

United States District Court
For the Northern District of California

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

E-FILED on 11/17/09

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

In re EXTREME NETWORKS, INC.
SHAREHOLDER DERIVATIVE
LITIGATION

This Document Relates To:

ALL ACTIONS.

No. C-07-02268 RMW

ORDER DENYING NOMINAL
DEFENDANT'S MOTION TO STRIKE AND
MOTION TO DISMISS

[Re Docket No. 101]

Lead plaintiff Kathleen Wheatley brings the present action as a derivative suit on behalf of Extreme Networks, Inc. ("Extreme") against certain current and former directors and officers of Extreme. Nominal defendant Extreme moves to strike allegations in the third amended complaint ("TAC") concerning transactions that predate lead plaintiff's ownership of Extreme stock. Extreme also moves to dismiss the TAC in its entirety for failure to make demand against the company or to plead with particularity that demand should be excused. Plaintiffs oppose the motions. The court heard argument on the motions on December 19, 2008. The court has read the moving and responding papers and considered the arguments of counsel. For the reasons set forth below, the court DENIES Extreme's motion to strike and motion to dismiss.

I. FACTS

This case consolidates a number of lawsuits asserting violations of federal securities and state laws against certain current and former directors and officers of Extreme based on alleged conduct in the granting of stock options. Specifically, plaintiffs allege that the defendants engaged in a scheme to manipulate the grant dates and associated documentation of stock options issued by Extreme. TAC ¶¶ 5, 10. Plaintiffs also allege that defendants made false and misleading representations regarding Extreme's stock option granting and accounting practices in financial reports, proxy statements, press releases, and SEC filings. *Id.* ¶ 13. Plaintiffs challenge conduct that occurred between 1999 and 2005 (the "relevant period"). *Id.* ¶ 2.

A. Structure of the Board of Directors

During the relevant period, Extreme's Board of Directors included a Compensation Committee, an Audit Committee, and a Nominating Committee. *Id.* ¶ 64. The Compensation Committee was responsible for administering Extreme's stock option plans and for making decisions concerning compensation for officers and directors, including option grants. *Id.* ¶¶ 65-66. The Audit Committee was responsible for financial oversight of the company. *Id.* ¶ 67.

At the time plaintiffs filed the TAC, Extreme's Board of Directors consisted of defendants Gordon L. Stitt, Charles P. Carinalli, Kenneth Levy, Robert L. Corey, and Harry Silverglide, and non-defendants Mark Canepa and John C. Shoemaker (the "Demand Board"). *Id.* ¶ 31. Three of these directors, Carinalli, Corey, and Levy, are alleged to have engaged in wrongdoing during their service on the Compensation and Audit Committees. *Id.* ¶¶ 32-33. The Demand Board's membership in the two committees may be summarized as follows:

	Compensation Committee	Audit Committee
FY98	Carinalli	
FY99	Carinalli	
FY00	Carinalli	Carinalli
FY01	Carinalli	Carinalli
FY02	Carinalli	Carinalli
FY03	Carinalli	Carinalli, Corey

1	FY04	Carinalli, Corey, Levy	Carinalli, Corey, Levy
2	FY05	Carinalli, Corey, Levy	Carinalli, Corey, Silverglide

3 *Id.* ¶ 34.

4 **B. Extreme's Internal Investigation**

5 On September 15, 2006, Extreme announced in a Form 8-K that the Board had appointed a
6 Special Committee to review the Company's historical practices granting and accounting for stock
7 options. *Id.* ¶ 188. Extreme also announced that it had received and responded to an informal
8 inquiry letter from the SEC regarding the same. *Id.* On January 8, 2007, Extreme announced that it
9 had "reached a preliminary conclusion that the appropriate measurement dates for financial
10 accounting purposes of certain stock option grants differ from the recorded grant dates of those
11 awards." *Id.* ¶ 191. As a result, Extreme expected to restate some of its historical financial
12 statements to record additional stock-based compensation expense and indicated that its financial
13 statements from fiscal 2000 through the third quarter of 2006 should not be relied upon. *Id.*

14 On June 28, 2007 in a Form 8-K, Extreme disclosed that

15 The Special Committee found deficiencies in the Company's processes for approving
16 and documenting option grants, which resulted in the Company erroneously treating
17 the stated grant date as the measurement date for financial accounting purposes with
18 respect to certain options. These deficiencies occurred predominantly during 1999
through 2001 (fiscal 2000 through 2002), but continued in some respects until fiscal
2004.

19 *Id.* ¶ 195. The Special Committee's findings were set out more fully in Extreme's Form 10-K, filed
20 on the same day. *Id.* ¶ 196 & Ex. 2. The Special Committee found that Extreme would have to
21 recognize an additional \$223 million in non-cash share-based compensation charges as a result of
22 certain grants, including

23 grants that were not approved until after the stated grant date; grants that were dated
24 and priced at a time when lists of grant recipients and share allocations were not yet
25 complete; grants that were not accurately and timely documented; *grant dates that*
appeared to have been selected retrospectively, in some cases apparently due to price
considerations; grants that pre-dated the effective date of employment of the grantee;
and grants that were completed and subsequently modified.

26 *Id.*, Ex. 2 at 53 (emphasis added).¹

27 _____
28 ¹ Citations to Extreme's Form 10-K refer to the page numbers that appear in the original document
filed with the SEC.

1 During the relevant period, the Board of Directors had delegated authority to then-Chief
2 Executive Officer ("CEO") Stitt to approve grants of 40,000 shares or less to employees who were
3 not officers or directors. *Id.* at 56. The Special Committee found that, during a period when the
4 company had a policy of making weekly grants to newly hired employees, the policy had not been
5 followed. *Id.* Instead, the grants had been entered into the stock plan management system in
6 batches, with grants for multiple weeks entered on the same day. *Id.* "[A]nalysis showed the grant
7 dates generally reflected the lowest achievable price for the batch periods, which ranged from 1 to
8 60 days, and averaged 30 days." *Id.*

9 The Special Committee reviewed 43 grants that were made to officers, directors, and to other
10 individuals in amounts that required Board approval. *Id.* at 57. The Special Committee found that
11 11 of these grants had incorrect measurement dates. *Id.* Of those, 7 grants lacked sufficient
12 contemporaneous documentation to support the recorded grant date, 2 grants had been completed
13 and subsequently modified, and 2 grants predated the grantee's start date with Extreme. *Id.* The
14 Form 10-K noted that

15 None of the affected options granted to the Company's officers or directors during the
16 Review Period has ever been exercised. Only one such grant, to an outside Director,
17 remains outstanding; all other affected grants to officers or Directors were
surrendered or cancelled in accordance with their terms in the ordinary course of
business, prior to the Special Committee review.

18 *Id.* at 54. The Special Committee also found no evidence of fraud and concluded that none of the
19 individuals involved intended to mislead investors. *Id.* at 53.

20 **C. Allegedly Backdated Officer and Director Grants**

21 Between 1999 and August 2002, Extreme made twelve grants to officers and directors. *Id.*
22 ¶ 83. Plaintiffs allege that ten of these grants occurred on or near a monthly stock price low or in
23 advance of sharp stock price increases. *Id.* Plaintiffs also apply methodologies alleged to be used
24 by the *Wall Street Journal*, Merrill Lynch, and the Center for Financial Research and Analysis
25 ("CFRA") to analyze these grants. *Id.* ¶ 85. Taken together, plaintiffs argue that these facts support
26 an inference of a pattern of backdating at Extreme. *Id.* ¶¶ 84-85.

27 The ten challenged grants occurred on September 17, 1999, December 17, 1999, January 10,
28 2000, June 1, 2000, June 8, 2000, July 5, 2000, April 9, 2001, October 2, 2001, October 22, 2001,

1 and December 28, 2001. *Id.* ¶¶ 86-120. For each of the challenged grants, the TAC sets forth the
 2 recipients; the date on which the Form 4 reporting the grant was filed; the stock price on the grant
 3 date; the stock price 20 days later and the percentage gain this represents over the grant price; a
 4 "Merrill Lynch analysis" comparing the annualized 20-day cumulative return with the annualized
 5 return for investors; and a graph showing the stock price movement for an approximately two month
 6 period centered on the grant date. *Id.* For some grants, the TAC also alleges a "CFRA analysis"
 7 comparing the grant price to the 10- and 40-day period stock price low and comparing the stock
 8 price range to the lowest stock price. *Id.*²

9 Some of the challenged grants were made at relative lows in stock price. These allegations
 10 may be summarized as follows:

Grant Date	Relative Stock Price
January 10, 2000	lowest of month and fiscal quarter
June 1, 2000	lowest of month
April 9, 2001	third lowest of month, fiscal quarter, and fiscal year
October 2, 2001	lowest of month and fiscal quarter second lowest of year
December 28, 2001	second lowest of month

17 *Id.* ¶¶ 92, 95, 106, 109, 117.

18 Five of the challenged grants were made to recipients that include members of the Demand
 19 Board: the December 17, 1999 and July 5, 2000 grants to Silverglide and Stitt; the April 9, 2001
 20 grant to Carinalli, Silverglide, and Stitt; the October 22, 2001 grant to Levy; and the December 28,
 21 2001 grant to Carinalli. *Id.* ¶ 120.

22 Plaintiffs also challenge four out of twelve grants made after August 2002. *Id.* ¶¶ 122-24.
 23 For three grants, dated October 23, 2003, September 29, 2004, and January 25, 2006, defendants
 24 failed to file a Form 4 within 2 days as required by Sarbanes-Oxley. *Id.* Two of these grants fell on
 25 the third lowest price of the month and for all three grants the stock price increased between the
 26

27 ² Some of the allegations are internally inconsistent. For example, plaintiffs allege that the stock
 28 price 20 days after the July 5, 2000 grant was \$128.31, but the stock price graph shows that the price
 never exceeded around \$80 during that period. *Id.* ¶¶ 103, 105. Plaintiffs also report two different
 values for this grant's 20-day cumulative return, 35.15% and 41.5%. *Id.* ¶¶ 103-04.

1 grant date and the day on which the Forms 4 were filed. *Id.* A fourth grant, on June 3, 2004, fell on
2 the lowest price of the month. *Id.* ¶ 124. The stock price increased from \$4.97 to \$5.19 between the
3 grant date and the date the Form 4 was (timely) filed. *Id.* Plaintiffs do not identify the recipients of
4 these four grants.

5 **D. Levy's Conduct at Other Companies**

6 The TAC includes allegations of Levy's conduct at other companies, which plaintiffs argue is
7 relevant to the demand futility analysis. *Id.* ¶ 207(e)(iv). Specifically, Levy stands accused of
8 options backdating at two other companies, KLA-Tencor Corp. ("KLA-Tencor") and Juniper
9 Networks, Inc. ("Juniper"). *Id.* At both companies, shareholders have filed derivative actions and
10 shareholder class actions which name Levy as a defendant. *Id.*

11 Levy is the founder of KLA-Tencor. *Id.* He served as CEO of the company from 1975 until
12 mid-1997 and between mid-1998 and mid-1999. *Id.*, Ex. 3 at 25. He also served on the Board of
13 Directors from 1975 until 2006 and on the stock option committee from 1994 until use of the
14 committee was suspended in 2006. *Id.* KLA-Tencor conducted an internal investigation of its stock
15 option practices in response to the May 22, 2006 *Wall Street Journal* article about options
16 backdating, which specifically questioned the practices at KLA-Tencor. *Id.* at 23. The findings
17 were reported in its Form 10-K filed January 29, 2007. *Id.*, Ex. 3. KLA-Tencor's Special
18 Committee concluded that

19 (1) there was retroactive pricing of stock options granted to all employees who
20 received options, primarily during the periods from July 1, 1997 to June 30, 2002 . . .
21 , (3) *the retroactive pricing of options was intentional*, not inadvertent or through
22 administrative error, (4) *the retroactive pricing of options involved the selection of*
23 *fortuitously low exercise prices by certain former executive officers, and other former*
24 *executives may have been aware of this conduct*, (5) the retroactive pricing of options
involved the falsification of Company records, resulting in erroneous statements
being made in financial and other reports previously filed with the SEC, as well as in
information previously provided to our independent registered public accounting
firm, and (6) in most instances, the retroactive pricing of options violated the terms of
our stock option plans.

25 *Id.* at 24 (emphasis added). The Form 10-K went on to state:

26 Because virtually all holders of retroactively priced options issued by the Company
27 were not involved in or aware of the retroactive pricing, the Board of Directors
28 decided that we should continue to honor the options that violated the terms of our
stock option plans, except in certain individual cases as described below.

1 *Id.* at 24. Levy's was one of several individual cases described. *Id.* at 25. The Form 10-K indicated
2 that Levy had retired as a director and employee on October 16, 2006 and had entered into a
3 Separation Agreement and General Release with the company under which his outstanding
4 retroactively priced options had been re-priced to reflect the actual grant dates. *Id.*

5 Levy served on Juniper's Board of Directors from 2003 to May 2007 and was a member of
6 Juniper's Compensation Committee from 2003 to 2006. *Id.* ¶ 207(e)(iv). Juniper allegedly admitted
7 to backdating between 1999 and 2004 and restated its financial data for 2002 through 2005. *Id.* In
8 an action filed in this district, *In re Juniper Networks, Inc. Securities Litigation*, case number 06-
9 04327-JW, Levy is personally accused of authorizing and approving backdated options as a member
10 of the Compensation Committee and of signing Juniper's false and misleading financial statements.
11 *Id.* In his answer, Levy denies that he backdated options or that the financial statements he signed
12 were false and misleading. *Id.* & Ex. 4, 5.

13 II. ANALYSIS

14 Lead plaintiff Wheatley has owned Extreme stock since August 8, 2000. *Id.* ¶ 40. Extreme
15 moves pursuant to Fed. R. Civ. P. 12(f) to strike allegations concerning transactions that predate
16 Wheatley's ownership because she does not have standing to challenge such transactions. In
17 addition, plaintiffs did not make a demand on the Extreme board before filing this suit. *Id.* ¶ 31.
18 Extreme moves to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) and 23.1 on grounds that plaintiffs
19 have not adequately alleged that demand on the board would have been futile.

20 A. Wheatley's Standing

21 Under both Delaware law and the Federal Rules of Civil Procedure, a shareholder bringing a
22 derivative suit must allege that he was a shareholder at the time of the challenged transaction. 8 Del.
23 C. § 327; Fed. R. Civ. P. 23.1(b)(1). Wheatley has alleged that she "is a current holder of Extreme
24 Networks stock [and] has held shares since August 8, 2000." TAC ¶ 40. As such, she does not have
25 standing to challenge transactions that occurred before August 8, 2000. However, she purports to
26 sue for violations that occurred during the relevant period, which runs from 1999 through 2005. *Id.*
27 ¶ 2. In addition, the TAC contains many allegations of conduct that occurred before August 2000.
28 *E.g., id.* ¶¶ 86-105, 126-27, 140-42.

1 Rule 12(f) allows a court to strike from a pleading "any redundant, immaterial, impertinent,
2 or scandalous matter." Extreme argues that allegations of transactions and conduct prior to
3 August 8, 2000 are irrelevant as a result of Wheatley's lack of standing and should be stricken.
4 However, as Extreme concedes, lack of standing does not affect a demand futility analysis. *In re*
5 *MIPS Techs., Inc.*, 2008 WL 3823726 (N.D. Cal. Aug. 13, 2008) at *3. Plaintiffs argue that events
6 prior to August 8, 2000 illustrate a pattern of backdating that renders the Demand Board interested.
7 Thus, the allegations are relevant in spite of Wheatley's lack of standing, and the motion to strike is
8 denied. *See In re Zoran Corp. Derivative Litig.*, 511 F. Supp. 2d 986, 1005 (N.D. Cal. 2007)
9 (allowing plaintiff to refer to grants predating his ownership "to establish the predisposition of
10 management to engage in backdating").

11 **B. Demand Futility**

12 "A shareholder seeking to vindicate the interests of a corporation through a derivative suit
13 must first demand action from the corporation's directors or plead with particularity the reasons why
14 such demand would have been futile." *In re Silicon Graphics Inc. Securities Litig.*, 183 F.3d 970,
15 989-90 (9th Cir. 1999) (citing Fed. R. Civ. P. 23.1). The circumstances which make a demand futile
16 are established by the laws of the state in which the corporation is incorporated. *Id.* at 990. Extreme
17 is incorporated in Delaware and, as such, the court turns to Delaware law to consider whether
18 demand is excused.

19 Two tests for demand futility are applied under Delaware law. Where the challenged
20 decision was made by the board of directors, demand is excused if the plaintiffs make particularized
21 allegations raising a reasonable doubt that (1) a majority of the board of directors in place at the time
22 of the complaint is disinterested and (2) the challenged acts were the product of the board's valid
23 exercise of business judgment. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). However, if the
24 challenged decision was not a decision of the board of directors, the plaintiffs must create a
25 reasonable doubt that the board of directors in place at the time of the complaint "could have
26 properly exercised its independent and disinterested business judgment in responding to a demand."
27 *Rales v. Blasband*, 635 A.2d 927, 934 (Del. 1993). A decision made by a committee of the board is
28 not a decision of the board of directors unless a majority of the board sat on the committee. *See id.*;

1 *Ryan v. Conrad*, 918 A.2d 341, 353 (Del. Ch. 2007). Here, plaintiffs allege that backdated options
2 were granted by the Compensation Committee, which at all times consisted of less than half the
3 board. Thus, the *Rales* test applies.

4 At the time the TAC was filed, the board of directors consisted of seven members: Stitt,
5 Carinalli, Levy, Corey, Silverglide, Canepa, and Shoemaker. Thus, to excuse demand, plaintiffs
6 must show that at least four of these directors were not disinterested and independent. Plaintiffs
7 allege that Stitt, Carinalli, Levy, Corey, and Silverglide are interested because: (1) Stitt, Carinalli,
8 Levy, and Silverglide received backdated stock options; (2) Carinalli, Levy, and Corey face liability
9 for their service on the Audit Committee and for approving backdated options while on the
10 Compensation Committee; (3) Levy was involved in backdating at two other companies; and (4) all
11 five directors signed false and misleading SEC filings. Plaintiffs do not allege that Canepa or
12 Shoemaker were not disinterested and independent.

13 "A director is considered interested where he or she will receive a personal financial benefit
14 from a transaction that is not equally shared by the stockholders." *Rales*, 634 A.2d at 936 (citing
15 *Aronson*, 473 A.2d at 812). "Directorial interest also exists where a corporate decision will have a
16 materially detrimental impact on a director, but not on the corporation and the stockholders." *Id.* In
17 such circumstances, directors cannot be expected to consider a demand "without being influenced by
18 the adverse personal consequences resulting from the decision." *Id.* "However, the mere threat of
19 personal liability for approving a questioned transaction, standing alone, is insufficient to challenge
20 either the independence or disinterestedness of directors, although in rare cases a transaction may be
21 so egregious on its face that board approval cannot meet the test of business judgment, and a
22 substantial likelihood of director liability therefore exists." *Aronson*, 473 A.2d at 815.

23 1. Receipt of Backdated Stock Options

24 Receiving backdated options renders a director interested for the purpose of responding to a
25 demand because the benefit is not shared by the shareholders and "[a] decision to correct the grants
26 would have a detrimental impact on the directors by removing a financial benefit they received." *In*
27 *re CNET Networks, Inc. Shareholder Derivative Litig.*, 483 F. Supp. 2d 947, 958 (N.D. Cal. 2007).
28 At the pleading stage, "[t]he issue is whether plaintiffs have alleged circumstances from which we

1 may reasonably infer backdating as opposed to innocent bookkeeping error." *Id.* at 956.

2 **a. Statistical Methods for Assessing Backdating Risk**

3 Plaintiffs allege that they have analyzed the challenged pre-Sarbanes-Oxley grants pursuant
4 to methods used by the *Wall Street Journal*, Merrill Lynch, and CFRA to determine whether grants
5 are at risk of being backdated. Courts have encountered these methods before and at least the
6 Merrill Lynch analysis has met with some approval. *See Ryan v. Conrad*, 918 A.2d at 354
7 (accepting an analysis conducted by Merrill Lynch as supporting an inference of backdating);
8 *Edmonds v. Getty*, 524 F. Supp. 2d 1267, 1274, 1276 (W. D. Wash. 2007) (finding sufficient to
9 plead demand futility a complaint modeled after the one in *Ryan*, including allegations using the
10 Merrill Lynch analytical framework). However, courts decline to rely on such methods when not
11 rigorously applied. *CNET*, 483 F. Supp. 2d at 957 (rejecting alleged *Wall Street Journal* and CFRA
12 analyses where "plaintiffs only followed [the analysts'] footsteps halfway"); *In re Openwave Sys.*
13 *Inc. Shareholder Derivative Litig.*, 503 F. Supp. 2d 1341, 1351 (N.D. Cal. 2007). Upon examining
14 the allegations in the complaint, plaintiffs do not appear to have successfully reproduced any of the
15 three methodologies they cite.

16 The *Wall Street Journal's* method looks at the 20 trading days after a grant is made and
17 calculates how much the company's stock appreciated in that period. *CNET*, 483 F. Supp. 2d at 956-
18 57. This 20-day gain is ranked against the 20-day gains of all trading days in the year. *Id.* at 957.
19 Companies with consistently highly ranked grant dates are considered to be at risk for having
20 backdated options. *Id.* While plaintiffs allege the 20-day gains for each challenged grant in the
21 TAC, they fail to allege how such returns rank against other possible grant dates. Thus, these
22 allegations provide no indication of "how unusual, versus the rest of the stock's behavior, the activity
23 following the grant date was." *Id.*

24 The Merrill Lynch method also looks at the 20-day gain for option grants. Extreme's RJN,
25 Ex. 17. Merrill Lynch calculated the average stock return for the 20 days following any option
26 grants to senior executives and used these averages to determine an annualized management return.
27 *Id.* The firm then compared the annualized management return to the actual stock price returns for
28 the corresponding calendar year. *Id.* Merrill Lynch used the difference to measure the

1 "aggressiveness" of companies' options pricing policies. *Id.* Instead of looking at average 20-day
2 and annualized returns, plaintiffs' "Merrill Lynch analysis" evaluates each individual grant
3 separately. Plaintiffs also fail to include all officer and director grants and apply the analysis only to
4 the challenged grants. *See Openwave Systems*, 503 F. Supp. 2d at 1351 (rejecting plaintiffs' analysis
5 because it only examined the 20-day returns of its "handpicked option grants" rather than the return
6 on "all reported stock option grants during the relevant period"). Notably, the Merrill Lynch report
7 never attempts to identify specific grants that are potentially backdated, Extreme's RJN, Ex. 17, as
8 plaintiffs seek to have its method do.

9 The CFRA method attempts to identify grants made at exercise prices that match or are close
10 to a 40-day low following or preceding a period of material change in the company's stock price.
11 Extreme's RJN, Ex. 18. Specifically, it flags options where the price on the grant date was within
12 105% of the 10- or 40-day period stock price low and the stock price range was greater than 10% of
13 the lowest stock price. *Id.*; TAC ¶ 81. CFRA considered companies to be at risk where there were
14 more than three flagged grants among those made between 1997 and 2002. Extreme's RJN, Ex. 18.
15 While accurately reciting CFRA's criteria, plaintiffs appear to have misunderstood their application.
16 Plaintiffs consistently allege that the grant price is *lower* than what they assert to be the 40-day low.
17 *E.g.*, TAC ¶ 97 (alleging that the grant price is 72.9% of the 10- and 40-day period low). These
18 allegations are included even for grants that are not alleged to be anywhere near the lowest stock
19 price of the month or quarter. Plaintiffs also treat CFRA's two criteria as disjunctive, alleging that,
20 while a stock price was *not* within 105% of the lowest price, it nonetheless carried "indicia of
21 backdating" because the stock price had fluctuated a lot. TAC ¶ 105. By this logic, a grant would
22 be suspicious if made before a 20% *drop* in stock price.

23 The court notes that neither the Merrill Lynch report nor the CFRA report are particularly
24 transparent in explaining their methodology. While plaintiffs are not required to discover the exact
25 procedures used or reverse-engineer the results, they must explain why the analyses in the complaint
26 are informative and suggest backdating. *Cf. CNET*, 483 F. Supp. 2d at 957 (noting plaintiffs' failure
27 to plead "where their method came from, whether it was used by anyone else, or whether it was
28 peer-reviewed or bore other indicia of academic approval"). Plaintiffs have not provided sufficient

1 explanations here. Thus, the court must determine whether the remainder of plaintiffs' allegations
2 raise an inference of backdating. *See id.* at 958 ("Sound analytical methods are one way that
3 plaintiffs could have eliminated the possibility that the returns from the grants were the product of
4 dumb luck. Without them, that inference is more difficult to support.").

5 **b. Alleged Pattern of Backdating**

6 Of the twelve grants made before Sarbanes-Oxley, plaintiffs allege that three occurred at the
7 lowest price for the month, one at the second lowest, and one at the third lowest. Of those five, three
8 occurred not only at monthly lows but at quarterly and yearly lows. Since a month contains
9 approximately 20 trading days, the probability of selecting the lowest price is approximately one in
10 twenty if one is selecting dates randomly.³ Out of twelve grants, one would generally expect at most
11 one grant to bear the lowest price of the month and one or two grants to bear the third lowest price or
12 lower. The improbability of Extreme's results is heightened by the even smaller chances of hitting a
13 quarterly or yearly low in price. Thus, although the sample size is small, the results do to some
14 degree support an inference of backdating. *Cf. Zoran*, 511 F. Supp. 2d at 1004 (finding "hugely
15 suspicious" a pattern wherein seven out of thirty-two grants were at the lowest price of the month).

16 The court in *Zoran* also relied on the fact that many of the challenged grants had been made
17 sporadically in the discretion of the directors, rather than pursuant to a plan that specified fixed grant
18 dates. *Id.* at 1004-05. Plaintiffs do not provide extensive details about the stock option plans at
19 Extreme, but there is no evidence that the challenged grants were made pursuant to any
20 predetermined schedule. In addition, some grants to officers and directors examined by the Special
21 Committee lacked contemporaneous documentation to support the grant date, suggesting that such
22 dates were not selected in advance. A plan that allows flexibility in selecting grant dates "len[ds]
23 itself to possible backdating." *Id.* at 1005.

24 Plaintiffs also allege that the timing of many grants preceded a "run-up" in share price.
25 While the court does not always agree with plaintiffs' characterization, the stock price movements of

26 ³ Extreme argues that companies do not select grant dates randomly and in fact try to grant options
27 when they believe prices are low. But such a strategy would not enable companies to exactly select
28 *the* lowest (or second or third lowest) price in a month. At best, it weakens the implications of
plaintiffs' generalized allegation that most grants were made at prices below the average price for the
year, TAC ¶ 83.

1 the five low grants, combined with the improbability of obtaining the results at random, are
2 sufficient to raise an inference that these grants were backdated. *See id.* (finding sufficient plaintiff's
3 allegation that stock prices increased sharply after all eleven grant dates, "[c]oupled with the
4 statistical pattern of favorable grant dates and the fact that the grant date could be chosen at the will
5 of the compensation committee"). Plaintiffs have not sufficiently alleged that any of the other
6 challenged grants were backdated.

7 Members of the Demand Board received options on two of the five implicated grant dates.
8 Carinalli, Silverglide, and Stitt received options on April 9, 2001, and Carinalli received options on
9 December 28, 2001. Thus, plaintiffs have pleaded sufficient facts to create a reasonable doubt that
10 directors Carinalli, Silverglide, and Stitt were disinterested.

11 **c. Material Benefit**

12 Extreme argues that plaintiffs are required to plead that the benefit of these options was
13 material to the directors and that plaintiffs have failed to do so. Extreme relies on *Orman v.*
14 *Cullman*, 794 A.2d 5 (Del. Ch. 2001) and *In re General Motors Class H Shareholders Litigation*,
15 734 A.2d 611 (Del. Ch. 1999) for the proposition that plaintiffs must plead materiality. Neither of
16 these cases dealt with demand futility. In both cases, plaintiffs were challenging a decision made by
17 the board of directors and seeking to overcome the business judgment presumption by alleging that
18 the directors were interested. *Orman* relies on the definition of interestedness in *Rales*, which
19 considers a director interested when he will suffer a *materially* detrimental impact not shared by the
20 corporation and the shareholders. *Orman*, 794 A.2d at 23 (quoting *Rales*, 634 A.2d at 936).
21 However, *Orman* imposed the materiality requirement only where the challenged transaction did not
22 involve self-dealing, i.e. a personal financial benefit that does not devolve upon the shareholders
23 generally. *Id.* at 23 (quoting *Aronson*, 473 A.2d at 812). Here, the directors' receipt of options was
24 not a benefit shared with shareholders.

25 Many courts have found that pleading receipt of backdated options is sufficient for assessing
26 demand futility without further inquiry into whether such options were material. *E.g.*, *Zoran*, 511 F.
27 Supp. 2d at 1003 ("[I]f plaintiffs can plead with particularity that the directors received backdated
28 grants, those directors will be considered interested."). The court in *CNET* specifically rejected an

1 argument similar to the one made here about failure to plead materiality, finding that "[b]y receiving
2 backdated options, [the director] still has a chance of being subject to personal liability despite
3 plaintiffs' sloppy pleading." 483 F. Supp. 2d at 962. Thus, the court declines to hold plaintiffs to a
4 stricter pleading standard.

5 Extreme points to the Special Committee's finding that none of the affected options granted
6 to directors were ever exercised and all except one have been surrendered or cancelled. It would
7 seem that if a director received backdated options but never realized any benefit and could no longer
8 benefit from them, such options would not be a basis for rendering him interested. *See CNET*, 483
9 F. Supp. 2d at 958 (explaining that receiving backdated options renders directors interested because
10 they would be unwilling to correct the grant and thereby "remov[e] a financial benefit they
11 received"); *Zoran*, 511 F. Supp. 2d at 1003 (same). However, the statement in the Form 10-K cited
12 by Extreme is insufficient to support such a conclusion. First, the Form 10-K does not explicitly
13 identify the "affected grants" that were never exercised, leaving the possibility that the implicated
14 grants to Carinalli, Silverglide, and Stitt were exercised or remain outstanding. Second, surrender of
15 a stock option does not necessarily equate with deriving no benefit.⁴ Even though plaintiff has not
16 alleged whether the backdated options were exercised or whether they remain outstanding, the court
17 finds the fact that these directors received them is sufficient to create a reasonable doubt as to their
18 disinterestedness.

19 2. Levy's Disinterestedness

20 Plaintiffs focus the bulk of their demand futility allegations on Levy, as this court previously
21 found plaintiffs' failure to plead Levy's interestedness dispositive of the demand futility issue.
22 August 11, 2008 Order at 15. Plaintiffs allege that Levy is interested because (1) he received
23 backdated options, (2) he served on the Compensation Committee, (3) he served on the Audit
24 Committee and executed false SEC filings, and (4) he is implicated in backdating at two other
25 companies. As discussed above, plaintiffs have not adequately alleged that the one challenged grant
26

27 ⁴ Plaintiffs suggest that stock options grants may have been accompanied by the grant of tandem
28 stock appreciation rights, which are exercisable only when the corresponding stock option is
surrendered. TAC at 74 n.14. However, plaintiff cites only the 2005 Plan, which does not cover any
of the implicated grants.

1 to Levy, on October 22, 2001, was backdated. *See also* August 11, 2008 at 14-15.⁵ Levy joined the
2 board in October 2001 and the Compensation and Audit Committees in 2004. TAC ¶ 34, 51. The
3 only allegations that backdating occurred after Levy joined Extreme are the December 28, 2001
4 grant and Extreme's nonspecific admissions that some examined options appeared backdated and
5 that process deficiencies occurred through 2004.

6 Plaintiffs argue that Levy's role in or knowledge of backdating at Extreme may be inferred
7 from the fact that he has been accused of backdating at two other companies. Caution is needed
8 before accepting such an argument. A director does not become interested simply because a
9 sufficient number of lawsuits has been filed against him, particularly when none of those lawsuits
10 have resulted in any factual findings of wrongdoing. Nor by referring to accusations in other
11 lawsuits can a plaintiff avoid the requirement that he plead with particularity the grounds for demand
12 futility. With respect to Levy's conduct at Juniper, plaintiffs have provided no more details than that
13 Juniper discovered backdating and Levy was a member of the Compensation Committee. The court
14 has already found, in the context of Levy's involvement at Extreme, that a bare allegation of
15 Compensation Committee service is insufficient. August 11, 2008 Order at 15-16.⁶ The mere fact
16 that Levy was a director at multiple companies, during a time when many companies were engaged
17 in backdating, does not implicate him in any particular alleged scheme.

18 Plaintiffs have provided more specific details regarding Levy's conduct at KLA-Tencor. The
19 revelations in KLA-Tencor's Form 10-K strongly support an inference that Levy was knowingly
20 involved in backdating stock options at that company and that he received such backdated options.
21 In turn, this supports an inference that Levy was knowingly involved in alleged backdating at

22
23 ⁵ Plaintiffs argue that the court improperly inferred that this grant coincided with Levy's joining the
24 Board of Directors, noting Extreme's admissions that some option grants predated the employees'
25 start date and that its SEC filings contained false financial information. Plaintiffs argue they are
26 entitled to an inference "that defendants intentionally manipulated Levy's start date in SEC filings in
27 furtherance of their backdating scheme." Plaintiffs ignore the fact that they are required to plead
28 with particularity why a director is interested. There are no allegations in the TAC that would link
Extreme's admissions to this particular grant or suggest that Extreme ever falsified director start
dates; in fact, plaintiffs acknowledge that Levy joined the board in October 2001, TAC ¶ 51.
Without more, such attacks on this grant are simply stray speculation.


⁶ This court does not express an opinion regarding how any allegations should be evaluated by the
court in the Juniper litigation.

1 Extreme. In light of the other allegations in the complaint, the court finds that these allegations are
2 sufficient to create a reasonable doubt that Levy is disinterested in the present litigation. Thus,
3 plaintiffs have successfully pleaded that demand is excused.

4 **III. ORDER**

5 For the foregoing reasons, the court DENIES Extreme's motion to strike and motion to
6 dismiss.

7
8
9 DATED: 11/17/09



10 RONALD M. WHYTE
11 United States District Judge
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

1 **Notice of this document has been electronically sent to:**

2 **Counsel for Plaintiffs:**

3 Robert Bramson rbramson@bramsonplutzik.com
4 Emanuel Shachmurove mshachmurove@sbtclaw.com
5 Aelish Marie Baig AelishB@csgrr.com
6 Lawrence Timothy Fisher ltfisher@bramsonplutzik.com
7 Alan R Plutzik aplutzik@bramsonplutzik.com
8 Frank James Johnson frankj@johnsonbottini.com
9 Shawn A. Williams shawnw@csgrr.com
10 Eric L. Zagar ezagar@sbtclaw.com
11 Lucas F. Olts like.olts@bullivant.com

8 **Counsel for Defendants:**

9 John Henry Hemann jhemann@morganlewis.com
10 Jonathan DeGooyer jdegooyer@morganlewis.com
11 Joseph Edward Floren jfloren@morganlewis.com
12 Laura Alexis Lee llee@morganlewis.com

12 Counsel are responsible for distributing copies of this document to co-counsel that have not
13 registered for e-filing under the court's CM/ECF program.

14

15

16 **Dated:** 11/17/09

CCL

Chambers of Judge Whyte

17

18

19

20

21

22

23

24

25

26

27

28