

STATE OF NORTH CAROLINA

WAKE COUNTY

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

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ANDREW EGELHOF, Derivatively on Behalf  
of RED HAT, INC.,

Plaintiff,

vs.

MATTHEW J. SZULIK, KEVIN B.  
THOMPSON, PAUL J. CORMIER,  
TIMOTHY J. BUCKLEY, MARK H.  
WEBBINK, ALEX PINCHEV, ROBERT F.  
YOUNG, EUGENE J. MCDONALD, F.  
SELBY WELLMAN, MARYE A. FOX,  
WILLIAM S. KAISER, DR. STEVE  
ALBRECHT and H. HUGH SHELTON,

Defendants,

- and -

RED HAT, INC., a Delaware corporation,

Nominal Defendant.

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

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### *Introduction*

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

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

## ***Background and Factual Allegations***

### **A. The Parties**

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

### **B. Events Precipitating The Suit**

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

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

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

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

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

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

### **C. Plaintiff’s Allegations**

#### **1. General Allegations of Misconduct**

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

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

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

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

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

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

## **2. Insider Trading**

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

## **3. Demand Futility.**

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

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

- The Directors would not bring this action against Compensation Committee members because “[t]o do so would jeopardize each defendant’s personal financial compensation,” id. ¶¶ 123(b)-(c);
- Audit Committee members would not bring this action because they allegedly “breached their duties by causing or allowing ... improper financials” id. ¶ 123(d);
- Compensation Committee members would not bring this action because they breached their duties by approving incentive compensation to Red Hat officers that was tied to inflated revenues, id. ¶ 123(e);
- The outside Directors would not bring this action because they
  - are interested in “safeguarding” their compensation, and breached their duties by allowing the Company to issue false and misleading statements while voting to increase their compensation, id. ¶ 123(f); and
  - “would not jeopardize” being able to exercise the options that the Company awarded them and that have or will soon vest, id. ¶ 123(k);
- CFO Kevin B. Thompson, a non-Director, would not bring this action because to do so would “jeopardize” an interest-free \$200,000 advance that the Company gave him that has not yet been fully forgiven, id. ¶ 123(j); and
- The Directors would not bring this suit against themselves and/or their ability to do so would be impaired because they
  - breached their fiduciary duties by participating in or permitting the “wrongs” alleged in the Complaint, see id. ¶ 123(l), including issuance of “improper financials,” id. ¶ 123(i) (especially McDonald and Albrecht because each had “financial expertise,” id. ¶ 123(g)-(h)), thereby subjecting Red Hat to liability for *possibly* violating securities laws, id. ¶ 123(l);
  - would not sue themselves and “persons with whom they have extensive business and personal entanglements,” id. ¶ 123(m);
  - would likely “expose their own misconduct,” which would expose Red Hat and defendants to more litigation and liability, id. ¶ 123(p)-(r);
  - have not brought suit already, id. ¶¶ 123(j), (t); and
  - would not be covered under the Company’s D&O insurance, id. ¶ 123(s).

## *Argument*

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

#### **A. The Standards For Pleading Demand Futility.<sup>3/</sup>**

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

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

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

