

No. 81817-7

IN THE SUPREME COURT OF THE STATE OF WASHINGTON
ON CERTIFICATION FROM THE UNITED STATES DISTRICT
COURT FOR THE WESTERN DISTRICT OF WASHINGTON

GLENN HUTTON, et al.,

Plaintiffs,

v.

JOHN McADAMS, et al.,

Defendants,

and

F5 Networks, Inc.,

Nominal Defendant.

BRIEF OF *AMICUS CURIAE*
ASSOCIATION OF WASHINGTON BUSINESS

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TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	IDENTITY AND INTEREST OF <i>AMICUS CURIAE</i>	2
III.	ISSUES OF CONCERN TO <i>AMICUS CURIAE</i>	3
IV.	STATEMENT OF THE CASE.....	4
V.	ARGUMENT	4
	A. THE COURT SHOULD AFFIRM THE UNIVERSAL DEMAND STANDARD FOR SHAREHOLDER DERIVATIVE LITIGATION.	4
	<u>1. Washington Has Not Recognized a Demand Futility Standard.</u>	5
	<u>2. Universal Demand is the Superior Choice.</u>	7
	B. THE COURT SHOULD NOT ADOPT DELAWARE'S DEMAND FUTILITY DOCTRINE.....	12
	<u>1. Washington Does Not Generally Follow Delaware Corporate Law.</u>	12
	<u>2. Washington Must Compete with Delaware for Incorporation and Should Maintain a Body of Law that Attracts, Rather than Repels, New Incorporation.</u> .	13
VI.	CONCLUSION.....	14

TABLE OF AUTHORITIES

Cases

<i>Beall v. Pacific Nat. Bank of Seattle</i> , 55 Wn.2d 210, 347 P.2d 550 (1960).....	4
<i>Elliott v. Puget Sound Wood Prod. Co.</i> , 52 Wash. 637, 101 P. 228 (1909)	4
<i>Gilliland v. Mount Vernon Hotel Co.</i> , 51 Wn.2d 712, 321 P.2d 558 (1958).....	4
<i>Kamen v. Kemper Fin. Servs., Inc.</i> , 939 F.2d 458 (7 th Cir. 1991)	9
<i>Kamen v. Kemper Fin. Servs., Inc.</i> , 500 U.S. 90, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991).....	6
<i>McCormick v. Dunn & Black</i> , 140 Wn. App. 873, 167 P.3d 610 (2007).....	4
<i>Pomerantz v. Clark</i> , 101 F. Supp. 341 (D. Mass 1951).....	10
<i>RCW Northwest, Inc. v. Colorado Res., Inc.</i> 72 Wn. App. 265, 864 P.2d 12 (1993).....	9
<i>Ryan v. Gifford</i> , 918 A.2d 341 (Del. Ch. 2007).....	2, 3

Statutes and Court Rules

RCW 23B.07.400.....	3, 5-6
Fed R. Civ. P. 23.1	6

Secondary Authority

Ashby Jones, <i>Firms Settle Backdating Suits --- Some Private Cases End in Agreements; More Deals Ahead</i> , Wall St. J., Nov. 19, 2007, at A15	11
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Cyril Moscow, <i>Michigan or Delaware Incorporation</i> , 42 Wayne L. Rev. 1897 (1996).....	13
Daniel R. Fischel & Michael Bradley, <i>The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis</i> , 71 Cornell L. Rev. 261 (1986).....	9, 10
Dominic Gates, “Boeing’s Carson: “Location is a choice,” The Seattle Times, Nov. 7, 2008	1
Eric Chiappinelli, <i>Cases and Materials on Business Entities</i> (2006).....	13
Heather Flanagan, Comment, <i>The Difficulty of a Plaintiff’s Playground Being Truly “Open for Business”</i> : An <i>Overview of West Virginia’s Corporate Law Governing Derivative Lawsuits</i> , 110 W. Va. L. Rev. 883 (2008)	8, 10, 14
Justice Jack B. Jacobs, <i>The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay</i> , 41 Suffolk U. L. Rev., 1 (2007).....	8
Letter from Richard O. Kummert to Kristopher I. Tefft (Feb. 17, 2009).....	6, 7, 12
Mark Maremont & John Hechinger, <i>Corporate News: Brocade Settles Suit for \$160 Million</i> , Wall St. J., June 3, 2008, at B4.....	11
Omari Scott Simmons, <i>Branding The Small Wonder: Delaware’s Dominance and the Market for Corporate Law</i> , 42 U. Rich. L. Rev. 1129 (2008).....	13
Press Release, Governor Chris Gregoire, Gov. Gregoire Unveils Washington Jobs Now Initiative (Jan. 15, 2009)	14

Sherrie R. Savett, *Plaintiffs' Vision of Securities Litigation: Current Trends and Strategies*, 1692 PLI/CORP 143 (Sept.-Oct. 2008)..... 11

Stewart M. Landefeld & Eric A. Dejong, *Washington Business Entities, Law & Forms* § 1.13 (2d ed. 2007) 13

I. INTRODUCTION

For corporate entities, location is a choice.¹ States vigorously compete with one another to attract and retain enterprise in order to stimulate job growth and creation, spur private investment and economic development, and expand revenue flow to state and local governments. One of the bedrock components of a competitive business climate is the legal structure under which firms incorporate. Does the state's statutory and common law of corporations appropriately recognize the paramount role of officers and directors in managing the corporation? Does it contain appropriate limitations on the liability of corporations, including exposure to meritless litigation? Is it enforced by clear and consistent procedural rules and a policy of judicial minimalism with respect to proposed expansions of corporate liability?

This case evokes these questions because it asks the court to clarify that Washington follows the "universal demand" standard by which a shareholder, in order to proceed derivatively in the name of the corporation, must always make a demand to the corporate board of directors, or, in contrast, establish that this requirement may be excused by

¹ Scott Carson, Boeing Commercial Airplanes Chief Executive Officer, Address at the Prosperity Partnership Luncheon (Nov. 7, 2008) *quoted in* Dominic Gates, "Boeing's Carson: "Location is a choice," The Seattle Times, Nov. 7, 2008 *available at* http://seattletimes.nwsourc.com/html/business/technology/2008361655_boeing07.html (last visited Feb. 22, 2008).

a showing that demand would be futile. If Washington law departs from the clear national trend favoring universal demand and instead recognizes a “demand futility” standard, the court must then explain what substantive standards govern the evaluation of demand futility and whether, in this regard, Washington follows Delaware’s flawed approach, particularly as set forth in *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (the “*Maxim*” opinion).

The Association of Washington Business (“AWB”), the principal representative of the business community in Washington, submits this brief of *amicus curiae* to urge the court to affirm the universal demand approach and reject the demand futility exception. Alternatively, should the court recognize a demand futility exception, AWB would urge the court to reject the recently iterated Delaware standard as confusing and unworkably lenient and instead articulate a clear, appropriate safeguard against disfavored derivative litigation.

II. IDENTITY AND INTEREST OF *AMICUS CURIAE*

AWB, founded in 1904, is the state’s oldest and largest general business trade association. AWB represents over 6,600 member businesses who are engaged in all aspects of commerce in Washington and who provide jobs to over 650,000 employees in Washington. Acting as the state’s chamber of commerce, AWB is also an umbrella organization

representing the interests of 114 trade and business associations engaged in industry-specific activities as well as 56 local and regional chambers of commerce across Washington.

AWB's membership includes many companies that are incorporated under Washington law, as well as companies that have incorporated elsewhere but have chosen to reincorporate in Washington. AWB also represents smaller unincorporated entities that must choose whether to incorporate in Washington or under the laws of another state. AWB's interest is therefore in a clear, stable body of corporate law that appropriately recognizes the proper role of officers and directors in managing corporate affairs and that contains important procedural safeguards to protect corporations and their shareholders from the serious harms caused by meritless litigation.

III. ISSUES OF CONCERN TO *AMICUS CURIAE*

This case is before the court on a Certification Order from the District Court, which asks:

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

If Washington follows Delaware's demand futility standard, does it also follow the reasoning of *Ryan v. Gifford*, 918 A.2d 341 (Del.

Ch. 2007) in cases where the improper backdating of stock options has been alleged?

Certification Order at 2.

IV. STATEMENT OF THE CASE

For the sake of brevity, AWB adopts, as if set forth herein, the statement of the case provided by Nominal Defendant F5 Networks, Inc. (herein “F5 Networks”). *See Opening Br.* at 3-6.

V. ARGUMENT

A. THE COURT SHOULD AFFIRM THE UNIVERSAL DEMAND STANDARD FOR SHAREHOLDER DERIVATIVE LITIGATION.

Washington’s common law of corporations for over a century has contained a substantive demand requirement for shareholder derivative proceedings. *See, e.g., Elliott v. Puget Sound Wood Prod. Co.*, 52 Wash. 637, 641-43, 101 P. 228 (1909). This requirement that reflects the elemental public policy that corporations are appropriately managed by their officers and directors and only in extraordinary circumstances may a shareholder commandeer control of corporate governance to act in the corporation’s name. *See, e.g., Gilliland v. Mount Vernon Hotel Co.*, 51 Wn.2d 712, 721, 321 P.2d 558 (1958); *Beall v. Pacific Nat. Bank of Seattle*, 55 Wn.2d 210, 212, 347 P.2d 550 (1960); *McCormick v. Dunn & Black*, 140 Wn. App. 873, 895, 167 P.3d 610 (2007). AWB would agree

with F5 Networkers’ observation that early cases discussing some kind of futility exception to this demand standard are “at best, confusing and inconclusive.” *Opening Br.* at 15. Washington law has not, however, affirmatively recognized a demand futility exception, and the court should refrain from adopting one. Moreover, given the clear policy advantages of universal demand, the court should affirm a strict demand requirement for derivative litigation in Washington.

1. Washington Has Not Recognized a Demand Futility Standard.

There is no recognition in our common law of a substantive demand futility standard, and it is important to note that our Legislature has not established one either. Judge Lasnik’s Certification Order, referencing RCW 23B.07.400(2), implicitly recognizes this fact. RCW 23B.07.400 is a merely procedural statute and does not codify a substantive demand futility standard.

When the Corporate Act Revision Committee of the Washington State Bar Association recommended adoption of Section 7.40 of the American Bar Association’s Revised Model Business Corporation Act (RMBCA), codified in 1989 at RCW 23B.07.400, the Committee did not intend to suggest the Legislature adopt a substantive demand futility

standard.² Instead, as the plain language of the provision suggests, the provision sets forth a procedural framework for determining the sufficiency of pleadings in a derivative proceeding and nothing more. This follows from the well-known fact that RMBCA 7.40 and RCW 23B.07.400 are derived from Rule 23.1 of the Federal Rules of Civil Procedure, which, it rather goes without saying, is a merely procedural standard. *See Kamen v. Kemper Fin. Servs.*, 500 U.S. 90, 96, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991).

Although certainly within the power of the court to backfill the procedure of RCW 23B.07.400 with a substantive demand futility standard, AWB would urge a policy of judicial minimalism in this regard. As Washington corporate law has become increasingly codified in the modern era, it has fallen to the Bar Association's Corporate Act Revision Committee to consider changes to the state's Business Corporation Act, and recommend revisions to the Legislature. Tellingly, the bar committee has never recommended a substantive demand futility standard to the Legislature.³ In light of the fact that the bar committee and the Legislature

² This view is confirmed by a founding member of the Corporate Act Revision Committee and eminent authority on Washington corporate law, Richard Kummert, the Gittinger Professor of Law at the University of Washington. Letter from Richard O. Kummert to Kristopher I. Tefft (Feb. 17, 2009) (on file with author). A copy of Professor Kummert's letter is attached to this brief as Appendix A.

³ Kummert Letter, Appendix A at 2.

have not seen fit to endorse a substantive demand futility standard, the wisdom of which is confirmed by the clear national trend away from demand futility, the court should refuse to now take the step of creating, by judicial fiat, a substantive demand futility standard for Washington.

2. Universal Demand is the Superior Choice.

There are a number of compelling policy reasons why the universal demand standard is now widely considered by commentators and states as superior to a demand futility standard. Keeping in mind respect for the fundamental policy of vesting corporate governance in officers and directors, universal demand establishes an important gatekeeper role in derivative litigation by requiring a form of exhaustion of corporate remedies prior to bringing a lawsuit. This is a salutary rule for three primary reasons.

First, universal demand sets up a structure that encourages efficiency and cost-containment in the pleadings stage of derivative litigation. This case is a prime example of the preliminary litigation that can engulf a corporation and its shareholders – not on the merits of the dispute, but on preliminary issues of futility – when a simple demand standard is not clearly in place. This case alone has generated years of litigation and millions of dollars in corporate expense over the putative futility of making demand on the nominal defendant’s board. *See Opening*

Br. at 29, n. 23. Such expensive, unnecessary, and drawn out litigation over the uncertain futility of a demand and the degree of interest or disinterest of corporate management is the typical course in derivative litigation under demand futility regimes.⁴ Universal demand, on the other hand, avoids pleading-stage futility litigation and imposes virtually no cost on the would-be plaintiff.

Second, universal demand puts in place a simple, concise bright-line rule that lower courts can easily follow. As noted, it is often difficult to ascertain whether and under what corporate conditions a demand would be futile. And so the demand futility exception invites judicial interpretation and application to facts across a divergent range of instances, resulting in a patchwork of precedents for corporations, shareholders, and courts to navigate in considering and addressing derivative litigation. The confusion is compounded where Delaware's

⁴ See, e.g., Justice Jack B. Jacobs, *The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay*, 41 Suffolk U. L. Rev., 1, 5 (2007) (“[M]any corporate cases are often over-litigated. Such cases typically involve a motion to dismiss for failure to state a claim, followed by discovery, then a motion for summary judgment, and then a trial or a settlement of whatever claims remain in the case. A demand excused motion added yet another round of briefing, argument and judicial opinion – all at the pleading stage – that further prolonged the duration of the lawsuit.”); see also Heather Flanagan, Comment, *The Difficulty of a Plaintiff's Playground Being Truly “Open for Business”*: An Overview of West Virginia's Corporate Law Governing Derivative Lawsuits, 110 W. Va. L. Rev. 883, 910 (2008) (“The traditional demand standard, which allows for the plaintiff to wave demand if the demand would be futile, often results in unnecessary litigation over the claim. In addition, it also results in unnecessary litigation over the futility of the demand. It is difficult to ascertain if a demand on a board would be futile, and such litigation can be expensive.”).

demand futility standard applies because of that standard's invocation of a "reasonable doubt" analysis, inviting an improper borrowing from the better-known "reasonable doubt" burden of proof in the criminal context. The universal demand requirement, by contrast, is a simple rule – either demand has been made or it hasn't – that forecloses the possibility for confusion on the part of litigants, their counsel, and lower courts. This furthers the cost-savings and efficiencies of universal demand.⁵

Third, universal demand discourages costly and meritless "strike suits" against corporations. The "strike suit," an unfortunate but recognized feature of corporate litigation, is a tenuous claim brought in an effort to force a settlement and payment of attorney's fees rather than address a real corporate injury. *RCW Northwest, Inc. v. Colorado Res., Inc.*, 72 Wn. App. 265, 270-71 n. 5, 864 P.2d 12 (1993). The strike suit, not fully unlike derivative litigation in general, provides no or very little benefit to corporate shareholders but rather causes significant economic harm to corporations. *See, e.g., Kamen v. Kemper Fin. Servs., Inc.*, 939 F.2d 458, 461-62 (7th Cir. 1991) (noting "the burgeoning research casting doubt on the value of derivative litigation for investors."). Such a view is

⁵ See Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261, 286-87 (1986) (appraising the desirability of legal rules that act to minimize the cost of derivative suits).

not only of recent vintage. See *Pomerantz v. Clark*, 101 F. Supp. 341, 346 (D. Mass. 1951) (“In the state court there is also an evident if not declared skepticism about the effectiveness of minority stockholders’ suits in promoting the welfare, enhancing the reputation or enriching the coffers of those corporations which are supposed to have been wronged.”).⁶

Universal demand deters meritless strike suits by requiring would-be plaintiffs to allow a corporation to act in its best interests in the presence of a legitimate harm or injury, rather than exposing the corporation to expensive collateral litigation over whether the corporation is in a legitimate position to act on the matter.⁷

Some might argue universal demand is too stringent given the view, indeed strongly implied by plaintiffs here, that corporate misconduct is rampant and must be checked through the mechanism of shareholder litigation. Such a contention not only fails to speak to the superior policy reasons underlying a universal demand standard and ignores the fact that universal demand does not prevent meritorious derivative litigation, but is,

⁶ See also Fischel & Bradley, *supra* note 5, at 271 (“The derivative suit is a striking exception to this fundamental principle of corporate law [that shareholders with the largest economic stake in a venture have the greatest effect on corporate policy]. Shareholders with tiny investments can bring derivative actions on behalf of a corporation. Because of his small stake in the venture, the complaining shareholder (or his attorney) has very little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs. If the action appears to be a positive net value project because of the possible recovery of attorney’s fees, an attorney will pursue it regardless of its effect on the value of the firm.”).

⁷ Flanagan, *supra* note 4, at 908.

more importantly, false. AWB corporate members, and corporations generally, are not involved in pervasive misconduct. Corporate wrongdoing is actually quite rare, including in the context of the backdating controversy. Of the thousands of public companies in the United States, only a relative handful are under regulatory or judicial scrutiny for alleged backdating of stock options.⁸ There is no statistic that would suggest corporate fraud or malfeasance is a typical, or even common, phenomenon justifying litigation rules like demand futility that erode the central principle of corporate governance.

Universal demand is the preferred position in state derivative litigation regimes because it obviates the need for costly and inefficient pleading-stage litigation, promotes an easily followed bright line rule, and deters meritless strike suits. Any suggestion that universal demand promotes or protects corporate wrongdoing should be dismissed as tendentious. Since neither the court nor the Legislature has adopted a demand futility excuse, universal demand is consistent with Washington's

⁸ See Ashby Jones, *Firms Settle Backdating Suits --- Some Private Cases End in Agreements; More Deals Ahead*, Wall St. J., Nov. 19, 2007, at A15 (noting the backdating "scandal" has only led to about 80 financial restatements, 30 class action lawsuits, and a number of derivative suits, of which many have been dismissed or settled for small sums.); Mark Maremont & John Hechinger, *Corporate News: Brocade Settles Suit for \$160 Million*, Wall St. J., June 3, 2008, at B4 (noting about 45 companies are under Securities and Exchange Commission investigation for backdating irregularities); see also Sherrie R. Savett, *Plaintiffs' Vision of Securities Litigation: Current Trends and Strategies*, 1692 PLI/CORP 143, 165-73 (Sept.-Oct. 2008) (surveying the fairly limited universe of backdating class and derivative cases).

long-standing demand requirement and supported by compelling public policy. The court should clearly articulate an affirmation of universal demand.

B. THE COURT SHOULD NOT ADOPT DELAWARE’S DEMAND FUTILITY DOCTRINE.

1. Washington Courts Do Not Generally Follow Delaware Corporate Law.

Washington does not have a tradition of applying Delaware’s corporate case law to resolve questions under the Washington Business Corporation Act, nor have Washington courts afforded any particular deference or priority to corporate law decisions from Delaware. As Professor Kummert points out, the opposite is true. Insofar as Washington courts seek guidance on matters not resolved by our own common law, the typical practice is to survey decisions in many other states and national commentaries, and follow the best approach regardless of its state of origin.⁹ Making that survey, the court will find “[t]he national consensus has clearly been away from Delaware’s standards on the issue of demand futility and toward universal demand.”¹⁰

⁹ Kummert Letter, Appendix A at 2; *see also Opening Br.* at 33 n. 6 and accompanying text (citing Washington cases that decide novel corporate law issues without any reference to Delaware authorities).

¹⁰ *Id.*

2. Washington Must Compete with Delaware for Incorporation and Should Maintain a Body of Law that Attracts, Rather than Repels, New Incorporation.

States must compete for the incorporation of companies doing business or potentially doing business within their borders. That competition is generally between the company's home state and Delaware.¹¹ This is very much the case in Washington, where significant differences between Washington and Delaware corporate law make the difference between incorporation or reincorporation here.¹²

A frequently cited example is the Microsoft Corporation which, in 1993, reincorporated in Washington State after having previously incorporated in Delaware. According to Microsoft, the modernization of Washington corporate law occasioned by the Legislature's 1989 overhaul of the Washington Business Corporation Act made Washington law

¹¹ See, e.g., Eric Chiappinelli, *Cases and Materials on Business Entities* 123 (2006) (noting the typical choice is between home state or Delaware incorporation); Omari Scott Simmons, *Branding The Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. Rich. L. Rev. 1129, 1134-35 (2008) (same).

¹² See Stewart M. Landefeld & Eric A. Dejong, *Washington Business Entities, Law & Forms* § 1.13, 1-24 (2d ed. 2007) ("Before deciding to incorporate as a Washington corporation, the incorporators must first decide whether to incorporate in Delaware, Washington or another state. . . . For most corporations . . . the differences between the Delaware General Corporation Law and the Washington Business Corporation Act will be important.").

“clearer and better addresses the company’s concerns” than Delaware’s law.¹³

It is becoming increasingly clear that one of the key considerations for companies choosing whether to incorporate in Washington or Delaware is the company’s exposure to strike suits under the state’s rules governing derivative litigation.¹⁴ It is difficult for a state to project an image of a friendly business climate, while maintaining loose or non-existent protections against strike suits.¹⁵ Accordingly, it would make no sense for the court, at a time when Washington is attempting to bolster the competitiveness of its business climate to attract new enterprise to the state,¹⁶ to trade a very appropriate limit on strike suit liability (universal demand) for a looser, more confusing and less protective standard (Delaware’s demand futility regime).

VI. CONCLUSION

Both Washington and its corporate citizens reap substantial benefits from incorporation in Washington State. They include increased

¹³ Microsoft Corporation, Proxy Statement for Annual Meeting of Shareholders (Oct. 12, 1993), *quoted in* Cyril Moscow, *Michigan or Delaware Incorporation*, 42 Wayne L. Rev. 1897, 1901-02 (1996).

¹⁴ Flanagan, *supra* note 4, at 884-85.

¹⁵ *Id.* at 885 (noting the experience of West Virginia which “offers very little substantive law governing derivative actions, leaving it extremely plaintiff friendly and hostile to corporate boards and directors.”).

¹⁶ Press Release, Governor Chris Gregoire, Gov. Gregoire Unveils Washington Jobs Now Initiative (Jan. 15, 2009) *available at* <http://www.governor.wa.gov/news/news-view.asp?pressRelease=1093&newsType=1> (last visited Feb. 22, 2009).

job creation, significant private investment, expanded tax revenue, and in this time of unprecedented economic challenge, the prospect of long-term financial recovery. It is critical that the state's business corporations' law keep pace with the intense need to attract and grow business. Affirming the universal demand standard and rejecting Delaware's demand futility standard is one important step in that project.

Respectfully submitted this 23rd day of February, 2009.

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