

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

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

MICHAEL BROWN,

No. C 09-05881 SI

Plaintiff,

**ORDER GRANTING DEFENDANTS’
MOTION TO DISMISS**

v.

FREDERIC H MOLL, et al.,

Defendants.

Defendants’ motion to dismiss plaintiff’s Amended Complaint came on for hearing on November 5, 2010. After considering the pleadings submitted and argument made, the Court GRANTS defendants’ motion to dismiss and dismisses plaintiff’s complaint without leave to amend.

BACKGROUND

Plaintiff filed this shareholder derivative action on December 9, 2009, against “nominal defendant” Hansen Medical, Inc. (“Hansen”), Frederick H. Moll, Steven M. Van Dick, Gary C. Restani, seven members of the Hansen’s Board of Directors (Freund, Shapiro, Lowe, McConnell, Hirsch, Mandato, Hykes), and Christopher Sells (collectively “defendants”). Plaintiff alleges that Hansen, which builds medical robots, improperly accounted for revenue from the sale of its primary product, the Sensi system. Amended Complaint ¶¶ 4, 18, 92. As a result, Hansen was required to restate and adjust various financial statements from 2007 through 2009. *Id.*, ¶¶ 9-10. Plaintiff alleges that the individual defendants caused Hansen to engage in the improper revenue recognition conduct, *id.* ¶ 8, 92, and caused various false and misleading disclosures to be made. *Id.* ¶¶ 99-117. Plaintiff also alleges that defendant Restani engaged in insider trading. *Id.* ¶¶ 51-54. Based on these allegations, plaintiff pleads

1 claims for breach of fiduciary duty, unjust enrichment, and waste of corporate assets related to the
2 improper revenue recognition conduct, as well as claims related to Restani's alleged insider trading.

3 4 DISCUSSION

5 Under Delaware law, "the right of a stockholder to prosecute a derivative suit is limited to
6 situations where the stockholder has demanded that the directors pursue the corporate claim and they
7 have wrongfully refused to do so or where demand is excused because the directors are incapable of
8 making an impartial decision regarding such litigation." *Rales v. Blasband*, 634 A.2d 927, 932 (Del.
9 1993). In order to show demand futility, plaintiff must allege "particularized" facts showing that more
10 than half of the board members have a personal and substantial interest in the subject matter of the
11 proposed lawsuit that renders them unable to exercise independent judgment in responding to a demand.
12 *Rales*, 634 A.2d at 934 (plaintiff needs to show facts that "create a reasonable doubt that, as of the time
13 the complaint is filed, the board of directors could have properly exercised its independent and
14 disinterested business judgment in responding to a demand."). If plaintiff can show that more than half
15 of the directors are "interested," then demand will be deemed futile and excused. *Id.* Facts specific to
16 each director must be alleged to support a finding of demand futility. *See, e.g., Desimone v. Barrows*,
17 924 A.2d 908, 943 (Del. Ch. 2007). The seven defendants who were on the board at the time the
18 complaint was filed are defendants Hirsch, Mandato, Hykes, Freund, Shapiro, Lowe and Moll
19 ("Directors"). *See* Original Complaint ¶ 87; AC ¶¶ 20, 23, 24, 25, 27 - 29.¹

20 In ruling on defendants' prior motion to dismiss, the Court found that plaintiff had failed
21 adequately to plead that a majority of the Directors were sufficiently "interested" to excuse demand,
22 but granted plaintiff leave to amend to attempt to add particularized facts – as opposed to conclusions
23 – to support his futility allegations. The Court rejected plaintiff's generalized allegations that since the
24 revenue recognition information at issue concerned Hansen's "core" business – sales and installation
25 of the Sensi system – knowledge of the improper revenue recognition scheme could be imputed to the
26 outside Directors. *See* July 21, 2010 Order at 5-6. The Court also found that plaintiff had failed to plead

27
28 ¹ "Outside Directors" refers to all of these directors except Moll, who is Hansen's CEO.

1 any facts showing that the Outside Directors faced a “substantial likelihood” of personal liability as a
2 result of their actions, as plaintiff failed to plead any particularized facts to show that any Outside
3 Director acted in bad faith or with intentional misconduct. *Id.* at 6-9. Plaintiff filed his Amended
4 Complaint on August 9, 2010. Defendants now move to dismiss the Amended Complaint, arguing that
5 plaintiff has not cured the deficiencies identified by the Court.

6
7 **A. Allegations with Respect to All Directors**

8 Plaintiff asserts that he has made sufficient allegations with respect to all of the Directors
9 because: (1) the misconduct related to Hansen’s “core product,” and therefore knowledge of the
10 improper revenue recognition scheme can be imputed to defendants; (2) the Directors failed to terminate
11 and instead gave a generous separation agreement to defendant Sells – the employee who “largely
12 orchestrated” the improper revenue recognition scheme, *see* AC ¶ 7 – and, therefore, face personal
13 liability for waste of corporate assets; and (3) Hansen’s directors and officers liability policy’s “insured
14 versus insured exclusion” means that each director faces substantial financial liability from this
15 derivative action.

16 Each of these arguments, however, was rejected by the Court on the prior motion to dismiss.
17 Plaintiff has not alleged any new facts to cause the Court to revisit that conclusion. With respect to the
18 “core product” argument, the Court previously found that the cases which allow knowledge of
19 fraudulent conduct to be inferred to members of the board of directors where the fraud concerned the
20 “core operations” of the business are distinguishable because there are no *facts* alleged here that the
21 Sensi system itself had problems or that the Outside Directors had (or should have had) knowledge of
22 defendant Sells’ improper revenue accounting scheme which resulted in the restatement. *See* Order at
23 5-6 & n.3 (distinguishing plaintiff’s core business cases, including *Pfeiffer v. Toll*, 989 A.2d 683, 692
24 (Del. Ch. 2010); *In No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding*
25 *Corp.*, 320 F.3d 920, 943 (9th Cir. 2003); *In re Biopure Corp. Derivative Litig.*, 424 F. Supp. 2d 305,
26
27
28

1 307 (D. Mass. 2006)).²

2 Plaintiff's "core business" argument is based on the following allegations: Hansen is a small
3 company that has one "core product," the Sensi system; that Hansen sells two or three systems a month;
4 and under its revenue recognition policy can only recognize revenue when the systems have been fully
5 installed and the end users trained. AC ¶ 3, 7. As a result, plaintiff asserts, the method for recognizing
6 revenue is of "critical importance" for the company and that "revenue recognition issues" were
7 discussed at board meetings. AC ¶¶ 70-73, 134. In addition, at oral argument, plaintiff identified the
8 following allegations in support of his argument:

- 9 1. That defendant Moll (Hansen's CEO) had intimate detailed knowledge of "revenue
10 recognition policies and issues" and thus "knew that Hansen Medical's financial reports
11 contradicted its revenue recognition policies." AC ¶ 128(c).
- 12 2. That the "Audit Committee Defendants" had intimate knowledge of Hansen's revenue
13 recognition policies; that they discussed revenue recognition "issues" before and during
14 the 2009 investigation of accounting irregularities; and they "knew that Hansen
15 Medical's financial reports contradicted its revenue recognition policies." AC ¶ 133(a)-
16 (c).
- 17 3. That "through their discussions of revenue recognition issues at board meetings during
18 the Relevant Period" the other outside directors "acquired intimate, detailed knowledge
19 of Hansen Medical's revenue recognition issues concerning its core produc[t], the Sensi
20 systems" and those outside directors "knew that Hansen Medical's financial reports
21 contradicted its revenue recognition policies." AC ¶ 136.

22 These allegations, however, are insufficient to support an inference that the Outside Directors
23 knew that employees in the company were misapplying the company's revenue recognition policy. The
24 generalized allegations that the Directors discussed revenue recognition or knew that their approved
25 method for recognizing revenue was "of critical importance" are not sufficient. Plaintiff has failed to
26 plead facts indicating that the Outside Directors knew or could have known that there were *problems*
27 with the way that defendant Sells recorded revenue under the Audit Committee's approved method or
28 that concerns with how revenue was being recognized under that method were discussed by the Board,
such that a majority of the Outside Directors face a substantial risk of liability sufficient to excuse

² Plaintiff's new "core operations" cases are likewise inapposite. *See Cosmas v. Hassett*, 886 F.2d 8 (2d Cir. 1989) (strong inference of scienter established where import restrictions would have "eliminated a potentially significant source of income for the company"); *In re KeySpan Corp. Sec. Litig.*, 383 F. Supp. 2d 358 (E.D.N.Y. 2003) (finding generalized scienter allegations insufficient, and distinguishing cases where fundamental problems with the core product or the most significant contract in company's history excused "plaintiffs from the usual rule requiring specificity").

1 demand.

2 In his Opposition and during oral argument plaintiff continues to rely heavily on *Pfeiffer v. Toll*,
3 989 A.2d 683 (Del. Ch. 2010), to support his argument that, particularly in a small company, knowledge
4 of improper conduct related to the company's "core operations" can be inferred to board members.
5 *Pfeiffer*, however, was an insider trading case where the outside directors were named as individual
6 defendants in the federal securities action. As such, and as the complaint in the securities action had
7 survived a motion to dismiss, the Court found that demand futility was established. *Id.* at 689-90. The
8 portions of the *Pfeiffer* decision cited by plaintiff do not address the heightened "particularity" pleading
9 standard required for demand futility under Rule 23.1, but address whether plaintiffs in that case
10 adequately alleged insider trading under "the plaintiff-friendly Rule 12(b)(6) standard." *Id.* at 693-94.
11 Therefore, even if this Court were to revisit its decision that the factual allegations made in *Pfeiffer* –
12 allegations that defendants knew that the remarkably high earning projections about the "core
13 operations" of the company were being overstated to the public because of contradictory internal
14 company metrics – are not similar to the conclusory allegations made here – see Order at 5-6 – the
15 *Pfeiffer* Court's determination that plaintiffs there had adequately alleged insider trading sufficient to
16 pass muster under Rule 12(b)(6) does not suggest plaintiff passes the heightened "particularity standard"
17 for demand futility here. *Id.* at 693-94 (distinguishing the insider trading case from cases contending
18 that "outside directors should have uncovered financial fraud" and cases finding demand futility not
19 established where the pleadings failed to "explain how the directors would have known about the
20 accounting problems").

21 Plaintiff's argument that the Directors' failure to terminate defendant Sells when they had
22 knowledge of Sells' misconduct creates a substantial likelihood of individual liability for corporate
23 waste, has already been rejected. In the prior Order, the Court found the prior complaint's allegations
24 on their own do not rise above the level of negligence to demonstrate bad faith conduct by the Outside
25 Directors. See Order at 7-8 (distinguishing *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del.
26 Ch. 2003)). In the Amended Complaint, the only allegations about the Outside Directors' knowledge
27 of Sells' conduct are conclusory allegations, that the "[i]ndividual Defendants were aware of Hansen
28 Medical's culture of driving up revenues and Sells's obsession with inflating revenues" and yet "[i]n

1 light of Sells's egregious conduct and his role in causing the accounting irregularities at Hansen
2 Medical, the Director Defendants acted in bad faith in allowing Sells to resign and allowing Hansen
3 Medical to enter into the separation agreement." AC ¶¶ 85, 88. There are no new factual allegations
4 explaining how any of the Outside Directors had or would have had knowledge of Sells' scheme, or how
5 they wholly abdicated their responsibilities with respect to Sells' separation agreement, and therefore
6 no support for the argument that the acts taken by the Outside Directors amount to bad faith or
7 intentional misconduct.

8 Finally, with respect to "insured versus insured" exclusion for derivative actions against
9 directors, the Court previously found that the exclusion, standing alone, does not demonstrate an
10 inability of the Directors to disinterestedly consider a demand. Order at 8. As described in more detail
11 below, the Amended Complaint fails to allege sufficient particularized facts, considered alone or in
12 conjunction with an insured versus insured clause, to demonstrate demand futility.

13
14 **B. Allegations with Respect to Audit Committee Defendants Freund, Shapiro,
15 and Lowe**

16 Plaintiff asserts that he has included new allegations regarding the Audit Committee members
17 that adequately allege bad faith conduct sufficient to survive the motion to dismiss. Specifically,
18 plaintiff points to his allegations that the Audit Committee Defendants discussed Hansen's medical
19 revenue "issues" before and during the 2009 investigation of accounting irregularities; the Audit
20 Committee Defendants "knew that Hansen Medical's financial reports contradicted its revenue
21 recognition policies"; the Audit Committee Defendants abdicated "their duties in violation of the Audit
22 Committee Charter"; and the Audit Committee Defendants allowed "Sells to resign and causing Hansen
23 Medical to enter into a separation agreement with Sells." AC ¶ 133-134. This Court, however, already
24 found these allegations to be deficient. Plaintiff has not alleged *facts* to support his conclusion that these
25 outside directors knew of or even had reason to know of defendant Sells' improper revenue recognition
26 scheme or any other problem with the way their approved revenue recognition method was being
27 applied. See Order at 8-9 (distinguishing *In re Taser Int'l S'holder Derivative Litig.*, 2006 U.S. Dist.
28 LEXIS 11554 (D. Ariz. Mar. 17, 2006); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch.

United States District Court
For the Northern District of California

1 2003); *In re Livent, Inc. Sec. Litig.*, 78 F. Supp. 2d 194, 222 (S.D.N.Y. 1999), *Ryan v. Gifford*, 918 A.2d
2 341 (Del. Ch. 2007)).


3 As plaintiff has failed to alleged particularized facts about Outside Directors Freund’s, Shapiro’s
4 or Lowe’s interest – and plaintiff fails to argue that he has alleged *any* new factual allegations with
5 respect to defendants Hirsch, Mandato and Hykes – plaintiff has failed to adequately allege demand
6 futility with respect to a majority of the Board of Directors who were on Hansen’s Board at the time
7 plaintiff’s complaint was filed.³

8
9 **CONCLUSION**

10 Plaintiff has failed to allege facts to support his allegation that a majority of the Directors would
11 be unable to exercise independent judgment in responding to a demand. As such, plaintiff has failed
12 to adequately allege demand futility and the Court GRANTS defendants’ motion to dismiss without
13 leave to amend.

14
15
16 **IT IS SO ORDERED.**

17
18 Dated: November 12, 2010

19 
20 _____
21 SUSAN ILLSTON
22 United States District Judge

23
24
25
26
27 _____
28 ³ As such, the Court need not consider the specific allegations regarding defendant Moll. *See*
29 *Oppo*. at 16-17.