

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 4/2/10

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

In re EXTREME NETWORKS, INC.
SHAREHOLDER DERIVATIVE
LITIGATION

No. C-07-02268-RMW

This Document Relates To:

ALL ACTIONS

ORDER DENYING EXTREME'S MOTION
FOR RECONSIDERATION AND FOR STAY
OF ACTION AND CERTIFICATION OF
APPEAL

[Re Docket No. 112, 114]

Nominal defendant Extreme Networks, Inc. ("Extreme") moves for reconsideration of the court's November 17, 2009 order denying Extreme's motion to strike and motion to dismiss the Third Amended Complaint. In the alternative, Extreme moves for a stay and certification of the issue for interlocutory appeal. For the reasons set forth below, the court denies both motions.

I. BACKGROUND

In April and May 2007, Extreme shareholders brought three derivative lawsuits on behalf of Extreme, against certain current and former directors and officers of Extreme, asserting violations of federal securities and state laws. These suits were brought without any prior demand on Extreme's board of directors. On August 2, 2007, the court consolidated these actions. On October 11, 2007,

1 plaintiffs filed the First Amended Complaint ("FAC"). Extreme moved to dismiss the FAC, and the
2 parties then stipulated to allow plaintiffs to file a Second Amended Complaint ("SAC").

3 Extreme moved to dismiss the SAC for failure to make demand against the company or to
4 plead with particularity that demand should be excused. On August 12, 2008, the court held that the
5 SAC failed to specifically allege facts creating a reasonable doubt that a majority of Extreme
6 directors were disinterested and independent and thus dismissed the SAC with leave to amend. In its
7 August 12, 2008 order ("Aug. Order"), the court rejected plaintiffs' argument that Kenneth Levy, one
8 of the members of Extreme's board of directors at the time suit was filed, was interested based on an
9 October 22, 2001 stock option grant he received, finding that the SAC failed to allege facts raising a
10 reasonable inference that this grant was backdated. Aug. Order at 14.

11 Plaintiffs sought reconsideration of the Aug. Order, complaining in part that the court did not
12 discuss in its order their allegations about Levy's board position at other companies facing
13 backdating allegations in other lawsuits. On September 23, 2008, the court denied plaintiffs' motion
14 for reconsideration. In its September 23, 2008 order ("Sept. Order"), the court noted in a footnote
15 that it had not expressly cited facts relating to Levy's position at other companies in its previous
16 order because "the court did not find them critical to its decision." Sept. Order at 3 n.1.

17 On September 21, 2008, plaintiffs filed the Third Amended Complaint ("TAC"). The TAC
18 alleges that Levy was interested because: (1) he received backdated options, (2) he served on the
19 Compensation Committee, (3) he served on the Audit Committee, and (4) he was implicated in
20 backdating at two other companies. Extreme moved to dismiss the TAC for failure to plead with
21 particularity that demand should be excused.

22 On November 17, 2009, the court denied Extreme's motion to dismiss, finding that the TAC
23 alleged sufficient facts to create a reasonable doubt that a majority of Extreme's board, including
24 Levy, was disinterested. In its November 17, 2009 order ("Nov. Order"), the court held that
25 evidence of Levy's knowing involvement in backdating at KLA-Tencor suggested that Levy was
26 knowingly involved in backdating at Extreme and, combined with other allegations in the TAC,
27 provided sufficient facts to reasonably doubt Levy's disinterestedness. Nov. Order at 15-16.

1 Extreme now moves for reconsideration of the Nov. Order, or in the alternative, a stay and
2 certification of the Nov. Order for interlocutory appeal.

3 **II. ANALYSIS**

4 **A. Motion for Reconsideration**

5 Reconsideration is appropriate only when there is: (1) newly discovered evidence, (2) a
6 change in controlling law, or (3) the need to correct clear error or to prevent manifest injustice.
7 *School Dist. No. 1J v. AC&S, Inc.*, 5 F.3d 1255, 1263 (9th Cir. 1993). Local Rule 7-9 allows parties
8 to seek leave to file a motion for reconsideration when there has been a "manifest failure by the
9 Court to consider material facts or dispositive legal arguments which were presented to the Court."

10 Extreme does not allege newly discovered evidence or a change in the controlling law. Its
11 motion for reconsideration is based on its claim that the court clearly erred by manifestly failing to
12 consider: (1) the fact that Levy did not serve on Extreme's Compensation and Audit Committees
13 until after the issuance of the alleged backdated stock options and thus had no opportunity to engage
14 in backdating at Extreme; (2) established case law concerning the standard for pleading demand
15 futility; and (3) the court's own Sept. Order.

16 **1. Levy's Opportunity to Engage in Backdating at Extreme**

17 Extreme contends that Levy could not have been involved in the alleged stock option
18 backdating at Extreme because all of the alleged backdating occurred prior to fiscal year 2005, and
19 Levy did not serve on Extreme's Compensation and Audit Committees until fiscal year 2005. In the
20 Nov. Order, the court held that, other than the five stock option grants that occurred on January 10,
21 2000, June 1, 2000, April 9, 2001, October 2, 2001, and December 28, 2001, plaintiffs had not
22 alleged facts sufficient to raise a reasonable inference of backdating. Nov. Order at 5, 12-13. The
23 parties agree that Levy did not serve on the Compensation and Audit Committees under fiscal year
24 2005, long after these allegedly backdated grants took place.

25 The TAC erroneously states that Levy served on these committees in fiscal year 2004, TAC
26 ¶¶ 34, 206(e)(i) n.16, and citing the TAC, the court's Nov. Order also incorrectly stated that Levy
27 was on the Compensation Committee and Audit Committee in fiscal year 2004, Nov. Order at 3.
28 However, this error was harmless, as the court did not rely upon Levy's membership on these

1 committees in reaching its conclusion that plaintiffs had alleged sufficient facts to create a
2 reasonable doubt regarding Levy's disinterestedness. Instead, the court based its holding on the
3 specific details in the TAC regarding Levy's conduct at KLA-Tencor combined with his service as
4 an Extreme board member beginning in October 2001. Nov. Order at 15-16. As discussed above,
5 the court found that plaintiffs had alleged sufficient facts to create a reasonable inference of
6 backdating with respect to the December 28, 2001 stock option grant. *Id.* at 5, 12-13. The TAC
7 alleges that Extreme's board of directors "ultimately had to approve all option grants."¹ TAC ¶ 209.
8 Since Levy was a member of the board of directors at the time when the December 28, 2001 stock
9 option grant was approved, the court rejects Extreme's contention that Levy could not have been
10 involved in any of the alleged backdating.

11 The court recognizes that "board approval of a transaction, even one that later proves to be
12 improper, without more, is an insufficient basis to infer culpable knowledge or bad faith on the part
13 of individual directors." *Wood v. Baum*, 953 A.2d 136, 142 (Del. 2008). However, the court did not
14 rely upon Levy's approval of an allegedly backdated stock option grant alone in reaching its
15 conclusion that demand futility had been adequately pled; rather, the court considered specific
16 factual allegations in the TAC that strongly supported an inference that Levy was *knowingly*
17 involved in backdating stock options at KLA-Tencor, which in turn supported an inference of Levy's
18 *knowing* involvement in the alleged backdating at Extreme. Nov. Order at 15-16.

19 2. Established Case Law on Pleading Demand Futility

20 Extreme claims that the court manifestly failed to consider established case law concerning
21 the standard for determining whether allegations suffice to impeach a director's presumed
22 disinterestedness. In its papers, Extreme makes the bald assertion that controlling Delaware law
23 "establishes that a director's alleged involvement in backdating at other companies could not suffice

24
25 ¹ This statement appears to be partially incorrect based on Extreme's 10-K, which states that the
26 board of directors delegated its authority to approve grants for 40,000 shares or less per employee so
27 long as the employee was not an officer or director of the company. TAC Ex. 2 at 44. However, it
28 does appear that Extreme's board of directors had to approve option grants for officers and directors,
as well as for other employees when the grant was for over 40,000 shares per employee. *See* TAC
Ex. 2 at 44-46. Since the December 28, 2001 option grant was to top executive officers, it appears
that the board had to approve this grant. TAC ¶ 117.

1 to render him interested at Extreme." Mot. at 17. However, Extreme has failed to cite to any
2 controlling Delaware cases actually supporting this proposition.

3 The established case law on pleading demand futility is set forth in *Rales v. Blasband*, 634
4 A.2d 927 (Del. 1993). In *Rales*, the Delaware Supreme Court held that demand futility has been
5 adequately pled when a complaint "alleges particularized facts creating a reasonable doubt that a
6 majority of the Board would be disinterested or independent in making a decision on a demand." *Id.*
7 at 930. A plaintiff need not demonstrate a reasonable probability of success on the merits. *Id.* at
8 934. Moreover, directorial interest can be found when bringing suit would "have a materially
9 detrimental impact on a director, but not on the corporation and the stockholders. In such
10 circumstances, a director cannot be expected to exercise his or her independent business judgment
11 without being influenced by the adverse personal consequences resulting from the decision." *Id.* at
12 936. Although "[n]ormally, the mere threat of personal liability for approving a questioned
13 transaction, standing alone, is insufficient to challenge either the independence or disinterestedness
14 of directors," the Court held that directorial interest may be found when the potential for liability
15 rises beyond "a mere threat" to the level of "a substantial likelihood." *Id.*

16 This court applied the standard set forth in *Rales* in reaching its holding in the Nov. Order.
17 The court considered particularized facts alleged in the TAC, including details regarding Levy's
18 involvement in backdating at KLA-Tencor, his membership on the Extreme board beginning in
19 2001, and facts indicating that the December 28, 2001 stock option grant had been backdated.² Nov.
20 Order at 12-13, 15-16. From these facts, it can reasonably be inferred that Levy faced a substantial
21 likelihood of personal liability for his conduct as an Extreme board member, such that he "cannot be
22 expected to exercise his [] independent business judgment without being influenced by the adverse
23 personal consequences resulting from the decision." *Rales*, 634 A.2d at 936. Thus, drawing all

24
25 _____
26 ² Extreme argues that Fed. R. Evid. 404(b) prohibits consideration of Levy's involvement in
27 backdating at KLA-Tencor. However, Fed. R. Evid. 404(b) explicitly permits admission of evidence
28 of prior acts to show intent, knowledge, and absence of mistake or accident. The court's finding that
Levy's *knowing* involvement in backdating at KLA-Tencor supported an inference that he was
knowingly involved in alleged backdating at Extreme falls within this exception. Moreover, the
court is not aware of any cases suggesting that a court is limited to considering admissible evidence
when determining the sufficiency of demand futility pleadings.

1 reasonable inferences in plaintiffs' favor, *Wood*, 953 A.2d at 140, the court found that the factual
2 allegations in the TAC sufficed to create a reasonable doubt that Levy was disinterested.

3 Extreme points to *In re VeriSign*, 531 F. Supp. 2d 1173 (N.D. Cal. 2007), as holding that "a
4 director's alleged involvement in backdating at other companies cannot support an inference that
5 demand on that director would have been futile." Mot. at 17. The court notes that this case is not
6 controlling precedent, nor was it cited by Extreme in addressing allegations of Levy's involvement in
7 backdating at other companies in its motion to dismiss the TAC. *Id.* at 17 n.10. Regardless,
8 *VeriSign* is distinguishable from this case and does not stand for such a sweeping proposition. In
9 *VeriSign*, plaintiffs alleged that various directors were disinterested because they had been
10 implicated in options backdating at other companies. 531 F. Supp. 2d at 1201. However, plaintiffs'
11 only argument was that "an agreement by a VeriSign director to sue the individual defendants on the
12 Company's behalf might be considered an 'admission' that the same conduct by that director at
13 another company was unlawful." *Id.* The *VeriSign* court found this particular line of reasoning to be
14 "highly speculative" and "irrelevant to the question whether a director on the VeriSign Board is
15 capable of acting independently of other directors or majority shareholders at VeriSign." *Id.* This
16 holding does not indicate that a director's knowing involvement in backdating at other companies is
17 always irrelevant to demand futility.


18 Adequate pleading of demand futility is a fact-specific determination. *See Beam*, 845 A.2d at
19 1049. Courts are to consider the alleged facts in the context of a specific case to determine whether
20 they create "a reasonable doubt that a majority of the Board would not be disinterested or
21 independent in making a decision on a demand." *Rales*, 634 A.2d at 930. In this case, the court
22 found Levy's conduct at KLA-Tencor to be relevant, not because bringing suit at Extreme could be
23 considered an admission that his conduct at KLA-Tencor was unlawful, but because evidence of his
24 knowing involvement in backdating at KLA-Tencor permits the reasonable inference that he was
25 knowingly involved in backdating at Extreme. Accordingly, this court's holding that demand futility
26 was adequately pled in the TAC, based in part on allegations regarding Levy's conduct at KLA-
27 Tencor, does not conflict with the holding in *VeriSign*.

1 litigation." *In re Cement Antitrust Litigation*, 673 F.2d 1020, 1026 (9th Cir. 1982) (citing *U.S.*
2 *Rubber Co. v. Wright*, 359 F.2d 784, 785 (9th Cir. 1966)). "It was not intended merely to provide
3 review of difficult rulings in hard cases." *U.S. Rubber Co.*, 359 F.2d at 785.

4 Extreme argues that there is a substantial ground for difference of opinion on the issue of
5 whether a director's conduct at another company can be considered in a demand futility motion
6 based on "the apparent conflict between this Court's own orders as well as the intra-district conflict
7 between the Order and *Verisign*." Mot. at 21. As explained above, there is no conflict, either
8 between the court's own orders or between the court's Nov. Order and the decision in *VeriSign*.
9 Therefore, Extreme has failed to demonstrate a basis for finding a substantial ground for difference
10 of opinion on this issue.

11 **III. ORDER**

12 For the foregoing reasons, the court denies Extreme's motion for reconsideration as well as
13 its motion for a stay and certification for interlocutory appeal.

14
15
16
17
18
19 DATED: 4/2/10 
20 RONALD M. WHYTE
21 United States District Judge
22
23
24
25
26
27
28

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

2 **Counsel for Plaintiff:**

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

12 **Counsel for Defendants:**

13 John Henry Hemann jhemann@morganlewis.com
14 Jonathan DeGooyer jdegooyer@morganlewis.com
15 Joseph Edward Floren jfloren@morganlewis.com
16 Laura Alexis Lee llee@morganlewis.com

17
18 Counsel are responsible for distributing copies of this document to co-counsel that have not
19 registered for e-filing under the court's CM/ECF program.
20

21 **Dated:** 4/2/10

22 CCL
23 **Chambers of Judge Whyte**