IN THE SUPREME COURT OF THE STATE OF DELAWARE

TALBOT, INC., TIMOTHY GUNNISON, FRANCOIS PAYARD, NAOMI ROTHMAN, ROSARIA GABRIELLI, MARSHALL CANNON, AJEET GUPTA, DANIEL LEMON, CLARE LEONARD and PATRICK RHANEY	:	
	:	No. 162, 2015
Defendants Below, Appellants,	:	
v.	:	
ALPHA FUND MANAGEMENT L.P.,	:	Court Below: The Court of Chancery of
Plaintiff Below, Appellee.	:	the State of Delaware, C.A. No.10428-CJ

Appellee's Reply Brief

Team A
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February 6, 2015

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NATURE OF PROCEEDINGS

On December 22, 2014, appellee-plaintiff below Alpha Fund Management L.P. ("Alpha") filed a motion for preliminary injunction in the Court of Chancery of the State of Delaware in and for New Castle County against appellants-defendants below Talbot, Inc. ("Talbot") and each member of the board of directors individually (the "Board"). (Mem. Op. at 9-10). Alpha alleged the Proxy Fee-Shifting Bylaw (the "Bylaw") adopted by the Board is facially invalid under Delaware law and otherwise unenforceable as the product of inequitable conduct in violation of the Board's fiduciary duties. (Mem. Op. at 10). Alpha sought to prevent Talbot and the Board from enforcing the Proxy Fee-Shifting Bylaw in connection with any proxy contest for the election of directors to the Board at the upcoming May 2015 annual stockholders meeting. (Mem. Op. at 10). Although declining to rule on the facial validity issue, the chancery court granted the injunction as the bylaw was unenforceable because it was adopted for an inequitable purpose: "[T]he Board hurriedly adopted the [bylaw] on a 'cloudy' day, little more than a week after [Alpha's] Schedule 13D filing, and thus in direct response to what the Board regarded as the looming threat of a contested election." (Mem. Op. at 14).

The chancery court heard arguments and granted Alpha's motion for a preliminary injunction on January 14, 2015. (Mem. Op. at 1, 10). Talbot filed a Notice of Appeal from Interlocutory Order of the Court of Chancery on January 22, 2015. (Ntc. Of Appeal). This Court issued an Order Accepting Interlocutory Appeal on January 29, 2015. (Order Accepting Appeal).

SUMMARY OF THE ARGUMENT

This Court should affirm the chancery court's order granting a preliminary injunction on the unresolved ground that the Proxy Fee-Shifting Bylaw is facially invalid. A bylaw that conflicts with the Delaware General Corporation Law ("DGCL") is void on its face. The Bylaw is a flagrant violation of DGCL § 112 because its chilling effect renders the unequivocal right of shareholders to nominate and elect directors meaningless. Additionally, the authority cited by the chancery court does not support the validity of a Proxy Fee-Shifting Bylaw. Recent jurisprudence has upheld the facial validity of bylaws that impinge shareholder litigation, but this case infringes the right to shareholder proxies. When bylaws touch upon issues of control, heightened scrutiny is needed to protect the shareholder franchise.

This Court should also affirm the order because the chancery court correctly held the Bylaw is unenforceable as it was adopted for an inequitable purpose. The stringent *Blasius* standard is the proper way to review the directors' actions because their conduct equates to purposeful disenfranchisement when the Bylaw was adopted in response to an imminent proxy contest. To that end, the Board did not have a compelling justification for its actions. Alternatively, *Schnell* demands injunctive relief even if *Blasius* is not applicable. The Bylaw was adopted for an inequitable purpose because the Board was motivated to kill Alpha's proxy contest and perpetuate itself in office. The Bylaw's adoption also produced an inequitable effect, as Alpha disclosed it will abandon its proxy if relief is not obtained leaving the incumbent Board to run for reelection uncontested.

STATEMENT OF FACTS

Talbot is a publicly traded Delaware corporation headquartered in Chestertown, Maryland. (Mem Op. at 2). Its nine member board is comprised of one inside director, Chariman and CEO Timothy Gunnison, and eight outside directors: Lead Independent Director Francois Payard, Naomi Rothman, Rosaria Gabrielli, Marshall Cannon, Ajeet Gupta, Daniel Lemon, Clare Leonard and Patrick Rhaney. (Mem. Op. at 3). Talbot's other key officers are Vice President for Finance and Operations Mack Rosewood, Vice President and General Counsel Renee Stone, and Sandra Ellsworth, who is a partner at Talbot's regularly retained outside law firm of Jackson and Wyeth LLP. (Mem. Op. at 5).

Talbot posted net earnings after taxes of $120 million on revenues of $1.1 billion in the most recent fiscal year. (Mem. Op. at 2). With 75 million shares outstanding currently trading at $30 per share, Talbot's market capitalization is about $2.25 billion. (Mem. Op. at 2). Its primary line of business is the manufacture of highly engineered, critical fasteners for aerospace and other general industry markets (the "Fasteners Division"). (Mem. Op. at 2). The Fasteners Division is undoubtedly Talbot's "core strength" and "most profitable business." (Mem. Op. at 3). Talbot also produces micro-electronic circuitry components for use in the consumer tablet and gaming device industry (the "Components Division"), and has a small stake in the development of software for industrial manufacturing applications (the "Software Division"). (Mem. Op. at 2).

Alpha is a relatively small but exclusive investment manager that owned an equity portfolio worth $1.1 billion at the end of 2014. (Mem.

Op. at 2). Under current founder and CEO Jeremy Womack, Alpha is an activist shareholder in companies which it invests. (Mem. Op. at 2). Media sources describe Alpha as "a determined activist investor that had successfully caused other companies to undergo one form of restructuring or another." (Mem. Op. at 5).

Starting in late 2013, Alpha began to acquire Talbot stock and eventually acquired 3 million shares by June 2014. (Mem. Op. at 3). On July 10, 2014, Womack met with Gunnison to suggest a detailed restructuring proposal for Talbot that Womack maintained would "substantially improve value for Talbot's stockholders" (the "Restructuring Proposal"). (Mem. Op. at 3). The Restructuring Proposal stated that Talbot could create immediate shareholder value by shedding its Components and Software Divisions and cut overall operating expenses to focus on the more profitable Fasteners Division. (Mem. Op. at 3). Gunnison "expressed immediate skepticism to Womack about the merits" of the Restructuring Proposal. (Mem. Op. at 4).

Alpha then proceeded to acquire more Talbot shares to bring its total to 5.25 million, or 7%, of shares outstanding. (Mem. Op. at 4). Alpha timely filed a Schedule 13D on December 10, 2014 with the Securities and Exchange Commission disclosing its new ownership stake of $157.5 million at $30 per share. (Mem. Op. at 4). Alpha also disclosed that its purchase of Talbot shares was only "for investment purposes" and it "would not seek to acquire a controlling stockholder position or otherwise try to acquire the Company outright." (Mem. Op. at 4). Moreover, Alpha disclosed that it was "rebuffed" when it presented the Restructuring Proposal and would seek to advance its

proposal by nominating four directors for election to the Talbot board at the annual stockholders meeting in May 2015. (Mem. Op. at 4).

Because the Board's regular monthly meeting had convened on December 5, 2014, Gunnison immediately called a special meeting of the Board for December 18, 2014 that was "devoted exclusively" to Alpha's Schedule 13D filing. (Mem. Op. at 5). At the meeting, Rosewood, Stone and Ellsworth presented Alpha's Restructuring Proposal and detailed the specifics of the Proxy Fee-Shifting Bylaw. (Mem. Op. at 5-6). The Bylaw requires a dissident shareholder to reimburse Talbot for all reasonable and professional fees and expenses it might incur in resisting a proxy contest that is ultimately "not successful." (Mem. Op. at 6-7).[1] Ellsworth's presentation included evidence that larger firms incur expenses ranging from $4 million to $14 million in defending proxy contests. (Mem. Op. at 6). For Alpha's impending proxy, the expenses are estimated in the range of $8 to $12 million.[2]

The Bylaw also contains a provision that gives the Board authority to waive any fee-shifting obligations if required in the proper exercise of its fiduciary duties. (Mem. Op. at 6). Waiver by the Board is completely discretionary. (Mem. Op. at 6). At the special meeting, however, the Board "resolved not to waive the fee-shifting obligation for the Alpha proxy contest, but agreed that this non-waiver determination could be revisited" later. (Mem. Op. at 9).

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[1] A proxy contest is deemed unsuccessful if less than one half of the shareholder's nominees win election to the Board, or in Alpha's case if only one or none of its four nominees are elected. (Mem. Op. at 7).

[2] The exact amount is in dispute. Rosewood estimated the expenses approximate $8 million, whereas Alpha's proxy solicitor anticipates the expenses to be "likely in excess of $12 million." (Mem. Op. at 8).

While discussing the Bylaw, Gunnison "urged the Board to approve" the Bylaw and "disparaged the Restructuring Proposal as 'an ill-conceived short term plan at best' that would harm the company in the long run." (Mem. Op. at 8). He also warned that Alpha's proxy contest is a "potential camel in the tent problem." (Mem. Op. at 8). Gabrielli expressed strong support for adopting the bylaw "as a means of holding Alpha at bay" and pronounced "we need to raise the stakes for this guy." (Mem. Op. at 8). Cannon agreed "the risk of added costs imposed by the [bylaw] 'might get Alpha to think twice about all this.'" (Mem. Op. at 8). Additionally, Leonard belittled Alpha as "playing financial games for purely short term wins" and advocated "if the [ ] Bylaw helps to stop Alpha, then I'm for it." (Mem. Op. at 8-9). Only Payard offered a slightly different view by couching his support of the Bylaw as a way for Talbot to "recoup its costs if an insurgent's proxy contest was not successful." (Mem. Op. at 9). Although not all directors expressed these views, "no one expressed disagreement with them." (Mem. Op. at 9). Ultimately, the Board *unanimously* approved the Bylaw. (Mem. Op. at 9). Alpha has stated in press releases and SEC filings that it will abandon the upcoming proxy contest if judicial relief is not obtained. (Mem. Op. at 12).

On December 22, 2014, Alpha formally gave notice to Talbot of its intention to nominate four candidates for election to the Board and filed suit that instigated the present litigation. (Mem. Op. at 9-10). The Board has since met on January 9, 2015 and considered Alpha's four nominees, but unanimously decided not to support Alpha's candidates and nominated the nine incumbent directors. (Mem. Op. at 10).

ARGUMENT

I. WHILE THE CHANCERY COURT DECLINED TO RULE ON THE ISSUE, THE PROXY FEE-SHIFTING BYLAW IS FACIALLY INVALID AS A MATTER OF LAW.

A. QUESTION PRESENTED

Whether a board-adopted bylaw that requires a shareholder to reimburse the corporation for expenses incurred in defending an unsuccessful proxy contest is facially valid as a matter of law when the bylaw would prevent an otherwise lawful proxy contest and allow a board of directors to proceed uncontested.

B. STANDARD OF REVIEW

A preliminary injunction requires the moving party to demonstrate (1) a reasonable probability of success on the merits, (2) an imminent threat of irreparable harm, and (3) a balancing of the equities of the case tips in its favor. *SI Mgmt. L.P. v. Wininger*, 707 A.2d 37, 40 (Del. 1998). (Mem. Op. at 10).[3] Preliminary injunctions are reviewed for abuse of discretion and legal conclusions are reviewed de novo. *Kaiser Aluminum Corp. v. Matheson*, 681 A.2d 392, 394 (Del. 1996).

C. MERITS OF ARGUMENT

It should be noted at the outset that although the chancery court did not rule on the Bylaw's facial validity, "facial challenges to [bylaws] are regularly resolved by this Court." *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 947 (Del. Ch. 2013). The failure to rule on a bylaw's facial validity often results in "unnecessary costs or delay." *Id.* at 946-47.

[3] Appellants concede that "if [appellee] were to demonstrate a reasonable probability of success on the merits at a final hearing, a preliminary injunction would be appropriate." (Mem. Op. at 10-11). Thus, the second and third requirements are not at issue.

The "fundamental tenets of Delaware corporate law provide for a separation of control and ownership," and the stockholder franchise is commonly characterized as the "ideological underpinning" upon which the legitimacy of the directors' managerial power rests. *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1126 (Del. 2003). As this Court has made clear, bylaws constitute part of a binding broader contract among the directors, officers and stockholders formed within the statutory framework of the DGCL. *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229, 233 (Del. Ch. 2014).

A corporation may "confer the power to adopt, amend or repeal bylaws upon the directors." 8 Del. C. § 109(a). Also, a corporation's bylaws "may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs . . . or the rights or powers of its stockholders . . . ." 8 Del. C. § 109(b). Bylaws are presumptively valid under the DGCL. *Frantz Mfg. Co. v. EAC Indus.*, 502 A.2d 401, 407 (Del. 1985). Nonetheless, a bylaw must meet three distinct requirements to be valid on its face: (1) it must be authorized by the DGCL, (2) it must be consistent with the corporation's certificate of incorporation, and (3) its enactment must not be otherwise prohibited. *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 557-58 (Del. 2014).

Directorial misconduct that frustrates corporate democracy by restricting the shareholder vote cannot survive judicial scrutiny. The Court of Chancery wrongfully declined to rule on the facial validity of Talbot's Proxy Fee-Shifting Bylaw because it patently runs

afoul of DGCL § 112 and the recent Delaware trend validating board-adopted bylaws is inapposite to the present case.

1. The Proxy Fee-Shifting Bylaw Is Facially Invalid Because It Contravenes The DGCL To The Extent It Abolishes The Statutory Right Of Shareholders To Nominate And Elect The Directors Of The Corporation.

It is axiomatic that a bylaw will be struck down for its facial invalidity if it "is so pervasive as to intrude upon fundamental stockholder rights guaranteed by statute." *Datapoint Corp. v. Sec. Plaza Co.*, 496 A.2d 1031, 1036 (Del. 1985). In that regard, a bylaw that conflicts with the DGCL is void. *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 398 (Del. 2010).

During proxy contests, DGCL § 112 "gives stockholders the chance to shape their own company-specific approach to issues like proxy access." *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 356 n.244 (Del. Ch. 2010). Section 112 states that "if the corporation solicits proxies with respect to an election of directors, it may be required . . . to include in its proxy solicitation materials . . . [one] or more individuals nominated by a stockholder." 8 Del. C. § 112. Interpreting the DGCL, courts unequivocally recognize that the "right of shareholders to participate in the voting process includes the right to nominate an opposing slate." *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 345 (Del. Ch. 2008). Thus, it is indisputable that shareholders have the ultimate right to nominate and elect the directors of a corporation. *See e.g.*, *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

A bylaw is "patently unreasonable as a matter of law" if it "effectively deprives the members thereof from exercising some

dominion over [the] Board." *In re Osteopathic Hosp. Ass'n*, 195 A.2d 759, 765 (Del. 1963). In *Osteopathic*, the bylaws of an association composed of physician members contained a provision that allowed laymen to be elected to the association by a majority vote of the association's members. *Id.* at 761-62. The association's board of trustees contained both members and nonmembers of the association, who amended the bylaws to make all trustees full voting members, thus taking control of membership of the association from the physicians and giving it to the laymen. *Id.* at 765. The bylaw created "an abuse far too apparent and unreasonable for [the Court] to permit." *Id.*

The Proxy Fee-Shifting Bylaw is a flagrant violation of DGCL § 112. Much like the bylaw enacted in *Osteopathic*, the Bylaw here is an abuse of directorial power as it fundamentally deprives Talbot shareholders from exercising their dominion over the board of directors. Alpha has a significant stake in the continuing success of Talbot. (Mem. Op. at 4). The Bylaw's adoption perpetuates the incumbent board in office by ensuring that shareholders, like Alpha, do not challenge the board via proxy contests. The Bylaw is designed to operate so that no stockholders will challenge the board unless they are certain or willing to bet up to $14 million that at least half of its nominees will win election. Therefore, the Proxy Fee-Shifting Bylaw runs afoul of DGCL § 112 because it renders a stockholder's statutory right to vote through a proxy contest useless.

2. Recent Delaware Jurisprudence Is Inapposite To The Invalidity Of Talbot's Proxy Fee-Shifting Bylaw Because The Authority Cited By The Court Of Chancery Does Not Threaten Shareholder Disenfranchisement.

Although Delaware case law now indicates that fee-shifting bylaws

can be facially valid, *ATP*, 91 A.3d at 650, a fee-shifting bylaw for unsuccessful proxy contests invokes special considerations involving the shareholder franchise. The shareholder franchise occupies a special place in Delaware corporation law and courts "are vigilant in policing fiduciary misconduct that has the effect of impeding or interfering with the effectiveness of the stockholder vote." *In re MONY Group, Inc. S'holder Litig.*, 853 A.2d 661, 673 (Del. Ch. 2004).

Courts have even gone so far as to apply a rule of construction in favor of franchise rights.[4] In *Harrah's Entm't, Inc. v. JCC Holding Co.*, the court applied this rule of construction to a bylaw limiting the ability of stockholders to nominate multiple candidates to the board. 802 A.2d 294, 310 (Del. Ch. 2002). The court reiterated that "[b]ecause of the obvious importance of the nomination right in our system of corporate governance, Delaware courts have been reluctant to approve measures that impede the ability of stockholders to nominate candidates." *Id.* Likewise, "the unadorned right to cast a ballot. . . is meaningless without the right to participate in selecting the contestants." *Id.* at 311. The nominating process "is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise." *Id.* (quoting *Durkin v. Nat'l Bank of Olyphant*, 772 F.2d 55, 59 (3d Cir. 1985)). Essentially, the right to vote is meaningless without the right to nominate.

[4] The rule of construction in favor of franchise rights requires a court to interpret ambiguous bylaws "in the manner most favorable to the free exercise of traditional electoral rights." *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 345 (Del. Ch. 2008).

Because stricter scrutiny is triggered when the shareholder franchise is threatened, the recent trend upholding board-adopted bylaws does not extend to the case at hand. *ATP*, *Providence* and *Chevron* validated bylaws that impinge the right of stockholders to hold boards accountable through shareholder litigation, but here the Board infringed the right of stockholders to hold it accountable through the electoral process. Again, the importance of this distinction lies in the rationale that "careful judicial scrutiny" is given to a situation in which directors use their authority to restrict the ability of shareholders to replace them. *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 239 (Del. 1982). In other words, "[t]he duty of courts to protect the stockholder vote is at its highest when the board action relates to the election of directors." *Esopus Creek Value LP v. Hauf*, 913 A.2d 593, 602 (Del. Ch. 2006).

The authority cited by the chancery court does not call into question Delaware's emphasis on "a general policy against disenfranchisement." *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 669 (Del. Ch. 1988). In *ATP*, the court stated that fee-shifting bylaws are not *per se* invalid under Delaware law. *ATP Tour*, 91 A.3d at 560. The bylaw in *ATP* required shareholders to reimburse the corporation if they were unsuccessful in litigation against the corporation. *Id.* at 556. To reiterate, Talbot's Bylaw is inherently different from *ATP*'s bylaw in that it obstructs the statutory right of shareholders to elect directors by mandating fee-shifting after an unsuccessful proxy. The heightened concerns implicated in this case when the Board's action relates to the election of directors were not addressed in *ATP*.

In *Chevron*, the court again upheld the facial validity of a provision limiting the right of shareholders in intra-corporate litigation, this time through a board-adopted forum selection bylaw. *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 939 (Del. Ch. 2013). The court reasoned that any concerns about the bylaw's facial validity are trivial because "[the] annual opportunity to elect directors [gives] stockholders [ ] a potent tool to discipline boards" who refuse to accede to a stockholder vote. *Id.* at 956-57; *see also City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229, 235 (Del. Ch. 2014) ("[T]he same analysis of Delaware law outlined in *Chevron* validates the Forum Selection bylaw here."). *Chevron* and *Providence* plainly do not implicate shareholder voting rights, but the right to check directors through litigation. Therefore, the Proxy Fee-Shifting Bylaw demands a different result.

Alpha was deprived of this "potent tool" because the adoption of the Proxy Fee-Shifting Bylaw led to Alpha disclosing its intention to abandon the proxy contest if injunctive relief is not obtained. (Mem. Op. at 12). The record also stresses "[i]t is troubling to the Court that the Proxy Fee-Shifting Bylaw would prevent an otherwise robust proxy contest for the composition of the Talbot board from going forward and would result in an uncontested election of the incumbents." (Mem. Op. at 12). Consequently, the court's reasons for upholding the bylaw in *Chevron* do not extend to the present case.

As a whole, bylaws that hinder shareholder litigation cannot serve as the foundation for validating bylaws that hinder shareholder voting rights. When a bylaw polices intra-corporate litigation, it

protects against certain dangers that do not exist during a proxy contest. Scholars opine that "competition among plaintiffs' counsel seeking to maximize their [ ] economic advantage" is the dominant factor contributing to the growth of multiforum litigation. Joseph A. Grundfest & Kristen A. Savelle, *The Brouhaha over Intra-Corporate Forum Selection Provisions: A Legal, Economic and Political Analysis*, 68 BUS. LAW. 325, 328 (Feb. 2013). The resulting "fee spiral" compels competing jurisdictions to offer increased fee awards simply to attract filings without regard to the best interests of shareholders. *Id.* at 341. Forum selection bylaws, like those in *ATP*, *Providence* and *Chevron*, are the best way to combat multiforum shareholder litigation.

In contrast to a Proxy Fee-Shifting Bylaw, forum selection bylaws incur an economic benefit to shareholders. Filings in multiple forums increase litigation costs, create the possibility for opportunistic settlements, and produce jurisdictional inconsistencies. *Id.* at 328-29. All of these make shareholder litigation susceptible to inflated agency costs. Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137, 151 (2011). Forum selection bylaws thus eliminate the risk of high agency costs and generate a pecuniary benefit for shareholders. Conversely, it cannot be contested that the Proxy Fee-Shifting Bylaw burdens Alpha; it commands Alpha to reimburse costs up to $12 million.[5]

In light of the foregoing, this Court should affirm the chancery

[5] The exact amount is in dispute. Rosewood estimated the costs incurred might approximate $8 million "give or take," whereas Alpha's proxy solicitor estimated costs "as likely in excess of $12 million." (Mem. Op. at 8).

court's grant of Alpha's preliminary injunction because Talbot's Proxy Fee-Shifting Bylaw is invalid on its face.

II. REGARDLESS OF ITS FACIAL VALIDITY, THE CHANCERY COURT CORRECTLY ENJOINED THE TALBOT BOARD FROM ENFORCING THE PROXY FEE-SHIFTING BYLAW AS A MATTER OF EQUITY.

A. QUESTION PRESENTED

Whether a board-adopted bylaw that requires a shareholder to reimburse the corporation for expenses incurred in defending an unsuccessful proxy contest is unenforceable as a matter of equity when the board acted with knowledge of an imminent proxy contest and the shareholder publicly stated it will abandon its attempt to challenge the board if judicial relief is not obtained.

B. STANDARD OF REVIEW

As noted previously, this Court shall only review the reasonable probability of success on the merits of Alpha's claims.[6] Preliminary injunctions are reviewed for abuse of discretion, and legal conclusions are reviewed de novo. *Kaiser Aluminum*, 681 A.2d at 394.

C. MERITS OF ARGUMENT

A bedrock of the DGCL is that "inequitable action does not become permissible simply because it is legally possible." *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971). This theory stems from the view that the DGCL "confers power upon directors as the agents of the shareholders; it does not create Platonic masters." *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988). The stockholders of Delaware corporations enjoy the fundamental right to

[6] Appellant conceded the other two requirements for a preliminary injunction. *See supra* note 3 and accompanying text.

vote on certain corporate matters. *Esopus Creek Value LP v. Hauf,* 913 A.2d 593, 602 (Del. Ch. 2006). Accordingly, Delaware courts consistently strike down board actions that inequitably circumvent the proper exercise of the stockholder franchise. *Id.*

1. The Chancery Court's Factual Findings Dictate That The Conduct Of The Board Is Subject To A *Blasius* Review, Rendering The Bylaw Unenforceable.

a. The heightened *Blasius* standard is applicable because the Talbot board acted with the primary purpose of interfering with the effectiveness of a stockholder vote.

When the election of directors is at stake, board action designed to "'principally interfere with the effectiveness of a [stockholder] vote,' even if taken honestly and in subjective good faith, is not subject to the deferential business judgment rule." *Id.* (quoting *Blasius*, 564 A.2d at 660). Rather, the board's action is subject to a *Blasius* review, in which the board "bears the heavy burden of demonstrating a compelling justification for such action." *Blasius*, 564 A.2d at 661. Because of the sanctity of the shareholder franchise, "careful judicial scrutiny" applies when directors use their authority to restrict the ability of shareholders to replace them. *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 239 (Del. 1982).

Courts have applied *Blasius* when a board has either impermissibly impeded or delayed the shareholder vote of an opposing slate of directors or effectively negated a victory achieved by stockholders in an election of directors. *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 495-96 (Del. Ch. 1995). The prototypical *Blasius* case is a situation where a stockholder vote is imminent or threatened, and the board purposely thwarts the opportunity for that vote. *In re Gaylord*

Container Corp. S'holders Litig., 753 A.2d 462, 487 (Del. Ch. 2000).

In *Carmody v. Toll Bros., Inc.*, the board adopted a "dead hand" poison pill intended to thwart hostile bids by vesting shareholders with preclusive rights that could not be redeemed except by the continuing directors. 723 A.2d 1180, 1191 (Del. Ch. 1998). The court rejected the contention that this provision should be valid as "it does not on its face limit a dissident's ability to propose a slate or the shareholders' ability to cast a vote." *Id.* at 1194. Even though the "dead hand" provision did not completely prohibit the shareholder from voting or proposing a slate, the court held the board's action was subject to *Blasius*'s compelling justification standard because "[a] claim that directors have unilaterally 'create[d] a structure in which shareholder voting is either impotent or self defeating' is necessarily a claim for purposeful disenfranchisement." *Id.* at 1193.

Vital to *Blasius* is the principle that directors need not act in bad faith or in their self-interest for its heightened standard to apply. *Blasius*, 564 A.2d at 663. To require either at the threshold of a *Blasius* review would be superfluous, because they equate to a breach of fiduciary duty and invalidate any board action regardless of whether it interferes with the shareholder franchise. *Id.* at 658.

The record demonstrates that the primary purpose of the Board was to interfere with the effectiveness of Alpha's vote. Like the board in *Carmody*, the Board here purposefully disenfranchised Alpha when it created a structure that rendered shareholder voting self-defeating. "[T]he Board hurriedly adopted the Proxy Fee-Shifting Bylaw on a 'cloudy' day, little more than a week after Plaintiff's Schedule 13D

filing, and thus in direct response to what the Board regarded as the looming threat of a contested election challenging their incumbency." (Mem. Op. at 14). The Board viewed the Bylaw as a "show stopper, that could potentially dissuade Alpha from undertaking its proxy contest at all." (Mem. Op. at 14). While not all directors expressed these views, "no one expressed disagreement with them." (Mem. Op. at 9).

Any argument that the board had a proper purpose by legitimately responding "to the potentially significant costs the Company could reasonably expect to incur in defending against a proxy contest from Alpha or any other insurgent group" is meritless. (Mem. Op. at 14-15). Only one of nine directors considered the recovery of Talbot's expenses as a concern. Payard couched the decision to adopt the bylaw in a reasonable light of "helping Talbot recoup its expenses in the event of an unsuccessful proxy context." (Mem. Op. at 14).

On the other hand, Gunnison disparaged Alpha's position as an "ill-conceived short term plan at best" and saw the proxy contest as a "potential camel in the tent problem." (Mem. Op. at 8). Gabrielli vehemently supported the bylaw as a "means of holding Alpha at bay" and opined "we need to raise the stakes for this guy [Womack]." (Mem. Op. at 8). Cannon echoed that the risk of the added costs "might get Alpha to think twice about all this." (Mem. Op. at 8). Finally, Leonard reiterated he thought Alpha was "playing financial games for purely short term wins" and that "if the [Proxy Fee-Shifting] Bylaw helps to stop Alpha, then I'm for it." (Mem. Op. at 8-9). Because the Board here purposefully intended to thwart the shareholder franchise, its action is subject to *Blasius*'s compelling justification standard.

b. The Board cannot meet its heavy burden of establishing a "compelling justification" for its action.

There is "no certain prism" through which judges can apply *Blasius*'s compelling justification standard. *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d 786, 805 (Del. Ch. 2007). But in reality, "invocation of the *Blasius* standard of review usually signals that the court will invalidate the board action under examination." *Chesapeake Corp. v. Shore*, 771 A.2d 293, 323 (Del. Ch. 2000). Due to the stringent nature of *Blasius* review, "even a board's honest belief that its incumbency protects and advances the best interests of the stockholders is not a compelling justification." *Esopus Creek Value LP v. Hauf*, 913 A.2d 593, 602 (Del. Ch. 2006) (citing *Blasius*, 564 A.2d at 663). Such board action typically amounts to an unintentional violation of the fiduciary duty of loyalty. *Id.*

One of the rare instances where the compelling justification standard can be met is when "a board of directors acts in good faith and on the reasonable belief that a controlling shareholder is abusing its power and is exploiting or threatening to exploit the vulnerability of minority shareholders." *Mendel v. Carroll*, 651 A.2d 297, 304 (Del. Ch. 1994). For example, the chancery court in *Mercier* held that the board had a compelling justification to postpone the merger voting process to allow more time for deliberation when it "fear[ed] that stockholders are about to make an unwise decision that poses the threat that the stockholders will irrevocably lose a unique opportunity to receive a premium for their shares." *Mercier*, 929 A.2d

at 788. The board's compelling justification was the protection of their stockholders' financial best interests. *Id.*

In the present case, the Board lacked a compelling justification to adopt the Proxy Fee-Shifting Bylaw. The Board's only alleged justification, aside from purposeful disenfranchisement, was to preserve "the status quo of the Company's cost cutting business plan to Alpha's and Womack's more aggressive Restructuring Proposal." (Mem. Op. at 16). Even if true, this assertion does not change the outcome that the Board's conduct fails *Blasius*. "[E]ven a board's honest belief that its incumbency protects and advances the best interests of the stockholders is not a compelling justification." *Esopus Creek*, 913 A.2d at 602 (citing *Blasius*, 564 A.2d at 663). The chancery court appropriately reaffirmed this principle by noting that "such good faith disagreements on business strategy could not justify purposeful board interference with the electoral process . . . ." (Mem. Op. at 16). Accordingly, the conclusion that the Board lacked a compelling justification for adopting the Proxy Fee-Shifting Bylaw is inescapable.

2. Even Without *Blasius*, The *Schnell* Doctrine Mandates That The Bylaw Is Still Unenforceable.

Under *Schnell*, the enforceability of an otherwise facially valid bylaw "depends on the manner in which it was adopted and the circumstances under which it was invoked." *ATP Tour*, 91 A.3d at 558. A bylaw will not be enforced if it is adopted or used for an "inequitable purpose." *Id.* In other words, *Schnell* can invalidate board action whose conduct is fully consistent with corporate law. *In re Pure Resources Inc., S'holders Litig.*, 808 A.2d 421, 434 (Del. Ch.

2002). The *Schnell* inquiry involves two considerations: whether the bylaw was adopted for an "inequitable purpose" and whether it will have an "inequitable effect." *ATP Tour*, 91 A.3d at 559 (quoting *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1080 (Del. Ch. 2004)).

a. The Board adopted the Proxy Fee-Shifting Bylaw for an inequitable purpose.

The *Schnell* doctrine is routinely applied to invalidate a board's inequitable manipulation of the corporate machinery which adversely affects the shareholders' right to elect directors. *Helfer* paints a clear picture of the *Schnell* spectrum. *See Accipiter Life Sciences Fund, L.P. v. Helfer*, 905 A.2d 115, 126-27 (Del. Ch. 2006). *Helfer* dictated that *Schnell* should not enjoin the enforcement of a bylaw if a shareholder can preserve its rights with "reasonable diligence." *Id.* Ultimately, the court allowed a board's invocation of an advance notice bylaw when the shareholder could preserve its rights by carefully reading the company's press release in full. *Id.* at 127.

In contrast, the court in *Lerman v. Diagnostic Data, Inc.* granted equitable relief when the incumbent board set the annual shareholder meeting at a time 63 days in the future, when a bylaw required a stockholder wishing to nominate directors to submit the names of its nominees at least 70 days in advance of the meeting. 421 A.2d 906, 914 (Del. Ch. 1980). As a result, the board's action made compliance with the bylaw impossible, and a dissident stockholder would have to anticipate that the company would call its annual meeting in a way that would make further nominations impossible. *Id.* at 912.

Also, the fact that a shareholder still has the opportunity to nominate a slate of directors is not sufficient; the opportunity must

be fair and cannot impose unreasonable burdens. In *Hubbard v. Hollywood Park Realty Enters., Inc.*, the board's failure to waive an advance notice bylaw, after the time for shareholders to nominate candidates for election had passed, was invalidated under *Schnell*. 17 Del. J. Corp. L., 238, 258-59 (Del. Ch. Jan. 14, 1991). The court held that even though the shareholder had a prior opportunity to nominate a slate, the deprivation of a subsequent chance to nominate created "unreasonable burdens" that were inequitable. *Id.*

Moreover, directors act with an inequitable purpose when they adopt a defensive measure *in response to* an imminent proxy contest that impairs the shareholder's right to vote. In *Aprahamian*, the board postponed the annual shareholder meeting on the evening before after learning that a dissident board would be elected. *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1205 (Del. Ch. 1987). The court enjoined this conduct for want of a proper purpose because the board acted "upon learning that they might be turned out of office." *Id.* at 1208.

It cannot be disputed that the Board here acted with an improper purpose. As stated previously, a majority of the directors were motivated to prevent Alpha from launching its impending proxy contest.[7] Moreover, the Bylaw was a direct response to Alpha's actions. From the beginning, Alpha acted with candor in its dealings with both Gunnison and the SEC. Alpha disclosed in its Schedule 13D that it "would seek [to] advance the Restructuring Proposal by subsequently nominating four directors for election to the board of Talbot at the annual stockholders meeting in May 2015." (Mem. Op. at 4). Further,

[7] *See supra* pp. 18-19.

Alpha disclosed its purchase of Talbot shares was for investment purposes only and it would not seek to acquire a controlling stockholder position or otherwise try to acquire the Company outright." (Mem. Op. at 4). When considered in proportion to the non-hostile nature of Alpha's actions, the Board's response was suspect at best. The chancery court below properly recognized this inequity.

The actions of Talbot's board mirror the directorial misconduct in *Aprahamian*, where the court granted relief because the directors acted *in response to* an imminent proxy contest. The chronology of events is instructive. Since the Board already held its regular monthly meeting on December 5, it held a special meeting on December 18 that "devoted exclusively" to Alpha's Schedule 13D filing. (Mem. Op. at 5). As the chancery court emphasized, "the Board hurriedly adopted the [bylaw] on a 'cloudy' day, little more than a week after [Alpha's] Schedule 13D filing, and thus in direct response to . . . the looming threat of a contested election." (Mem. Op. at 14). This is an irrefutably an inequitable purpose.

In stark contrast to *Helfer*, no amount of diligence on behalf of Alpha, reasonable or not, could fairly preserve its fundamental right to launch a proxy contest. Even though some proxy contests are successful, there are undoubtedly numerous contests that fail. There is no way for Alpha with its 7% ownership stake, or any stockholder, to predict or guarantee that at least half of its nominees will unseat the incumbent board, especially when Talbot stock is publicly traded with 75 million shares outstanding. (Mem. Op. at 2, 4). Every dissident shareholder in Alpha's position must be willing to proceed

in the face of a prospective $14 million penalty to launch a proxy contest, (Mem. Op. at 6), in addition to its own costs incurred.

Any argument that the Board's conduct was equitable due to its inclusion of a waiver provision is unconvincing. This provision does not make the Bylaw enforceable because the Board already showed its previous hostility towards Alpha by rejecting its Restructuring Proposal. (Mem. Op. at 15). The possibility of waiver is also too speculative when Talbot already stated it will not waive enforcement of the bylaw if Alpha proceeds with its proxy contest. (Mem. Op. at 9). In any event, the Board's subsequent waiver would not disguise its inequitable purpose when adopting the bylaw to begin with.

Also, the proposition that the Board's actions are valid since it acted in good faith, was "well informed" and "legitimately responsive to the potentially significant costs" fails. (Mem. Op. at 14). Because according to *Blasius*, such good faith disagreements on business strategy cannot not justify purposeful board interference with the electoral process. *Blasius*, 564 A.2d at 661.

b. The Proxy Fee-Shifting Bylaw invariably has an inequitable effect.

Absent confessions of improper purpose, the most important evidence of what a board intended to do is often what effects its actions have. *Chesapeake Corp. v. Shore*, 771 A.2d 293, 320 (Del. Ch. 2000). The effect of the board's action is frequently persuasive evidence of its purpose. *Id.* at 320, 345. Accordingly, the shareholder franchise is so heavily protected that injunctive relief from an inequitable bylaw under *Schnell* does not even require a finding of improper purpose. *Helfer*, 905 A.2d at 125.

The court also accepted this notion in *Lerman*. 421 A.2d at 913 (recognizing board action would be inequitable if it received notice of shareholder's intent to launch a proxy). Even without evidence of inequitable purpose, the court "fail[ed] to see how [the board action] could be [allowed], even if management understandably lacked knowledge of all the facts and had no intention of thwarting a potential proxy contest in so doing." *Id.* at 914.

The inequitable effect of the Bylaw is obvious. Alpha has publicly stated it will abandon the upcoming proxy contest if relief is not obtained. (Mem. Op. at 12). The Board could then run unopposed. Further, enforcement of the Bylaw also creates an inequitable effect because Talbot is in a much better position to afford the expenses of an unsuccessful proxy contest. Delaware follows the American Rule where litigants must pay their own attorneys' fees and costs, but contracting parties may agree to modify this and obligate the losing party to pay the prevailing party's fees. *ATP Tour*, 91 A.3d at 558. Alpha does own an equity portfolio worth $1.1 billion, (Mem. Op. at 2), but as an investment manager its assets belong to its investors and Alpha retains only a small percentage of its portfolio. As a publicly traded corporation with a $2.25 billion market capitalization, Talbot retains all of its $1.1 billion in revenues. (Mem. Op. at 2). Due to Talbot's deep pockets, there is no need to opt out of the default rule and shift fees to the shareholder.

CONCLUSION

For the foregoing reasons, this Court should affirm the chancery court's order granting a preliminary injunction enjoining the Bylaw.