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Case No. 8657-CB

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

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| RENA A. KASTIS and JAMES E. CONROY, Derivatively on Behalf of HEMISPHERX BIOPHARMA, INC., | ) | |
| Plaintiffs, | ) | |
| v. | ) | |
| | ) | C.A. No. 8657-CB |
| WILLIAM A. CARTER, ET AL., | ) | |
| Defendants, | ) | |
| and | ) | |
| HEMISPHERX BIOPHARMA, INC., a Delaware corporation, | ) | |
| Nominal Defendant. | ) | |

**MOTION TO INVALIDATE RETROACTIVE FEE-SHIFTING AND SURETY BYLAW OR, IN THE ALTERNATIVE, TO DISMISS AND WITHDRAW COUNSEL**

Plaintiffs Rena A. Kastis and James E. Conroy ("Plaintiffs") hereby move for a declaration that the fee-shifting and surety bylaw (the "Bylaw") recently imposed on stockholders by the Board of Directors (the "Board") of Hemispherx Biopharma, Inc. ("Hemispherx" or the "Company"), a majority of whom are Defendants in this derivative action, is invalid, inapplicable and unenforceable.[1] In the alternative, if the Court declines to strike down the Bylaw or to consider Plaintiffs' invalidity motion at this point of the litigation, Plaintiffs move the Court for an Order voluntarily dismissing this action and their counsel, Prickett, Jones &

[1] The Bylaw is attached hereto as Exhibit A §5.7.

Elliott, P.A. ("Prickett Jones") and Kessler Topaz Meltzer & Check, LLP ("Kessler Topaz"), move the Court to withdraw as counsel. The reasons for the motion are as follows:

1. This stockholder derivative action was filed on June 18, 2013 seeking to invalidate approximately $2.5 million in bonuses paid in November 2012 (the "Bonuses"). The Bonuses were awarded by the compensation committee of the Board, consisting of Defendants William M. Mitchell, Iraj E. Kiani (Chairman), and Richard Piani (the "Compensation Committee") to Defendants William A. Carter, the Company's Chief Executive Officer, Thomas K. Equels, the Company's General Counsel, and Robert E. Peterson, the Company's former Chief Financial Officer. The Compensation Committee's purported rationale was that as a result of a 2012 public offering of Hemispherx common stock, the Company was required to award the Bonuses under the employment agreements of Equels and Carter and the severance agreement of Peterson (the "Agreements").

2. Given the limited amount at stake, on July 25, 2013 Plaintiffs moved for partial summary judgment that the Bonuses were not permissible under the plain language of the Agreements. On August 26, 2013, Defendants moved to stay the action pending investigation by a newly constituted special litigation committee ("SLC"), consisting of Defendant Kiani and Peter Rodino, III, who was

newly appointed to the Hemispherx Board for the purpose of chairing the SLC.[2] However, the Court was unwilling to render any decision on the summary judgment motion prior to a report being issued by the SLC.[3]

3. The December 20, 2013, SLC report recommended that the Company move to dismiss the action. The SLC filed its opening brief in support of its motion to dismiss on January 20, 2014. Plaintiffs' discovery concerning the SLC's investigation, is ongoing. Plaintiffs have a further document request pending, while the SLC claims depositions should begin.[4]

***The Board Adopts the Retroactive Fee-Shifting and Surety Bylaw***

4. On July 10, 2014, Hemispherx filed an 8-K announcing that on July 3, 2014, the Board had amended the Company's bylaws to impose fee-shifting and a bond requirement. The first paragraph of the Bylaw provides:

> Section 5.7 Litigation Fee-Shifting.
>
> (a) In the event that, ***after the date of adoption of this Section 5.7***, (i) ***any*** current or former ***security holder*** of the Company (the "Claimant") ***who*** initiates, asserts, ***maintains or continues*** against the Company ***any litigation***, claim or counter-claim ("Claim") (each such Claimant, together with any other person who joins with the Claimant,

[2] Rodino was a former director and officer of the Company, was a current consultant to the Company when recently appointed a director and has known Defendant Carter since 1979.

[3] *See Kastis v. Carter*, C.A. No. 8657-CC at 9 (Aug. 26, 2013) (TRANSCRIPT) (Exhibit B hereto).

[4] July 15, 2014 letter of Daniel J. Brown, Esquire (Exhibit C hereto).

***offers substantial assistance to the Claimant***, or ***has a direct financial interest in any Claim***, being herein collectively referred to as the "Claiming Party") ***against the Company or against any current or former director, officer*** or security holder (***including any Claim purportedly filed on behalf of or in the right of the Company*** or any security holder) arising in whole or in part out of any Internal Matter (as defined below), ***and*** (ii) ***the Claimant does not obtain a judgment*** on the merits ***that substantially achieves***, in substance and amount, ***the full remedy sought, then each Claiming Party shall be obligated*** jointly and severally ***to reimburse the Company and any such current or former director, officer*** or security holder for ***all fees, costs, and expenses of every kind*** and description (including, but not limited to, all reasonable attorneys' fees and other litigation expenses) that the Company and any such current or former director, officer or security holder have incurred in connection with such Claim. For purposes of this Section 5.7, the term "***Internal Matter***" ***shall mean*** and include (i) ***any derivative action*** or proceeding brought on behalf of or in the right of the Company, (ii) ***any action asserting a claim of breach of a fiduciary duty*** owed by any director, officer or other employee of the Company to the Company or the Company's security holders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, (iv) ***any action asserting a claim arising pursuant to any provision of the federal securities laws***, and any regulation promulgated pursuant thereto, or (v) any action asserting a claim governed by what is known as the internal affairs doctrine.[5]

5. Because the Bylaw applies to any stockholder who maintains or continues any litigation or claim after the date of the adoption of the Bylaw (July 3, 2014), the Bylaw applies retroactively to existing litigation, including this

[5] Ex. A §5.7(a) (emphasis added). Section 5.7(b) provides that the Company is entitled at any stage of the litigation to require a Claimant who holds 5% or less of the Company's stock to provide surety for defendants' litigation expenses and that the action shall be dismissed if the surety is not posted.

derivative action. By letter dated July 18, 2014 (Exhibit D hereto), the Company informed Plaintiffs that the defendants are invoking the Bylaw in this action and threatened Plaintiffs with liability if they continue this litigation.

6. The Bylaw imposes liability not only on stockholders but also on anyone who offers substantial assistance to the stockholders or who has a direct financial interest in a claim. Therefore, the Bylaw threatens Plaintiffs' counsel, who are prosecuting this case on a contingent basis, with liability for Defendants' fees and costs. The Bylaw would impose liability unless the litigation "substantially achieves, in substance and amount, the full remedy sought." For example, even if Plaintiffs prevailed on claims pertaining to the Carter and Equels agreements, they might still be liable if they do not prevail on the differently worded Peterson agreement.

7. The Bylaw subjects stockholders and counsel who maintain or continue litigation after July 3, 2014 to potential liability not just for Defendants' litigation costs after July 3, 2014, but for all costs "incurred in connection with such Claim." Thus, by continuing this litigation, Plaintiffs and their counsel would face a threat of retroactive liability for all defense costs since the commencement of the action on June 18, 2013.

8. The plain terms of the Bylaw and the Company's July 18, 2014 letter demonstrate an intent to force Plaintiffs and their counsel to discontinue this

litigation by threatening financial liability under the Bylaw. The Bylaw has had its intended effect. Plaintiffs and their counsel have concluded that, if the Bylaw is valid and enforceable, it would be economically irrational to continue this litigation.

9. The Company's July 18, 2014 letter claims that the Bylaw is "consistent with the Delaware Supreme Court's decision in *ATP Tour v. Deutscher Tennis Band*".[6] However, *ATP* does not validate the Bylaw. *ATP* provided only very limited and incomplete answers to four abstract certified questions concerning the "facial validity" of a hypothetical bylaw adopted by the board of a non-stock membership corporation. The Court acknowledged it could not "directly address the bylaw at issue."[7] So it did not hold that the terms of the *ATP* bylaw were valid. It could not provide any opinion on whether such a bylaw would be enforceable,

[6] 91 A.3d 554 (Del. 2014). *ATP* has prompted publicly traded Delaware corporations to adopt virulent bylaw packages intended to prevent stockholder litigation by making it financially and procedurally impracticable. *See, e.g.*, Echo Therapeutics, Inc. bylaw adopted June 24, 2014 §§ 5.12, 5.13 & 8-K Ex. 10.1 (non-reciprocal fee shifting, exclusive forum and enhanced indemnification and advancement) (Exhibit E hereto); LGL Group, Inc. bylaw adopted June 11, 2014 (non-reciprocal fee shifting, elimination of stockholder fees under common fund and corporate benefit doctrines and severability provision imposing procedural standards) (Exhibit F hereto); Lannett Company, Inc. bylaw adopted July 17, 2014 (non-reciprocal fee-shifting bylaw adopted one day after the company announced receipt of subpoenas concerning a Connecticut Attorney General's office investigation into price fixing) (Exhibit G hereto).

[7] *ATP*, 91 A.3d at 555.

even in a non-stock corporation.[8] The only holding in *ATP* was that unspecified "fee-shifting provisions ***in a non-stock corporation's*** bylaws ***can*** be valid and enforceable under Delaware law."[9] The Court also said some form of fee-shifting bylaw could be enforced against existing members of a non-stock corporation if it was "otherwise valid and enforceable".[10]

10. The Hemispherx Bylaw is invalid and unenforceable based on numerous factors that were not present in *ATP*, including that the Bylaw (i) applies to passive investors in a publicly traded stock corporation,[11] (ii) is not reciprocal,[12] but only imposes liability on stockholders and not Defendants, (iii) applies retroactively to litigation that has been pending for more than a year, (iv) imposes retroactive liability for Defendants' litigation costs incurred prior to enactment of the Bylaw, (v) is expressly applicable to class and derivative litigation and federal securities actions,[13] and (vi) imposes a bond requirement.

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[8] *Id.* at 558-59, 560.

[9] *Id.* at 555. (Emphasis added).

[10] *Id.* at 560.

[11] The members of the non-stock corporation in *ATP* were tennis professionals and tour operators who were active participants in the business. *ATP*, 91 A.3d at 555.

[12] ATP in its briefs and at argument represented that its bylaw was reciprocal and bilateral, imposing liability on whichever side lost.

[13] The Bylaw also applies to unrelated derivative actions pending in the Court of Common Pleas of Philadelphia County Pennsylvania and the United States District Court for the Eastern District of Pennsylvania ("EDPA"). The Bylaw also

11. Plaintiffs are not restricted to challenging the "facial validity" of the Bylaw, through hypothetical certified questions.[14] Moreover, the Company's July 18, 2014 letter admits the Board constructed the Bylaw so that it applies to Plaintiffs' pre-existing fiduciary duty claim challenging corporate conduct unrelated to the Bylaw. Thus, this case is not a challenge the Bylaw without an underlying claim relating to some other corporate action.[15] Therefore, Plaintiffs are entitled to a determination of whether the provisions of this particular Bylaw are valid, applicable and enforceable under the particular circumstances of this pre-existing derivative litigation.[16]

12. Plaintiffs and their counsel believe the underlying claims are meritorious and that the Bylaw is invalid, unenforceable and against public policy. However, the Bylaw places them in an impossible position because, as the July 18, 2014 letter threatens, Plaintiffs will risk substantial financial liability if they "continue to pursue their claims in this action." Plaintiffs and their counsel cannot

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encompasses a federal securities class action pending in the EDPA where the EDPA has denied a motion to dismiss and discovery is ongoing. *See Frater v. Hemispherx Biopharma, Inc. et al.*, --- F. Supp. 2d ---, 2014 WL 272027 (E.D. Pa. Jan. 24, 2014).

[14] *Cf. ATP*, 91 A.3d at 555, 557-560.

[15] *Cf. Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

[16] *See* 8 *Del. C.* § 111(a)(1).

pursue those claims if they will be at risk for hundreds of thousands or even millions of dollars in Defendants' litigation costs. By enacting this draconian Bylaw, the Board imposed a risk that neither Plaintiffs, their counsel, nor any economically rational stockholder or lawyer, could accept.

13. The amount of damages at stake in this case is relatively small and the legal issue is straightforward, involving the construction or interpretation of employment agreements and a separation agreement. Defendants unilaterally transmogrified this case into an expensive SLC investigation, then changed the rules in the middle of the game to place Plaintiffs and their counsel at risk not only for their own litigation costs, but for all litigation costs of the Defendants back to the beginning of the case, including the costs of the SLC the Defendants chose to create.

14. Plaintiffs and their counsel seek the intervention of this Court to determine whether they can continue this litigation without exposure to financial liability and bond requirements that render pursuit of the claims untenable. If the Court is not willing or cannot determine the validity and enforceability of the Bylaw before there is any continued litigation of this action, Plaintiffs and their counsel simply cannot risk that they may be required to post a large bond at some later stage in the case, or will face monetary liability for all the Defendants' attorneys' fees and expenses at the end of the litigation.

15. Therefore, Plaintiffs and their counsel respectfully request that the Court immediately determine the validity, applicability and enforceability of the Bylaw before this litigation continues. Alternatively, if the Court is not willing to or cannot determine the impact of the Bylaw on an immediate basis or concludes the Bylaw is valid and enforceable, then (i) Plaintiffs respectfully request that the Court dismiss this action without prejudice and (ii) Prickett Jones and Kessler Topaz request that the Court grant their motion to withdraw as counsel in this derivative action.

**PRICKETT, JONES & ELLIOTT, P.A.**

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Date: July 21, 2014

## CERTIFICATE OF SERVICE

I, Michael Hanrahan, do hereby certify that on this 21st day of July 2014, I caused a copy of the foregoing to be filed and served via LexisNexis File upon the following counsel of record:

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