of the Directors individually"). Instead, the *Oxford* Court looked generally to the insider trading allegations. *Id.* at 117-18. Contrary to Plaintiffs' suggestion, *Oxford* is devoid of any discussion regarding the interestedness of the Audit Committee but merely states generally, and without citation, that knowledge of another's improper insider trading is enough to demonstrate interestedness. *Oxford* does not support Plaintiffs' contention that the Audit Committee Directors are interested by virtue of their place on the Audit Committee.

Plaintiffs' additional reliance on *Caremark* is also misplaced. *Caremark* did not address demand futility, but only stated the liability standard for certain breaches of the duty of care. 698 A.2d at 970 (director's obligation includes a duty to attempt in *good faith* to assure that a

corporate information and reporting system exists and failure to do so may, in theory, render a director liable for losses caused by non-compliance). The *Caremark* Court held that "only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability." *Id.* at 971. The Court described such a claim as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" and noted that, even if the harm to the corporation was caused by a violation of the criminal law, it is not necessarily enough to create a breach of fiduciary duty. *Id.* at 967, 972. To demonstrate that the Audit Committee is interested as the result of a possible *Caremark* claim, Plaintiffs must provide "particularized factual allegations" that the members face a "materially detrimental impact" if the claim were to proceed. *See Rales*, 634 A.2d at 934, 936. The "mere threat" of liability under a *Caremark* claim is not enough. *Sagent*, 278 F.Supp.2d at 1089. Although the VADC alleges broadly that Cray was "virtually devoid of internal controls, processes and procedures in every area of the finance and accounting departments," Plaintiffs have not provided "particularized factual allegations" suggesting that (assuming this characterization is true for purposes of the motion) it was the result of a "sustained or systematic failure" by the Audit Committee. *See* VADC 119(e).

In sum, Plaintiffs' "demand futility" cases do not stand for the proposition that a committee assigned the general oversight responsibility of the activities underlying a derivative complaint (e.g., establishing accounting controls and guarding against irregularities) is *per se* "interested." Nor have Plaintiffs adequately alleged facts that suggest a substantial likelihood of liability under a *Caremark* duty of care claim. Plaintiffs must allege facts that state "with particularity" the manner in which a given director is interested. *See* RCW 23B.07.400(2). The mere threat of personal liability alone is insufficient. *Sagent*, 278 F.Supp.2d at 1089. Plaintiffs' generic allegation regarding the Audit Committee Directors fails to demonstrate that those Directors are interested.

b. Insider Sales

The VADC alleges that the Selling Directors include Rottsolk, Smith, Regis, and Kennedy. VADC ¶ 119(a). In its motion to dismiss, Cray contends that (1) Kennedy was an outside director presumed to have no information about day-to-day company affairs, and (2) Kennedy's one sale occurred in August 2003, which, while in the Relevant Period, was before the FY 2004 issues Plaintiffs rely upon. In response, Plaintiffs apparently abandon the allegation that Kennedy is interested as a result of his single stock sale during the

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Relevant Period. *See* Pls.' Opp., at 14 (no discussion of Kennedy). Accordingly, the Selling Directors, for purposes of this analysis, include only Rottsolk, Smith, and Regis.

The VADC alleges that the Selling Directors were privy to the adverse, non-public information regarding Cray's accounting systems when they sold shares of Cray stock during the Relevant Period. VADC ¶ 119(a). The Selling Directors engaged in at least nine separate sales during the Relevant Period. *Id.* ¶ 115 (Sales Schedule). [8]

In support of their argument that the Selling Directors were interested, Plaintiffs rely on a single unpublished opinion from the Delaware Chancery Court. *See Zimmerman v. Braddock (Zimmerman II)*, 2005 WL 2266566, 2005 Del. Ch. Lexis 135 (Del. Ch.2005). In *Zimmerman II*, nominal defendant Priceline licensed its technology to a separate privately-held company, WebHouse, in return for royalties. *Id.* at 2005 WL 2266566, *2, 2005 Del. Ch. Lexis 135, *8. In the derivative action, the plaintiff alleged that Priceline's management knew that WebHouse was losing \$5 million a week and having technical problems causing the website to crash. *Id.* at 2005 WL 2266566, *2, 2005 Del. Ch. Lexis 135, *9. In spite of these problems, Priceline's management continued to publicly tout the prospects of the technology and its relationship with WebHouse. *Id.* at 2005 WL 2266566, *2, 2005 Del. Ch. Lexis 135, *10. During this period, three of Priceline's directors sold approximately \$248 million worth of Priceline's stock in just 45 days. *Id.* at 2005 WL 2266566, *3 n. 21, 2005 Del. Ch. Lexis 135, *11 n. 21. In determining whether these three directors were interested for purposes of the demand futility analysis, the Delaware Chancery Court reasoned as follows:

A reasonable inference from the Plaintiff's allegations is that the Selling Defendants had knowledge--directly and by imputation--of Priceline and WebHouse's problems. In addition, it is a reasonable inference that the public was not aware of Priceline's true predicament because its problems--even if they had been partially disclosed--were likely overshadowed by the public hyperbole of Priceline's executives.

...

When the sheer size of the trades (collectively, approximately \$248 million dollars) is combined with the Plaintiff's well-pled allegations of insider trading culpability, the Selling Defendants, for motion to dismiss purposes, can be viewed as facing substantial personal liability even though the materiality of the trades (or the consequences of an action challenging them) to the Selling Defendants has not been specifically pled.

...

The question with regard to demand futility is whether the trading directors could impartially consider a shareholder's demand upon the corporation to pursue a claim against them based on their trades. In light of the allegations in the Second Amended Complaint and the value of the Selling Defendants' trades, it is a reasonable inference that the Selling Defendants would be personally and significantly concerned about, and opposed to, any such demand and, thus, interested in whether the Priceline Board would pursue a claim based on their trades.

Id. at 2005 WL 2266566, *7-8, 2005 Del. Ch. Lexis 135, *32-35.

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Also, in *Zimmerman v. Braddock* (*Zimmerman I*), 2002 WL 31926608, *8 n. 64, 2002 Del. Ch. LEXIS 145, *8 n. 64 (Del.Ch. Dec. 20, 2002), the selling defendants did not even contest the fact that they were interested as a result of the \$248 million in stock sales, which was likely a consideration for the *Zimmerman II* Court. *Id.* at 2005 WL 2266566, *7, 2005 Del. Ch. Lexis 135, *29.

In this case, Plaintiffs contend that the Selling Directors were privy to inside information concerning "the complete absence of the Company's internal controls and the difficulties Cray was encountering producing and qualifying its new products" as a result of their positions as CEO (Rottsolek), employee (Smith), and Chairman of Cray's Audit Committee (Regis). Pls.' Opp., at 14. Plaintiffs cite no other allegations in the VADC that state what specific information Rottsolek, Smith, and Regis knew, or when they would have become aware, of such information in relation to each stock sale.

Cray argues that Plaintiffs' insider trading claims do not demonstrate "interestedness" because (1) Regis was (like Kennedy) an outside director, (2) Plaintiffs' allegations are conclusory and insufficient under the case law, and (3) the sales by Rottsolek and Smith were made pursuant to Rule 10b5-1 plans, which provides an affirmative defense. First, Cray notes that Regis was an outside director during the entire Relevant Period and that the law presumes that outside directors are not responsible for false or misleading information under the "group published information" rule. *See In re GlenFed, Inc., Sec. Litig.*, 60 F.3d 591, 593 (9th Cir.1995). In *GlenFed*, the Ninth Circuit held that "[m]erely because the complaint identifies a corporation's outside directors, various committee assignments, and generic responsibilities for every committee" does not mean such outside directors are responsible for information published on behalf of the group. *Id.* Plaintiffs do not directly respond to this argument and appear to rely only on the fact that Regis was the Chairman of Cray's Audit Committee.

Second, Cray contends that at least two cases applying Delaware law, *Sagent* and *Guttman v. Huang*, 823 A.2d 492 (Del.Ch.2003), have held that similar insider trading claims were insufficient to demonstrate interestedness. In *Sagent*, the plaintiffs alleged that Zicker "sold 80,000 shares of Sagent common stock while in the possession of material, adverse, non-public information," reaping a \$1.3 million profit. 278 F.Supp.2d at 1088. The *Sagent* Court concluded that the director was not interested because the complaint contained no allegation that the director was in possession of any particular material adverse information when he sold Sagent stock. *Id.* at 1089. Similarly, in *Guttman*, the complaint alleged that "each of the defendants who sold during the contested period was in possession of material, non-public information and traded to his personal advantage using that information." 823 A.2d at 496. The complaint also stated that "[e]ach of the defendants was in a position to know of the improper accounting practices engaged in by NVIDIA" and "[e]ach of the defendants engaged in trades shortly after NVIDIA released a financial statement that was later restated." *Id.* at 496-97. The *Guttman* Court concluded that these allegations were "wholly conclusory" and did not include "well-pled, particularized allegations of fact detailing the precise roles that these directors played at the company, the information that would have come to their attention in those roles, and any indication as to why they would have perceived the accounting irregularities." *Id.* at 503.

Finally, Cray contends that the trades by Rottsolek and Smith are subject to an

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affirmative defense because those trades were effectuated under 10b5-1 plans that automatically dictated the amount and timing of the sales. For example, Rottsolek's scheduled sales included 15,000 shares each in August, September, October, and November 2003, and January 2004. VADC ¶ 115. In response, Plaintiffs argue that a ruling on this affirmative defense would only be appropriate in a summary judgment motion after the case has been developed factually through discovery. Plaintiffs are correct that the Court may not consider affirmative defenses at this juncture, particularly where Defendants have not yet filed an Answer to the VADC.

While the interestedness determination for insider sales is not entirely clear, the cases support Cray's contention that the Plaintiffs' allegations are insufficient. Both *Sagent* and *Guttman* analyzed nearly-identical allegations regarding insider sales and found those allegations conclusory and insufficient to demonstrate interestedness. In contrast, the more recent unpublished opinion in *Zimmerman II* held that similar allegations were sufficient to demonstrate interestedness. However, the *Zimmerman II* Court gave significant weight to the "sheer size of the trades (collectively, approximately \$248 million dollars)," all of which occurred in 45 days.

2005 WL 2266566, *3, 7-8, 2005 Del. Ch. Lexis 135 at *11, 33-35. That volume of trading is absent from this case, where the Selling Defendants sold a total of 161,527 shares of Cray stock for approximately \$1.71 million in proceeds over a 16-month period. See VADC pp 115, 119(a) (sales occurred from August 2003 to December 2004). As a result, the weight of authority analogous to this case supports Defendants' argument and the Court concludes that the Selling Directors were not interested. [9]

2. Independence of Board Members

The *Rales* Court described the "independence" considerations as follows:

[I]ndependence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. To establish a lack of independence, [plaintiff] must show that the directors are beholden to the [interested directors] or so under their influence that their discretion would be sterilized.

634 A.2d at 936 (quotations and citations omitted). In *Telxon Corp. v. Meyerson*, the Delaware Supreme Court elaborated on this standard, stating as follows:

A controlled director is one who is dominated by another party, whether through close personal or familial relationship or through force of will. A director may also be deemed "controlled" if he or she is beholden to the allegedly controlling entity, as when the entity has the direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.

802 A.2d 257, 264 (Del.2002).

In a single paragraph of argument, Plaintiffs contend that two members of Cray's Board, Rottsolk and Smith, are not independent. Pls.' Opp., at 11-12 (arguing Rottsolk and Smith are not independent

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because they rely on substantial income from Cray as employees). Plaintiffs are correct. In *Rales*, the Court found that two members of the board (Sherman, the CEO, and Ehrlich, the President of a related company) lacked independence from two controlling directors where they received large salaries from the companies and, therefore, it could be inferred that they were beholden. 634 A.2d at 937. [10] Additionally, Defendants do not respond to Plaintiffs' argument that Rottsolk and Smith lack independence and, at argument, Defendants' counsel all but conceded that the Delaware cases hold as such.

Therefore, the Court presumes that the argument has merit and concludes that Rottsolk and Smith are "interested" for purposes of this motion.

3. Plaintiffs have not Established that Demand was Futile

Under the demand futility analysis, Plaintiffs must demonstrate through the allegations contained in the VADC that a majority (five) of the members of Cray's Board of Directors are either interested or lack independence. *Rales*, 634 A.2d at 933-34. Plaintiffs have failed to make such a showing. The relevant case law does not hold that a director is interested merely by virtue of sitting on an Audit Committee while the corporation faces accounting and audit irregularities. Similarly, the weight of authority suggests that Rottsolk, Smith, and Regis are not interested as a result of having sold shares of Cray stock during the Relevant Period. Both *Sagent* and *Guttman* specifically held that insider sales such as those at issue here were insufficient, and the lone, unpublished case cited by Plaintiffs is distinguishable to the extent that the proceeds in this case (\$1.71 million) are vastly disproportionate to *Zimmerman*, where the Court noted the "sheer size of the trades" (\$248 million). Finally, the only directors who lack independence are Rottsolk and Smith. [11] Accordingly, the Court GRANTS Defendants' motion to dismiss for failure to comply with the pre-litigation demand requirement.

II. Individual Defendants' Motion to Dismiss [12]

In addition to joining Cray's motion to dismiss for failure to comply with the demand requirement, the Individual Defendants move separately to dismiss the VADC for failure to comply with the pleading requirements in Rule 9(b), and failure to state claims upon which relief can be granted under Rule 12(b)(6). First, the Individual Defendants contend that the VADC alleges a "unified course of fraudulent conduct," requiring Plaintiffs to state those fraud allegations with particularity. Second, the Individual Defendants argue that Plaintiffs' two claims relating to insider trading may not be brought in a derivative action. See VADC pp 120-24 (Count

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I: Breach of Fiduciary Duty for Misappropriate Information), 145-47 (Count VI: Unjust Enrichment). Third, the Individual Defendants contend that Plaintiffs' claims for breach of fiduciary duties, abuse of control, gross mismanagement, and waste (Counts II, III, IV, and V, respectively) must be dismissed because Plaintiffs fail to allege any cognizable claim for damages. Finally, the Individual Defendants contend that Plaintiffs' claim for corporate waste must also be dismissed for failure to allege facts sufficient to state a claim.

A. Failure to Plead Fraud Under Federal Rule of

Civil Procedure 9(b)

Under FED.R.CIV.P. 9(b), "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." In general, Rule 9(b) requires fraud allegations to include "the who, what, when, where, and how of the misconduct charged." *Vess v. Ciba-Geigy Corp., USA*, 317 F.3d 1097, 1106 (9th Cir.2003) (quotations omitted). The Ninth Circuit has distinguished between cases in which fraud allegations form the entire basis for a claim and cases in which there is both fraudulent and non-fraudulent conduct underlying a claim:

In some cases, the plaintiff may allege a unified course of fraudulent conduct and rely entirely on that course of conduct as the basis of a claim. In that event, the claim is said to be "grounded in fraud" or to "sound in fraud," and the pleading of that claim as a whole must satisfy the particularity requirement of Rule 9(b).

...

In other cases, however, a plaintiff may choose not to allege a unified course of fraudulent conduct in support of a claim, but rather to allege some fraudulent and some non-fraudulent conduct. In such cases, only the allegations of fraud are subject to Rule 9(b)'s heightened pleading requirement.

Id. at 1103-04 (citations omitted).

Here, the parties' dispute centers on whether any or all of Plaintiffs' claims are "grounded in fraud" such that they are entirely subject to Rule 9(b) or whether the fraud allegations may be addressed separately. The Individual Defendants argue that each claim is grounded in fraud because Plaintiffs incorporate by reference allegations of misrepresentation and concealment. *See* VADC pp 3, 4, 7, 41-42 (alleging knowing misrepresentations, concealment of facts, misleading of analysts, and conspiracy). The Individual Defendants contend that these allegations are conclusory and fail to allege what was false or misleading about the statements, which directors and officers knew they were misleading, and when they knew it.

In response, Plaintiffs first argue that a number of their claims do not rely on allegations of fraud. In particular, Plaintiffs refer to their claims for (1) breach of the fiduciary duties of good faith and due care, (2) gross mismanagement, and (3) waste. These claims are based in part upon allegations that the Individual Defendants failed to fulfill a duty to implement effective internal controls over Cray's financial reporting. *See* VADC pp 125-130 (breach of fiduciary duty of care and good faith), 136-140 (gross mismanagement), 141-144 (waste). This argument has merit. Plaintiffs allege that the Individual Defendants "abandoned and abdicated their responsibilities and fiduciary duties with regard to prudently managing the assets and business of Cray" and

failed "to conduct proper supervision." *Id.* pp 137, 142. These allegations and the claims they support do not rely on or involve fraud. Under the distinction described in *Vess*, the breach of duty of care, mismanagement, and waste claims are not subject to Rule 9(b) and do not fail in their

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entirety as the Individual Defendants contend.

Second, Plaintiffs argue that those claims dependant on averments of fraud may also stand because the VADC satisfies the "particularity" requirement of Rule 9(b). This argument is not well taken. In support of their position that they sufficiently alleged the "who, what, where, when, and how" of the fraud allegations, Plaintiffs simply cite to paragraphs 55, 63, 66-67, 75, 81, 93, 99, and 100 of the VADC, without further explanation. However, these allegations are largely conclusory and redundant. Paragraphs 55, 63, 66-67, 75, and 81 simply offer repeated citations to Cray's 10Q quarterly public disclosures, which each state (with some minor variation) in relevant part as follows:

Based on the evaluation, our principal executive and financial officers each concluded that, as of the date of the evaluation, our disclosure controls and procedures were effective in providing reasonable assurance that material information relating to Cray and our consolidated subsidiaries is made known to management, including during the period when we prepare our periodic SEC reports.

Id. at ¶ 55. The VADC alleges only that, in fact, Cray "did not have sufficient internal controls to ensure either that revenue was properly recognized or that financial information was accurately reported." *Id.* at ¶ 56. Plaintiffs do not explain why or when Cray's CEO and CFO stopped concluding that Cray's procedures were effective, nor do they state how or when the other Individual Defendants would have learned of this information. Similarly, paragraphs 93, 99, and 100 merely cite Cray's disclosure that it expected to, and ultimately did, identify material weaknesses in its internal controls and accounting procedures. The VADC fails to explain how these disclosures, which are apparently pled to demonstrate that the earlier statements were false, establish that the Individual Defendants knew the earlier statements were false when made.

Finally, Plaintiffs argue that much of the evidence related to the fraud allegations is in the hands of the Individual Defendants, essentially seeking to excuse the generality of the VADC until they can obtain such evidence through discovery. *See U.S. Ex. Rel. Lee v. SmithKline Beecham, Inc.*, 245 F.3d 1048, 1052 (9th Cir.2001) ("Rule 9(b) may be relaxed to permit discovery in a limited class of corporate fraud cases where the evidence of fraud is within a defendant's exclusive

possession."), *overruled on other ground by Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir.1990). However, the cases allowing for a relaxed application of Rule 9(b) continue to require significant particularity in the pleading. *See, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir.1987) (fraud allegations are "very precise" and specify "the exact dollar amount of each alleged overstatement, and the manner in which such representations were false and misleading"); *Fed. Sav. and Loan Ins. Corp. v. Musacchio*, 695 F.Supp. 1053, 1058-59 (N.D.Cal.1988) ("In virtually every instance in which fraud is alleged the plaintiffs have set forth the time, place and manner of the allegedly fraudulent acts."). No such precision or specificity is present in the VADC. Thus, the Court also GRANTS the Individual Defendants' motion to dismiss the fraud allegations for failure to comply with Rule 9(b) and dismisses those claims without prejudice. [13]

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B. Insider Trading Claims (Counts I and VI) Under Federal Rule of Civil Procedure 12(b)(6)

A motion to dismiss for failure to state a claim under FED. R. CIV. P. 12(b)(6) may be granted only where it appears beyond a reasonable doubt that the plaintiff can prove no set of facts that would entitle the plaintiff to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). Allegations of material fact are taken as true and construed in the light most favorable to the nonmoving party. *Smith v. Jackson*, 84 F.3d 1213, 1217 (9th Cir.1996). However, conclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss. *Associated Gen. Contractors v. Metro. Water Dist. of So. Cal.*, 159 F.3d 1178, 1181 (9th Cir.1998).

The Individual Defendants raise four arguments in support of their motion to dismiss the insider trading claims (Counts I and VI) for failure to state a claim: (1) not all of the Individual Defendants sold stock during the relevant period and those that did not should be dismissed as to the insider trading claims; (2) several of the Selling Defendants sold pursuant to 10b5-1 plans, which provides an affirmative defense; (3) several of the Selling Defendants *purchased* and continued to hold shares during the Relevant Period; and (4) there is no common law derivative cause of action for insider trading because Cray sustained no damages. Defs.' Mot. at 6-9.

The Individual Defendants' first three arguments are not well developed and are without merit in the context of a 12(b)(6) motion to dismiss. First, the VADC refers to the "Insider Selling Defendants" in Count I and the "defendants" in Count VI. *See* VADC pp 120-124, 145-147. Plaintiffs specify which Individual Defendants sold Cray stock during the Relevant Period. *Id.* ¶ 115. [14] Thus, under the minimal notice pleading requirement of Rule 8(a), the VADC adequately identifies the

Individual Defendants at issue in Counts I and VI. Second, the 10b5-1 argument is, as the Individual Defendants acknowledge, an affirmative defense. The Individual Defendants have filed no Answer to the VADC and, therefore, alleged no affirmative defenses. The Court will not dismiss the insider sales claims on the basis of a yet-to-be-pled affirmative defense, particularly where the Individual Defendants bear the burden of proof. *See* T. HAZEN, THE LAW OF SECURITIES REGULATION § 12.17 (5th ed.2002) (noting that courts require the defendant to demonstrate that stock sales were made pursuant to a 10b5-1 plan). Third, the Individual Defendants do not support their argument that Smith, Johnson, Rottsolk and Poteraki should be dismissed because they purchased and held additional shares during the Relevant Period. The Individual Defendants cite no authority for the proposition that a defendant's purchase of stock during a period of allegedly unlawful insider sales entitles them to dismissal.

The more closely contested issue is whether a common law derivative claim for insider selling even exists. The Individual Defendants cite two cases holding that such claims are not available and a leading corporate law treatise stating that a majority of courts are in agreement. *See Freeman v. Decio*, 584 F.2d 186, 192-95 (7th Cir.1978) (claim dismissed because (1) no damages to corporation and (2) defendants would be subject to double liability

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given availability of Rule 10b(5) claims); *Frankel v. Slotkin*, 795 F.Supp. 76, 79-80 (E.D.N.Y.1992) (claim dismissed for lack of actual damage to the corporation); 3A WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1174 (perm. ed. 2002) ("[M]ost courts considering the issue have rejected a common law corporate cause of action against directors and officers for insider trading"). The Individual Defendants also note that Washington State generally requires a showing of damages for breach of fiduciary duty and unjust enrichment claims. *See Interlake Porsche Audi, Inc. v. Bucholz*, 45 Wash.App. 502, 509, 728 P.2d 597 (1986) (showing of proximate causation of loss sustained by corporation required); *Bailie Communications, Inc. v. Trend Bus. Sys., Inc.*, 61 Wash.App. 151, 159, 810 P.2d 12 (1991) (unjust enrichment claim requires showing defendants enriched themselves at the expense of the corporation).

In response, Plaintiffs rely heavily on *Brophy v. Cities Service Company*, 70 A.2d 5, 8 (Del.Ch.1949), which held that "[i]n equity, when the breach of a confidential relation by an employee is relied on and an accounting for any resulting profits is sought, loss to the corporation need not be charged in the complaint." *See also Diamond v. Oreamuno*, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 83, 248 N.E.2d 910 (1969) (relying on

Brophy in holding that there may be an insider trading claim); *Walton v. Morgan Stanley & Co., Inc.*, 623 F.2d 796, 798 (2d Cir.1980) (stating that Delaware courts have "consistently followed" *Brophy's* holding that a breach of fiduciary duty is actionable absent an injury without analyzing *Brophy's* continued viability after the implementation of 10b(5) liability). In *Brophy*, the plaintiff alleged that the insider defendant had knowledge of the corporation's plan to buy back its own stock on certain prearranged dates. 70 A.2d at 6. The plaintiff further alleged that the defendant breached a duty of trust to the corporation by purchasing shares of the corporation's stock for himself just before the buy-back and then selling the shares after the buy-back for a profit. *Id.* Plaintiffs' reliance on *Brophy* is misplaced. In *Freeman*, the Seventh Circuit examined the continued viability of *Brophy* in 1978 and reasoned that allowing derivative common law claims for insider trading would create the problem of double liability because a statutory remedy was available under Rule 10b(5). 584 F.2d at 195-96. The *Freeman* Court also distinguished *Brophy* on the grounds that, at least implicitly, the *Brophy* Court recognized that the corporation did suffer potential harm in becoming a competitor in the market for its own stock with the insider defendant who purchased shares contemporaneously. *Id.* at 194.

Plaintiffs also cite an inapposite section of Fletcher's treatise on corporations, which is inconsistent with the section relating specifically to the insider trading cases cited above. *See* Pls.' Opp., at 14 (citing FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS at § 888). Finally, Plaintiffs cite the *Zimmerman II* Court's conclusion that the plaintiff had adequately pled an insider trading claim where defendants sold approximately \$248 million in Priceline stock with the knowledge that Priceline's business relationship with WebHouse was not succeeding. 2005 WL 2266566 at *8 n. 84, 2005 Del Ch. Lexis 135 at *8 n. 84 (2005) (unpublished).

The Individual Defendants' argument with regard to the unavailability of insider trading derivative claims has merit. The Court finds persuasive the Seventh Circuit's reasoning that *Brophy* is no longer relevant in this context because it was decided well before private causes of action were available to individual shareholders under Rule 10b(5). There is also no dispute that Washington State case law

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acknowledges the general requirement that damages are an essential element of derivative claims for breach of fiduciary duties and unjust enrichment. Thus, although it is an open question, the Court also concludes that the Washington State courts would decline to adopt a common law derivative claim for insider trading where there is no allegation of damage to the nominal defendant

corporation.

The Court GRANTS the Individual Defendants' motion to dismiss Counts I (breach of fiduciary duties by insider selling defendants) and VI (unjust enrichment) of the VADC for this reason as well.

C. Failure to Adequately Plead Damages (Counts II-V)

The Individual Defendants contend that Counts II (breach of fiduciary duties), III (abuse of control), IV (gross mismanagement) and V (corporate waste) must be dismissed because the VADC fails to allege any recoverable damages. Counts II through IV simply state that Cray has "sustained significant damages." VADC pp 129, 133, 138. Count V alleges that the Individual Defendants caused Cray to waste corporate assets by "paying incentive based bonuses to certain of its executive officers and incur [sic] potentially millions of dollars of legal liability and/or legal costs to defend defendants' unlawful actions." *Id.* ¶ 142. Plaintiffs' opposition brief suggests that these claims are based on allegations that Cray sustained damages in the form of (1) costs incurred to carry out internal investigations of, and defend against, potential legal liability from the pending class action lawsuit, and (2) harm to Cray's corporate image and good will that impairs Cray's ability to raise equity capital or debt. *Id.* pp 38-39, 104. The Individual Defendants maintain that these damage allegations are speculative and unrecoverable.

1. Costs of Investigating and Defending Class Action

The Individual Defendants rely on several cases holding that legal costs and potential legal liability arising out of a separate class action suit are not recoverable damages in a derivative action. *See* Defs.' Mot., at 10. For example, in *In re Symbol Technologies Securities Litigation*, the complaint alleged as damages that the corporation might be "caused to pay amounts with regard to the claims asserted in the Class Action, or [] caused to pay any legal fees and incidental expenses in connection with defending such claims." 762 F.Supp. 510, 516 (E.D.N.Y.1991). The District Court in *Symbol* deemed such damages unrecoverable because they were contingent on the outcome of a class action suit in which no judgment had been entered or settlement reached. *Id.* The Individual Defendants provide four other unpublished district court cases applying the same reasoning. *See* *Dollens v. Zions*, 2002 WL 1632261 *9 (N.D.Ill.2002); *In re United Telecomms., Inc., Sec. Litigation*, 1993 WL 100202 *3 (D.Kan.1993); *Daisy Sys. Corp. v. Finegold*, 1988 WL 166235 *4 (N.D.Cal.1988); *Falkenberg v. Baldwin*, 1977 WL 1025 *4 (S.D.N.Y.1977).

In response, Plaintiffs cite only a single unpublished case attached as a slip opinion to their Response brief.

See *Mehlenbacher v. Jitaru*, Case No. 04-cv-1118-Orl-22KRS (M.D. Fl. June 6, 2005). In *Mehlenbacher*, the plaintiff brought an indemnity and contribution claim alleging damages for legal costs incurred by "the SEC investigation, the securities fraud class actions, and the internal investigations of the Company." Slip Op. at 10. The class action had been voluntarily dismissed without payment of settlement. *Id.* at 9. Without discussion or citation to analogous cases, the District Court in *Mehlenbacher* simply concluded that "Count II may not

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be a model of pleading, but it does pass muster under the liberal Fed.R.Civ.P. 8(a) standard." *Id.* at 10. *Mehlenbacher* is not instructive due to its lack of analysis or support. In contrast, *Symbol Technologies*, *Dollens*, *United Telecommunications*, *Daisy Systems*, and *Falkenberg* each held that derivative claims are foreclosed when they merely allege damages based on the potential costs of investigating, defending, or satisfying a judgment or settlement for what might be unlawful conduct. The Court concludes that Plaintiffs' damage allegations based on potential costs of the class action suits are insufficient to state a claim for relief.

2. Loss of Goodwill and Increased Financing Costs

The Individual Defendants argue that Plaintiffs cannot recover damages based on allegations of lost goodwill and a "liar's discount" that will potentially increase the costs of obtaining financing. VADC pp 39, 104, 142. Again, the Individual Defendants rely on *Symbol Technologies* and similar cases which dismissed claims for such damages. 762 F.Supp. at 517 (allegation that defendants undermined the company's credibility in the marketplace was "boilerplate" and insufficient to withstand motion to dismiss). See also *United Telecomms.*, 1993 WL 100202 at *2; *Dollens*, 2002 WL 1632261 at *9.

In response, Plaintiffs cite only the unpublished *Cement-Lock v. Gas Technology Institute*, 2005 WL 2420374 at *13 (N.D.Ill.2002), in which the plaintiff alleged the following damages:

(1) misappropriation of millions of dollars in grant money, which prevented the development of the Technology and results in the future loss of profits from the licensing of the Technology; (2) *harm to Cement-Lock Group's business reputation*; (3) lost business opportunities to market the Technology to other individuals, corporations, or governmental entities, including Taiwan, Hong Kong, and China; and (4) devaluation of Cement-Lock Group's intellectual property by wasted years in the lifespan of certain patents and confusion and infringement on the Technology's service mark and trademark.

(Emphasis added). With reference to all of these allegations, the *Cement-Lock* Court stated only: "Such damages are neither speculative nor remote. Under the common law, concrete injury to business reputation will satisfy the injury element of standing." *Id.*

While there is some inconsistency in the case law (i.e., *Symbol Technologies*, *United Telecommunications*, and *Dollens* versus *Cement-Lock*), the weight of authority suggests that lost goodwill and business reputation damage allegations must be more than speculative and conclusory. Moreover, *Cement-Lock* is in agreement to a degree, requiring "concrete" injury to a corporation's business reputation. Here, Plaintiffs bring only a single allegation that specifies any present damage to Cray. VADC ¶ 104 (alleging that "the fees, interest rates and terms" of a June 1, 2005, credit agreement "were far less favorable than those that would have been available to a well managed company with established and fully functioning internal financial controls"). This allegation is conclusory, failing to identify the fees, interest rate or terms, or to provide any explanation as to how the credit agreement was unfavorable. Accordingly, the Court concludes that Counts II through V fail to identify recoverable damages for loss of goodwill or business reputation and GRANTS the Individual Defendants' motion to dismiss without prejudice for this reason as well.

D. Failure to Allege Waste of Corporate Assets (Count V)

Finally, the Individual Defendants contend that Plaintiffs' claim for

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waste of corporate assets (Count V) should also be dismissed for failure to state a claim under Rule 12(b)(6). Corporate waste is defined as "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del.Ch.1997). In this case, Plaintiffs allege that the Individual Defendants caused Cray to engage in corporate waste "by paying incentive based bonuses to certain of its executive officers and incur [sic] potentially millions of dollars of legal liability and/or legal costs to defend defendants' unlawful actions." VADC ¶ 142. The Individual Defendants argue that this claim must fail because (1) there is no allegation the bonuses were made without consideration or constituted a gift, and (2) there is no allegation that the costs associated with defending the pending legal actions are egregious or irrational. See *Lewis*, 699 A.2d at 336 (no corporate waste where any substantial consideration was received by the corporation); *White v. Panic*, 783 A.2d 543, 554 n. 36 (Del.2001) (corporate waste claim requires plaintiff to show (and by implication allege) that the board's decision was egregious and irrational). Plaintiffs provide no

opposition to this argument. Because the corporate waste allegation is unsupported and there is no opposition from the Plaintiffs, the Court GRANTS the Individual Defendants' motion to dismiss Count V without prejudice.

CONCLUSION

For the reasons stated above, the Court rules as follows:

The joint motion by Cray and the Individual Defendants to dismiss for failure to comply with the pre-litigation demand requirement, docket no. 18, is GRANTED and the VADC is DISMISSED WITHOUT PREJUDICE.

The Individual Defendants' motion to dismiss for failure to comply with Rule 9(b), docket no. 16, is GRANTED IN PART and DENIED IN PART. The motion is GRANTED as to specific allegations of fraud and misrepresentation and those claims are DISMISSED WITHOUT PREJUDICE. The motion is DENIED as to the request to dismiss Counts I through VI in their entirety.

The Individual Defendants' motion to dismiss Counts I and VI for failure to state breach of fiduciary duty and unjust enrichment claims on the basis of insider selling, docket no. 16, is GRANTED. Counts I and VI are DISMISSED WITH PREJUDICE.

The Individual Defendants' motion to dismiss Counts II through V, docket no. 16, is GRANTED. Counts II through V are DISMISSED WITHOUT PREJUDICE.

IT IS SO ORDERED.

Notes:

[1] The "Individual Defendants" are James E. Rottsolek, Peter J. Ungaro, David R. Kieffer, Scott J. Poteracki, Kenneth W. Johnson, Burton J. Smith, Kenneth W. Kennedy, Jr., Stephen C. Kiely, Daniel C. Regis, Sally G. Narodick, Frank L. Lederman, John B. Jones, Jr., and Stephen C. Richards.

[2] In their motion to dismiss, the Individual Defendants join in Cray's motion to dismiss for failure to comply with the demand requirement. Docket no. 18, at 1.

[3] Delaware has adopted a procedural demand requirement, which is found in Delaware Chancery Court Rule 23.1, as follows:

The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to

obtain the action or for not making the effort.

[4] In cases where the plaintiff challenges a specific transaction, the demand requirement may be excused where the plaintiff can show that the transaction was not a product of a valid exercise of the defendants' business judgment. *See Aronson*, 473 A.2d at 814. Here, Plaintiffs do not suggest that this prong of *Aronson* is applicable.

[5] Even a cursory review of the remaining allegations reveals that they are generic and conclusory under the "interested" and "independent" standards discussed below. *See* pp 119(b) (allegation that current directors are not independent of compensation committee), (f) (allegation that directors breached fiduciary duties), (g) (generic allegation of inter-related familiar, business, professional and personal relationships), (h) (generic allegation of knowledge of and/or benefits from wrongdoing), (i) (generic allegation of participation in and/or approval of wrongdoing), (j) (generic allegation that directors would be forced to sue themselves), (k) (repeated allegation of fiduciary duty violations), (l) (generic allegation that Board authorized and/or permitted false statements), (m) (allegation that suit by current directors would "likely expose" directors and officers to further violations of securities laws), (n) (allegation that Cray will be exposed to further losses), (o) (allegation that allowing derivative suit to move forward would expose directors to liability in the class action suits), (p) (allegation that directors may face uninsured liability).

[6] Plaintiffs allege that Johnson and Poteracki sold stock during the Relevant Period. VADC ¶ 115. However, those Defendants were not directors when this action commenced.

[7] At argument, Plaintiffs' counsel stated that they also relied on *In re Caremark Int'l, Inc., Derivative Litig.*, 698 A.2d 959 (1996), to support the argument that the Audit Committee is "interested." *Caremark* was discussed in Plaintiffs' brief with regard to the exculpatory provisions in Cray's bylaws and was not discussed in the "Audit Committee" section of Plaintiffs' brief. *See* Pls.' Opp., at 12-13, 15-16. In any event, *Caremark* is also discussed below.

[8] Plaintiffs' schedule of stock sales omits Individual Defendant Smith. *Id.* at ¶ 115. Plaintiffs allege that Smith sold 49,548 shares for a total of \$539,052 but do not provide the number of trades or dates of each trade. *Id.* at ¶ 119(a)(ii).

[9] The Court also notes that, for the reasons discussed in Part II.B below, common law insider trading claims are not available in Washington State. Because the Selling Directors are not subject to personal liability for derivative insider trading claims, the sufficiency of the "interestedness" futility allegation is further diminished.

[10] *But see Sagent*, 278 F.Supp.2d at 1089 (board

members do not lack independence based solely on their positions and the monetary compensation they received in connection with their duties as employee and consultant for the company). However, the *Sagent* Court relied only on a pre- *Rales* case from Delaware for this proposition and, therefore, does not provide a helpful analysis. *See id.* (citing *Grobow v. Perot*, 539 A.2d 180, 188 (Del.1988)).

[11] The Court notes that even if the Selling Directors were interested, Plaintiffs fail to demonstrate that a majority of Cray's Board is impartial because Rottsolk and Smith are in both groups.

[12] The motion to dismiss for failure to adequately plead demand futility is also GRANTED as to the Individual Defendants, who incorporate that argument by reference into their motion to dismiss. The Court will also consider the Individual Defendants' separate motion to dismiss.

[13] The claims based in fraud include Count I (breach of fiduciary duty of loyalty and good faith for insider selling), Count II (breach of fiduciary duty of loyalty and good faith for improperly misrepresenting Cray's financial statements), part of Count V (waste caused by improper public statements, financial results and prospectus), and Count VI (unjust enrichment for insider selling on the basis of misrepresented financial information).

[14] Plaintiffs have, however, mistakenly omitted Defendant Smith from this schedule, but they name Smith as a Selling Defendant in paragraphs 15 and 119(a).
