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.,	:	
Plaintiff Below, Appellee.	:	Court Below: Court of Chancery of the State of Delaware
	:	C.A. No. 10428-CJ

Appellant's Opening Brief

Team H
Attorneys for Appellants
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NATURE OF PROCEEDINGS

Appellees, Plaintiffs below, brought suit seeking injunctive relief against Appellants, Defendants below, in the Court of Chancery on claims of Talbot Inc.'s directors' breach of fiduciary duties on January 12, 2015. Chancellor Junge granted a preliminary injunction against any action to effectuate or enforce the terms and provisions of the proxy fee-shifting bylaw on January 15, 2015.

Appellants filed a notice of appeal on January 22, 2015, and this Court accepted expedited appeal on January 29, 2015.

Appellants request that this Court reverse the Order of the Chancery Court. Specifically, Appellants ask this Court to hold that the proxy fee-shifting bylaw was facially valid and the product of equitable conduct of Talbot's Board of Directors.

SUMMARY OF ARGUMENT

I. The proxy fee-shifting bylaw adopted by Talbot was facially valid because it was a bylaw enacted by the board of directors in furtherance of their business goals. It was not otherwise forbidden because it is within the bound of the Delaware General Corporation Law and its goal to promote independent boards that fulfill their fiduciary duties. The Chancery Court did not explicit rule on the facial validity of the bylaw, but this Court should find the bylaw valid and deny Appellee's preliminary injunction.

II. The Talbot Board of Directors adoption of the proxy fee-shifting bylaw was not the product of inequitable conduct; rather the proxy fee-shifting bylaw was adopted for the equitable purpose of protecting the corporation and its stockholders from perceived threat to Talbot's corporate policy and effectiveness. The Chancery Court erred in its application of the inequitable purpose analysis of *Schnell* because the present case is factually distinguishable. Furthermore, the Talbot Board of Directors meets *Unocal's* heightened level of scrutiny; the proxy fee-shifting bylaw the Talbot Board adopted meets *Unocal's* reasonableness test and proportionality test. Therefore, this Court should apply the business judgment standard when reviewing the adoption of the proxy fee-shifting bylaw and reverse the Chancery Court's order for preliminary injunction.

STATEMENT OF FACTS

This appeal and underlying action stems from Defendant Talbot Inc.'s ("Talbot") adoption of a bylaw which forces unsuccessful proxy context challengers to pay Talbot for expenses incurred as a result of Talbot's defense of an unsuccessful proxy challenge. Mem. Op. at 1. Talbot is a publicly traded Delaware corporation specializing in the manufacture of fasteners, electrical components, and industrial manufacturing software. Mem. Op. at 2. Plaintiff Alpha Fund Management, L.P. ("Alpha") is an investment manager that is currently seeking to oust and replace four of Talbot's directors in order to change the direction of business by selling off its components and software divisions.

Starting in 2013, Alpha attempted to acquire large amounts of Talbot's stock and by June 2014, it had acquired 4% of Talbot's outstanding shares. Mem. Op. at 3. On July 10, 2014, Alpha's CEO Jeremy Womack ("Womack") met with Talbot's CEO, Timothy Gunnison ("Gunnison") to discuss Womack's suggestion to sell or spin off Talbot's weaker divisions to improve corporate profits. *Id.* Gunnison was skeptical of Womack's suggestions and did not accept them because Womack did not take into account measures that Talbot was already putting in place to lower its costs and become more profitable. Mem. Op. at 4.

Not finding success in persuading Gunnison, Womack decided to take control of the company by electing four directors onto Talbot's nine member board. *Id.* In a schedule 13D filing made on December 10, 2014, Womack discloses that Alpha now owns 7% of Talbot and that it

seeks to replace four existing Talbot directors with four of its own directors. *Id.* Alpha also discloses its plan to use the four directors as leverage for restructuring Talbot to remove its components and software divisions.

In response to Alpha's aggressive attempt to restructure Talbot, Gunnison called an emergency meeting of Talbot's board of directors on December 18, 2014. Mem. Op. at 5. The board members discussed Alpha's proposal extensively and collectively decided that the proposed restructuring by Alpha would be harmful to the company in the short and long term. Mem. Op. at 5-6. With the advice of counsel, the board members decided to adopt a fee-shifting bylaw forcing unsuccessful proxy challengers to pay for expenses incurred by the company as a means to reduce the risk of possibly exorbitant costs that would arise as a result of a proxy context. Mem. Op. at 6.

In deciding the terms of the bylaw, the members choose to create a structure that allowed for some discretion in the enforcement of the bylaw. The proposed bylaw allows the fees to be waived for the challenger based on the judgment of the board at the time. *Id.* The bar for a successful proxy challenge was set relatively low, allowing the challenger to escape having to pay fees if 50% or more of the challenger's nominees up for election are elected. Mem. Op. at 7.

Talbot's board members expressed different reasons for why they wanted to adopt the new fee-shifting bylaw. Multiple members of the board suggested that the bylaw would be a good way to prevent a hostile takeover by Alpha, an investor they believed to be a threat to the business and would hurt the corporation if it ever took control.

Mem. Op. at 8-9. At least one member of the board suggested that recoupment of costs was the primary reason that he wanted the bylaw to be added. Mem. Op. at 9.

On December 22, 2014, almost immediately after Talbot adopted the proxy contest fee-shifting bylaw, Alpha sent a letter with its four nominees for directors at Talbot's upcoming director election to be held in May 2015. Mem. Op. at 9. On that same day, Alpha filed suit against Talbot for adopting the fee-shifting bylaw that they argued was invalid and inequitable. Mem. Op. at 10. Alpha also filed a motion for a preliminary injunction which was granted by the lower court on January 14, 2015. This Court accepted Defendant Talbot's appeal in the instant case on January 29, 2015.

ARGUMENT

I. THIS COURT SHOULD REVERSE THE COURT OF CHANCERY AND DENY PLAINTIFFS' REQUEST FOR A PRELIMINARY INJUNCTION BECAUSE DEFENDANTS' FEE SHIFTING BYLAW COMPLIES WITH THE DELEWARE GENERAL CORPORATION LAW AND IS OTHERWISE FACIALLY VALID.

A. Question Presented

Whether or not Talbot's proxy contest fee-shifting bylaw is facially valid under the Delaware General Corporation Law and is not otherwise prohibited by Delaware common law.

B. Scope of Review

This court does not give deference to the embedded legal conclusions of the lower court when reviewing motions for preliminary injunctions. Kaiser Aluminum Corp. v. Matheson, 681 A.2d 392, 394 (Del. 1996). Because the facts are not in controversy and any dispute remaining is purely legal, the lower court's decision is reviewed *de novo.*

C. Merits of Argument

1. Talbot'S Fee-Shifting Bylaw is Permitted by the Deleware General Corporation Law Because the Bylaw Furthers the Board of Director's Fiduciary Duties, Allows the Board to Focus its Efforts on Business Decisions and to Prevent Unnecessary Costs From Hurting the Company.

a. Talbot's Bylaw is Valid Because it Complies with the Principles of the Delaware General Corporation Law

To successfully prevail in a motion for a preliminary injunction, a moving party must demonstrate, "(1) a reasonable probability of success on the merits; (2) irreparable harm; and (3) a balance of equities in its favor." Matheson, 681 A.2d at 694 (citing Allen v. Prime Computer, Inc., 540 A.2d 417, 419 (Del. 1988). Talbot only disputes the first prong; Alpha's reasonable probability of

success on the merits. Alpha's first claim, that Talbot's proxy contest fee-shifting bylaw is facially invalid, has no probability of success on the merits because the bylaw falls in line with a number of other perfectly valid measures enacted by corporate boards to protect the wellbeing of their respective corporations.

Under Delaware General Corporation Law ("DGCL"), "a corporation's bylaws are presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws." ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 557 (Del. 2014) (citing Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985)). Because of this inherent presumption, the standard for striking down this bylaw is quite high. Only an explicit condemnation of a practice or essential element of this bylaw from binding authority will be sufficient to suggest that it is invalid and thus, provide the justification for upholding the grant of a preliminary injunction.

When creating bylaws, corporate boards can enact "any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." 8 Del. C. § 109(b). This is an especially broad statute that allows corporate boards to act with great flexibility to ensure that board members are given the freedom to do what is best for their company specifically. Talbot's fee-shifting statute is directly related to the business of the corporation because it is a tool to prevent potential costs to the

company and can be used to gauge the seriousness of proxy challengers.

Another part of the DGCL, § 141, gives the board sweeping authority to manage the business affairs of the corporation. 8 Del. C. § 141(a). There is no mention in § 141 of shareholder control in the business affairs of a corporation, complete control is ceded to the board of directors; individuals with the necessary expertise and requisite fiduciary duty to act in the best interest of the company. Taken in tandem, § 109 and § 141 suggest that the board of directors is solely charged with enacting bylaws that also effectively manage the business affairs of the corporation. A bylaw dealing with the costs associated with electing the board is most certainly a decision at the heart of the business affairs of the corporation because it is necessary to sort out who is leading the company before any business decisions can be made.

Although the DGCL is silent on the issue of fee-shifting in the context of proxy contests, that does not mean that Talbot's bylaw is invalid. "Our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. Merely because the General Corporation Law is silent as to a specific matter does not mean that it is prohibited." Moran v. Household Int'l, Inc., 500 A.2d 1346, 1351 (Del. 1985)(quoting Unocal,493 A.2d at 957). Talbot's bylaw is simply a new tool for Talbot's board to ward off activist investors who seek to radically change the direction of companies without justification. As corporate law further develops, other methods to prevent hostile takeovers may lose favor with the courts and it is within the spirit of the DGCL to move to another

method to protect the business of the company. This particular bylaw achieves the same goals of previous anti-takeover measures, but does not explicitly deny any electoral rights of shareholders, which may be a step towards a more equitable system of balancing the rights of shareholders and the board of directors.

b. Fee-Shifting Bylaw Deters Corporate Disruption Caused by Frivolous Proxy Contests.

The process of a proxy contest is incredibly draining on the time and resources of a Board of Directors and on a corporation as a whole. In the process of fending off an election of new directors, Board members can understandably become distracted:

> If proxy access and other election related reforms increase the potential for election contests, they could prove distracting in ways that undermine boards' ability to fully carry out their other responsibilities. Indeed, election contests are time-consuming and, thus, any spike in those contests could ensure that directors turn their attention away from other issues.

Lisa M. Fairfax, *Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties*, 95 Minn. L. Rev. 1692, 1714 (2011) (citing Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,765 (Sept. 16, 2010)). With all of the competing priorities that each board member must manage, it can be difficult for a board member to focus on all the issues that need to be carefully considered when a proxy challenger is attempting to overthrow and radically alter the corporation.

One of the primary fiduciary duties of a director is his or her duty of care. Within duty of care, a fiduciary must make a good faith effort to be informed when making decisions for the business. In re

Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 968 (Del. 1996). The need to prevent proxy contests, which suck time and energy away from the board of directors, is even stronger now that shareholders have recently gained greater access to proxy materials, increasing the frequency of proxy contests. Business Roundtable v. S.E.C., 647 F.3d 1144, 1152-53 (D.D.C. 2011). Through the adoption of this contested fee-shifting bylaw, Talbot's board is acting proactively to ensure that it is not bogged down with frivolous proxy battles so it can continue to do the work necessary to keep the corporation on the right track. The bylaw's adherence to the director's fiduciary duty, the bedrock of the relationship between shareholder and director, further cements the facial validity of the bylaw.

c. Fee-Shifting Bylaw Assists Board in Fulfilling its Duty of Loyalty to its Shareholders

As suggested by one of Talbot's directors, the bylaw also has a very direct consequence: it would save Talbot a great amount of money. Mem. Op. 9. One of the Board's attorneys that is familiar with proxy challenges estimated that the costs incurred in a defense of a proxy challenge could be upwards of 12 million dollars. Mem. Op. 8. Taking into account Talbot's previous yearly earnings of 120 million dollars, a proxy contest would eat up approximately 10% of total earnings for the company. Independent estimates found in Business Roundtable suggest that costs to defend a proxy contest could reach 14 million dollars for large companies like Talbot. 647 F.3d at 1150.

Whatever the exact figure, it is likely that Talbot would take a direct, substantial hit to its bottom line in circumstances where the proxy challenger might not even be successful in gaining a single director appointed to the board. Even more troubling is the possibility of special interests using a proxy contest for political gain or as leverage in negotiations with the company, with no real interest in gaining control over the corporation at all. *Id.* at 1152 Talbot's fee-shifting bylaw prevents the unfair manipulation of the corporation by outsiders to reach goals different from maximizing shareholder value in Talbot.

Although there is no direct fiduciary duty of a director to maximize profits for shareholders, directors are tasked with managing the business affairs of the corporation. 8 Del. C. § 141(a). If there was a way that a director could prevent the loss of 10% of yearly profits from a major company, it would most certainly be in the best interest of the company, while doing nothing in the face of this loss suggests that the director is incapable of handling the business affairs of the corporation. Granted, the business judgment rule would limit liability greatly for those making directors making bad judgment calls even after they were properly informed. In re Caremark, 698 A.2d at 967. However, in Talbot's case, there is less harm to scrutinize because the board is saving Talbot money that benefits all shareholders.

The timing on monetary gains is also very important in making the decision to adopt the fee-shifting bylaw. Many of Talbot's directors indicated that they thought Alpha's plan was focused purely

on short-term gains at the expense of an effective long-term strategy. Between the two possibilities, Talbot's Directors are obligated under their duty of loyalty to do what they think is best for shareholders in the long run. In re Trados Inc. Shareholder Litigation, 73 A.3d 17, 37 (Del. Ch. 2013)("[T]he loyalty-based standard of conduct requires that the alternative yield value exceeding what the corporation otherwise would generate for stockholders over the long-term"). Furthermore, it is solely up to the directors to decide what would be a better long-term investment and they do no need to listen to shareholders when making those business decisions. *Id.*

When it comes to making financial sound decisions on behalf of the corporation, Delaware courts are more sympathetic to cost saving solutions by the board than protecting shareholder interests, if the protection of those shareholder interests cost the corporation money or lack of freedom. In CA, Inc. v. AFSCME Employees Pension Plan, the court found a bylaw opposite to Talbot's, one that forces the corporation to reimburse every proxy challenger, to be invalid because it forces the corporation to pay money for something that the board could not later retreat from if it was necessary to fulfill their fiduciary duty. 953 A.2d 227, 238 (Del. 2008).

When Talbot is hit with a surprise proxy contest, they are tied to the same lack of control over how to spend the money of the corporation. It is a necessity for the board to spend money to prevent a takeover because it is their duty of loyalty to do what is best for the company in the long term. Talbot's fee-shifting bylaw provides an

escape hatch that may or may not be used, but is definitely within the spirit of the DGCL in promoting autonomous, independent boards.

2. Talbot's Bylaw is not Otherwise Prohibited because it does not Chill Shareholder Action

From first glance at the lower court decision in this instant case, it may seem like the rights of shareholders are strictly curtailed to a degree that would prevent any future proxy challenges. Chancellor Junge suggests that it is possible that Talbot's bylaw could stop a proxy challenge from going forward against the company because of the heightened stakes. However, the bylaw as it stands today is incredibly flexible, fair, and beneficial to all shareholders. The fee can be waived, is limited only to leniently defined unsuccessful attempts, and prevents one group of shareholders from harming the remaining shareholders. Mem. Op. at 6-7.

Although Womack may claim that the reason he would withdraw from a proxy contest if his legal challenge is unsuccessful is the chilling effect of the potential fees, it more likely that Womack did not plan to mount a serious fight for control of Talbot. If he was such a serious investor, he would be capable of either getting at least two out of four directors elected or be able to convince the board to waive the fee based on his ingenious ideas to make the company more profitable.

a. Shareholder's Retain all Existing Rights to Elect Directors Under Talbot's Bylaw.

Despite a bylaw being considered valid in the DGCL and in step with the certificate of incorporation, a bylaw can be struck down if

it prevents the exercise of shareholder rights or is otherwise prohibited. ATP, at 557. In other instances where the bylaw was otherwise valid, a provision which prevented the shareholder from doing something that was central to the role of a shareholder, like voting in an election. Talbot's bylaw is distinguished from outright bans or actions which prevent action on the part of a shareholder. The fee-shifting bylaw adopted by Talbot is a deterrent to shareholder action, but not an outright ban on what a shareholder is allowed to do within the corporation.

In MM Companies, Inc. v. Liquid Audio, Inc. the directors action to add 2 more seats to the board, as well as making it more difficult to participate in elections was found to be invalid by this Court. 813 A.2d 1118 (Del. 2003). In this case, the board clearly overstepped their bounds by directly removing voting rights from shareholders. The Talbot bylaw never goes as far as this and always insures that shareholders have the right to participate in elections. If anything, the Talbot bylaw ensures that the only proxy contests that do go forward are ones that have a serious chance of making a difference in the makeup of the board. Proxy contests maybe distracting for boards, but they are also distracting and a waste of time for shareholders who do not want to get stuck in the middle of warring corporate factions.

b. Bylaws That Limit Shareholder Rights to Greater Degree than Talbot's Bylaw are Considered Valid Under Delaware Law

There have been a number of more restrictive bylaws that have been deemed valid by this Court. If there is a bylaw that restricts

the rights of shareholders more than Talbot's fee-shifting bylaw, than Talbot's should also be considered facially valid. One of the most common forms of anti-takeover protection bylaws is the shareholder rights plan or poison pill. The poison pill can operate in a number of ways, but generally it provides discounts and incentives to existing shareholders to either dilute or shut out outside investors that wish to take over the target corporation.

In Air Products and Chemicals, Inc. v. Airgas, Inc., the court found that a poison pill and staggered board defensive measure was not excessively limiting on shareholder rights and was therefore valid. 16 A.3d 48, 123 (Del. Ch. 2011). The reason it was found valid was that there was a reasonable chance that an outsider could take over the corporation in the future, even if there might be a delay before that takeover could happen. In contrast, Talbot's fee-shifting bylaw could allow for immediate control by an outside investor, provided that they were able to win the director election. In fact, they would have no adverse consequences if they simply are half successful in electing who they intend to in a proxy contest.

In a different context that is probably most similar to Talbot's bylaw, the court in ATP held that a litigation fee-shifting bylaw was not prohibited under Delaware common law because an exception can be made to the American Rule, where each side pays its own legal fees, when both sides agree to that exception in a contract. 91 A.3d at 558. Because bylaws are contracts agreed upon by all of the corporation's shareholders together, all shareholders are bound by that contract. *Id.*

Talbot's bylaw would also be fee-shifting in a similar manner as the bylaw in ATP, so it should be considered valid. It may seem different because the bylaw in ATP involves which party pays for litigation and in Talbot's case, it is which party pays for proxy contest expenses, but the two are very similar. In both situations, the loser has to pay the fees incurred by the incorporation, except in the case of Talbot, the activist investor had an advantage of only having to win half or more of the proxy elections. Talbot's bylaw also has mechanisms for waiving the fees if there is a legitimate proxy election that does not seek to radically change the company.

II. THE CHANCERY COURT'S IMPOSITION OF PRELIMINARY INJUNCTIVE RELIEF WAS IMPROPER BECAUSE THE PROXY FEE-SHIFTING BYLAW WAS ADOPTED FOR THE EQUITABLE PURPOSE OF PROTECTING THE CORPORATION AND ITS STOCKHOLDERS FROM PERCEIVED THREAT TO TALBOT'S CORPORATE POLICY AND EFFECTIVENESS.

A. Question Presented

Whether or not Talbot's proxy contest fee-shifting bylaw was adopted for inequitable purposes under the *Unocal* test, not *Schnell* as indicated in the Court of Chancery decision.

B. Scope of Review

This court does not give deference to the embedded legal conclusions of the lower court when reviewing motions for preliminary injunctions. Kaiser Aluminum Corp. v. Matheson, 681 A.2d 392, 394 (Del. 1996). Because the facts are not in controversy and any dispute remaining is purely legal, the lower court's decision is reviewed *de novo.*

C. Merits of the Argument

1. The Talbot Board of Directors Adoption of the Proxy Fee-Shifting Bylaw was not the Product of Inequitable Conduct and The Chancery Court's Application of the Inequitable Purpose Analysis of Schnell was Improper.

Although Talbot's proxy contest fee-shifting bylaw is valid under the statute are corresponding common law, Talbot must also prove that the bylaw was not adopted for an inequitable purpose. "Corporate acts thus must be 'twice-tested'-once by the law and again by equity." Sample v. Morgan, 914 A.2d 647, 672 (Del. Ch. 2007) (quoting Adolphe A. Berle, *Corporate Powers As Powers In Trust*, 44 Harv. L. Rev. 1049, 1049 (1931)). The enforceability of a fee-shifting bylaw depends on

the "manner in which it was adopted and the circumstances under which it was invoked." ATP, 91 A.3d at 558. The Court of Chancery's conclusion that Talbot's proxy fee-shifting bylaw was adopted for the "inequitable purpose of thwarting corporate democracy" was predicated on the application of the "inequitable purpose" analysis of *Schnell*; however, the present case is distinguishable from *Schnell* for several reasons. Mem. Op. p. 17.

The board of directors in *Schnell* adopted an amendment in reaction to the threat of a proxy contest that moved the stockholder meeting from January 11 to December 8. In moving the stockholder meeting up, the board deliberately "acted to prevent the dissident group from conducting an election contest at all, because the dissident's proxy materials likely would not clear Securities and Exchange Commission review in time to allow for a meaningful electoral challenge by the dissidents." Mem. Op. p. 13. The Court concluded management "attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office; and, to that end, for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management." Schnell v. Chris-Craft Industries, 285 A.2d 439, 437 (Del. 1971). The Talbot Board adopted a proxy fee-shifting bylaw that would impose upon any dissident stockholder groups the financial obligation to reimburse the company for all reasonable professional fees and expenses it might incur in resisting a proxy contest if, and only if, the proxy contest is unsuccessful. In proper exercise of the directors' fiduciary duties, the bylaw "afforded the

Board the flexibility . . . to waive any fee-shifting obligations otherwise imposed by the proxy fee-shifting bylaw." Mem. Op. p. 6.

The most essential distinguishing point between *Schnell* and the present case is that the Talbot Board did not adopt the proxy fee-shifting bylaw for the "purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management." Schnell, 285 A.2d at 437. A fee-shifting bylaw, unlike rescheduling the stockholder meeting date, does not fundamentally restrict stockholders' right to conduct proxy contests. Furthermore, the adoption of a proxy fee-shifting bylaw for a publicly traded stock company is consistent with permitted modification under the American Rule to award the winning party compensation to cover fees against a losing party that has acted in bad faith. Proxy contests are often "noisy, expensive, combative and even distracting to management." Mem. Op. at 16. A proxy fee-shifting bylaw promotes corporate managerial stability and discourages frivolous proxy contests. Moreover, there is no empirical evidence to support a proxy fee-shifting bylaw directly interferes with a stockholders ability to vote on or conduct a proxy contest.

The present case is also distinguishable from *Schnell* because there is no factual basis to support the claim that the Talbot Board adopted the proxy fee-shifting bylaw for the "purpose of perpetuating itself in office." Schnell, 285 A.2d at 437. The Talbot Board consists of nine (9) individuals, only one of which is an inside director. "Talbot does not have a classified board of directors and thus, all nine (9) directors stand for election annually and will do

so at the upcoming stockholders meeting in May of 2015." Mem. Op. p. 3. The Board's adoption of the proxy fee-shifting bylaw did not seek to reschedule or eliminate the annual election nor did it function to preserve the current Director's positions.

While the enforceability of a facially valid bylaw turns on the circumstances surrounding its adoption and use, the *Schnell* application of the "inequitable purpose" analysis is insufficient to support the claim that the Talbot Board acted for the inequitable purpose of thwarting corporate democracy. Rather, the Talbot Board's decision to adopt the proxy fee-shifting bylaw was "well informed and legitimately responsive 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." Mem. Op. p. 14.

2. The Talbot Board of Directors meets *Unocal's* heightened level of scrutiny; therefore, this Court should apply the business judgment standard.

A corporation's board of directors is responsible for the effective and efficient management of the corporation. A board of directors has a fiduciary duty to act in the best interests of the corporation and its stockholders. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). A director's duty of care "extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders. Unocal Corp v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best

interest of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Defensive actions, like the adopted proxy fee-shifting bylaw, taken in response to some threat to corporate policy and effectiveness require an enhanced level of scrutiny articulated in *Unocal*. Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990). The *Unocal* standard is a "flexible paradigm that jurists can apply to the myriad of fact scenarios that confront corporate boards." Unitrin Inc. v. American General Corp., 651 A.2d 1361, 1374 (Del. 1995). To satisfy the enhanced level of scrutiny directors must meet both a reasonableness test and a proportionality test.

a. Talbot's Proxy fee-shifting bylaw meets *Unocal's* reasonableness test.

The reasonableness test "is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed." Unitrin Inc., 651 A.2d at 1373. This belief may be supported by "showing good faith and reasonable investigation." Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964). The Talbot Board called a special meeting on December 18 after Alpha filed the Schedule 13D with the SEC; the Schedule 13D disclosed that Alpha would seek to advance a "rebuffed" restructuring proposal through a proxy contest. Mem. Op. p. 4. The December 18 meeting lasted more than two hours and included a detailed presentation about the terms of the restructuring proposal and the ongoing cost cutting plans for the company's three divisions. Mem. Op. p. 5. After the presentation, each individual member of the Board agreed that Talbot's current business plan promised greater long term

value "(and possibly greater short term value)" for both the company and its stockholders than Alpha's "rebuffed" restructuring proposal. Mem. Op. p. 4 -5. The Talbot Board also heard presentations from in-house and outside legal counsel about the specific terms and mechanics of a proxy fee-shifting bylaw. The special meeting called to discuss the threatening Schedule 13D development demonstrates that the Talbot Board had reasonable grounds to believe a danger was developing that threatened corporate policy and effectiveness.

Additionally, proof of reasonableness is "materially enhanced, where a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards." Moran v. Household Intern., Inc., 500 A.2d 1346, 1356 (Del. 1985). An "outside" director is defined as a "nonemployee, nonmanagement director." Grobow v. Perot, 539 A.2d 180, 184 n. 1 (Del. 1988). An "independent" director "means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." Aronson v. Lewis, Del.Supr., 473 A.2d 805, 816 (1984). Only one of the individuals serving on the Talbot Board of Directors is an inside director. The remaining eight members of the board are outside directors consistent with Grobow and are also independent consistent with Aronson. Moreover, the lead director established support for the proxy fee-shifting bylaw in helping the company to recoup potentially significant expenses in the event of an unsuccessful proxy contest by an insurgent group. While four directors expressed specific concern about Alpha's proxy contest, not all directors expressed these views

and the Talbot board unanimously approved a resolution adopting the proxy fee-shifting bylaw. It would be difficult to argue that the directors would have an ulterior motives in voting for the bylaw because so few of them had an interest in the company. The other comments made by almost all of the members, that Alpha's plan was short-sighted and did not fully understand Talbot's business, are evidence that the board members made their decision based on a threat of an investor who could potentially damage the corporation.

b. Talbot's Proxy fee-shifting bylaw meets *Unocal's* proportionality test.

"It is not until both parts of the Unocal inquiry have been satisfied that the business judgment rule attaches to defensive actions of the board of directors." Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990). The proportionality test "is satisfied by a demonstration that the board of directors defensive response was reasonable in relation to the threat posed." Unitrin Inc., 651 A.2d at 1373. It is important to note that the adoption of the proxy fee-shifting bylaw is neither coercive nor preclusive in nature. The bylaw is not inherently coercive and there is no evidence to support coercive nature. The bylaw fee shift only applies when the fee is not waived by the board and when the proxy challenger fails in securing half of the director positions. Moreover, the bylaw does not preclude dissident shareholders from engaging in a proxy context. "If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the Unocal proportionality test requires the focus of the enhanced judicial scrutiny to shift to "the

range of reasonableness." Unitrin Inc., 651 A.2d at 1387-1388 (citing Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45-46 (Del. 1994)). "When a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders." Unitrin Inc., 651 A.2d at 1388.

The Talbot Board adopted the fee-shifting bylaw in response to the threat of a proxy context that jeopardized the corporation's policy and effectiveness. While it may seem as if the bylaw was adopted to thwart Alpha's proxy contest, it was designed to protect Talbot from not only immediate but also future threats of bearing significant expenses in the event of unsuccessful proxy context by an insurgent group. "Proper and proportionate defensive responses are intended and permitted to thwart perceived threats." *Id.*

Without these defenses, it would be very likely that Alpha would be able to greatly disrupt the inner workings of the corporation even if the investor group is unable to gather enough support to mount a real challenge to the incumbent board. The defensive responses from Talbot were measured and contained numerous safeguards to protect the shareholders from losing money as a result of a group of rogue, outside investors. If there is ever a need for a real change, a successful campaign or a discussion with the current board to waive the fee shift will remove any possible chilling effect that the threat of paying for the corporations costs could have on a shareholder.

CONCLUSION

Talbot's adoption of a proxy contest fee-shifting bylaw is facially valid under Delaware law because it comports with the DGCL and enhances the director's ability to effectively manage the corporation. Furthermore, the bylaw is equitable because its structure satisfies the reasonableness and proportionate tests under the *Unocal* standard. For the foregoing reasons, this Court should reverse the Court of Chancery and deny injunctive relief.

Respectfully submitted,

Team H, Attorneys for Appellants