EFiled: Aug 08 2014 02:39PM EDT
Transaction ID 55862991
Case No. 8657-CB

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

RENA A. KASTIS and JAMES E. CONROY, Derivatively on Behalf of HEMISPHERX BIOPHARMA, INC.,	)	
Plaintiffs,	)	
v.	)	C.A. No. 8657-CB
WILLIAM A. CARTER, THOMAS K. EQUELS, ROBERT E. PETERSON, IRAJ E. KIANI, WILLIAM M. MITCHELL and RICHARD C. PIANI,	)	
Defendants,	)	
and	)	
HEMISPHERX BIOPHARMA, INC., a Delaware corporation,	)	
Nominal Defendant.	)	

RESPONSE OF NOMINAL DEFENDANT HEMISPHERX BIOPHARMA, INC. TO PLAINTIFFS' MOTION TO INVALIDATE RETROACTIVE FEE-SHIFTING AND SURETY BYLAW OR, IN THE ALTERNATIVE, TO DISMISS AND WITHDRAW COUNSEL

Nominal Defendant Hemispherx Biopharma, Inc. ("Hemispherx" or the "Company") responds as follows to the Plaintiffs' Motion to invalidate amended Section 5.07 (the "Amended Bylaw") of the Company's Restated and Amended Bylaws (the "Bylaws"), or alternatively to dismiss this action and to permit counsel to withdraw.

SUMMARY OF ARGUMENT

1. Plaintiffs' request to invalidate the Amended Bylaw must be denied for multiple reasons, all of which are described in detail in the Argument section below.

2. *First*, Plaintiffs make a facial challenge to the Amended Bylaw, but the Amended Bylaw is facially valid under the teachings of the Supreme Court's *ATP Tour* decision.

3. *Second*, if Plaintiffs are seeking to invalidate the Amended Bylaw as inequitable or otherwise unenforceable as applied, as opposed to a facial challenge, there is no factual record relating to such matters as Hemispherx's intent and motive in adopting the Amended Bylaw, the purposes of the Amended Bylaw, and whether its impact in any concrete set of circumstances would be inequitable. The Court therefore could not determine the validity of the Amended Bylaw as applied without discovery and the presentation of a full factual record.

4. *Third*, because Hemispherx has not sought to apply the Amended Bylaw to Plaintiffs, and might never do so, the Motion is not ripe for decision by the Court.

NATURE AND STAGE OF THE PROCEEDINGS

5. Plaintiffs instituted this putative stockholder derivative action to challenge payments made to three current and former Hemispherx employees pursuant to agreements between the employees and the Company.

6. Plaintiffs' pursuit of their claims in this action has required Hemispherx to incur substantial expense, despite the fact that Hemispherx and its directors do not believe that the claims have merit.

7. For example, barely five weeks after filing their Complaint, and the same day that Hemispherx informed their counsel that Hemispherx had established a special litigation committee of independent directors (the "SLC") to address the matters set forth in the Complaint, Plaintiffs filed a motion for partial summary judgment on July 25, 2013. Hemispherx then moved for a stay of the proceedings, pending the conclusion of the SLC's work, on July 31, 2013.

8. Even though the stay motion meant, according to then-Chancellor Strine at an August 26, 2013 scheduling conference, that because"[t]he Delaware Supreme Court has set the rules on this," "[i]t's pretty clear that there is going to be a stay," (8/26/13 conference transcript at 5) (Mot. Ex. B), Plaintiffs sought to press their motion for partial summary judgment (*id*. at 3), a request that the Court denied. *See, e.g., Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. Ch. 1984) (after appointment of a special committee to investigate a derivative plaintiff's

claims, "It is a foregone conclusion that such a stay must be granted. Otherwise, the entire rationale of *Zapata*, i.e., the inherent right of the board of directors to control and look to the well-being of the corporation in the first instance, collapses.").

9. Following the August 26, 2013 conference, the parties agreed to a schedule for the SLC's work. The SLC filed its report on December 20, 2013. It concluded in its report that the dismissal of Plaintiffs' Complaint would be in the best interests of the Company and its stockholders. The SLC then filed a formal Motion to Dismiss and opening brief on January 20, 2014, per the parties' agreement. The work performed by McCarter & English LLP as counsel to the SLC generated legal fees for which Hemispherx is responsible.

10. Following the filing of the SLC's report, Plaintiffs have conducted extensive discovery into the SLC's process and independence, including requests for production of documents addressed to the SLC and to Hemispherx itself, and a Rule 45 subpoena directed to the SLC's counsel. Responses to the requests and the subpoena have been served, and the parties have met and conferred about the SLC's and McCarter & English's objections. Barring the filing of a motion to compel additional discovery by Plaintiffs, document discovery is complete, but the process of completing document discovery, starting six months

ago in early February 2014, has caused additional defense-side legal fees to be incurred.

11. Plaintiffs noticed the depositions of the two SLC members on February 3, 2014, but more than six months later, the depositions have not yet been taken or even scheduled. Plaintiffs have not responded to the SLC's motion to dismiss or requested a meeting to discuss a briefing schedule for that motion. Further defense-side legal fees will be incurred in attending the depositions of the SLC members and in completing the briefing on the SLC's motion to dismiss.

12. The legal fees incurred by Hemispherx are in response to an action filed by two stockholders who in the aggregate own (or, as of the August 26, 2013 conference, owned) 1,460 Hemispherx shares (*see* 8/26/13 conference transcript at 13), out of 183,853,828 Hemispherx shares that were issued and outstanding as of April 25, 2014 (*see* Form 10-Q filed May 9, 2014, at 1). At the stock's current trading price in the range of about $0.30, the Plaintiffs' investment in Hemispherx is worth approximately $438.00, yet their lawsuit is forcing Hemispherx to invest hundreds of thousands of dollars to defend against their claims.

13. The Supreme Court issued its *ATP Tour* decision, *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), on May 8, 2014. Hemispherx did not adopt the Amended Bylaw immediately. Rather, it waited,

because there were numerous press reports to the effect that the General Assembly might adopt legislation in response to *ATP Tour*. Only after the General Assembly ended its 2014 session without acting in response to the *ATP Tour* decision did Hemispherx adopt the Amended Bylaw, on July 3, 2014, modeling it very closely on the bylaw whose facial validity had been upheld in the *ATP Tour* decision. The clear purpose of the Amended Bylaw is to permit Hemispherx, in certain specified circumstances, to recoup its litigation expenses from litigants who file unsuccessful claims against Hemispherx and/or its officers, directors, or stockholders, and to require stockholder plaintiffs who do not have a large stake in the company to post security to cover the estimated amount of litigation expenses.

14. Hemispherx gave notice of the adoption of the Amended Bylaw through a Form 8-K filed with the SEC on July 10, 2014 (*see* Mot. Ex. A). Hemispherx further specifically notified Plaintiffs' counsel of the amendment by letter dated July 18, 2014, with which it provided copies of the July 10, 2014 Form 8-K and a full copy of the Company's Amended Bylaws (Mot. Ex. D). Plaintiffs filed their Motion three days later, on July 21, 2014.

15. This is Hemispherx's response to the Plaintiffs' Motion.

ARGUMENT

The Amended Bylaw Is Facially Valid

16. Because there is no record before the Court addressing the reasons why Hemispherx adopted the Amended Bylaw, and thus no context that would enable the Court to determine whether the Amended Bylaw was adopted for an inequitable purpose or has an inequitable impact, the Plaintiffs' Motion is definitionally a challenge to the Amended Bylaw's facial validity.

17. The first certified question in *ATP Tour* was whether the bylaw at issue there was facially valid. Using the analytical framework provided by the *ATP Tour* decision, one can conclude only that the Amended Bylaw at issue here is facially valid.

18. In *ATP Tour*, the *en banc* Supreme Court held that fee-shifting bylaws are "facially valid." 91 A.3d at 558. The Court was unequivocal in its ruling (*id.*) (citations omitted):

> A fee-shifting bylaw, like the one described in the first certified question, is facially valid. Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws. A bylaw that allocates risk among parties in intra-corporate litigation would also appear to satisfy the DGCL's requirement that bylaws must "relat[e] 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." The corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence.

> Moreover, no principle of common law prohibits directors from enacting fee-shifting bylaws.

19. The Supreme Court further ruled that "[t]o be facially valid, a bylaw must be authorized by the Delaware General Corporation Law (DGCL), consistent with the corporation's certificate of incorporation, and its enactment must not otherwise be prohibited." 91 A.3d at 558 (footnotes omitted). There is thus a three-part test to determine the facial validity of a bylaw: (a) Is the bylaw authorized by statute? (b) Is the bylaw authorized by the corporation's charter? (c) Is the adoption of the bylaw otherwise prohibited? Using that test, the Court held that "[a] fee-shifting bylaw, like the one described in the first certified question, is facially valid." *Id*. For the same reasons, the Amended Bylaw at issue here meets the three-part test and is facially valid.

20. (a) The adoption of the Amended Bylaw is authorized by Section 109(a) of the DGCL, which empowers boards of directors, where the certificate of incorporation permits it, to "adopt, amend or repeal bylaws," without limiting the right of the stockholders to do the same. The Amended Bylaw also satisfies the standards of Section 109(b), because it "relat[es] to the business of the corporation, the conduct of its affairs, and it rights or powers or the rights or powers of its stockholders, directors, officers or employees," and it thus addresses a permissible subject for bylaws. As the Court held in *ATP Tour*, "a bylaw that allocates risk among parties in intra-corporate litigation would also appear to

satisfy" Section 109(b). 91 A.3d at 558. With the language of the Amended Bylaw very closely tracking that of the bylaw that was the subject of the *ATP Tour* decision, the Court's analysis there applies equally here

21. (b) The adoption of the bylaw is also authorized by Hemispherx's certificate of incorporation. Specifically, Article Sixth of its certificate provides that "the Board of Directors is expressly authorized to make, alter or repeal the By-Laws of the Corporation, subject to the power of the stockholders to adopt any By-Laws or to amend or repeal any By-Laws adopted, amended or repealed by the Board of Directors" (Ex. A). Coupled with Section 109(a) of the DGCL, that provision in the certificate gives the Board the full power to adopt the Amended Bylaw.

22. (c) The adoption of the Amended Bylaw is not otherwise prohibited. There is nothing in the DGCL that bars the Board from adopting the Amended Bylaw, and the *ATP Tour* Court expressly recognized that contractual fee-shifting (with bylaws being considered a contract among the corporation's constituencies) is permissible, and thus that "a fee-shifting bylaw would not be prohibited under Delaware common law." 91 A.3d at 558.

23. For those reasons, there is no merit to the Plaintiffs' facial challenge to the Amended Bylaw, and their Motion must be denied.

24. Perhaps cognizant of the fact that any facial challenge to the Amended Bylaw would fail, Plaintiffs identify six factors which, they say, distinguish the Amended Bylaw from the bylaw that was involved in the *ATP Tour* case. *See* Motion ¶ 10. The fairest reading of Plaintiffs' presentation of those six factors is that they are designed to support an as-applied challenge, not a facial challenge, to the Amended Bylaw, which, as shown below, is premature. We nonetheless address them here.

25. Plaintiffs first contend that the Amended Bylaw's application to "passive investors in a publicly traded stock corporation" compels a different result than *ATP Tour*. But nothing in *ATP Tour* suggests that its holding on facial validity turned in any way on whether investors are passive or active, how many investors there are, or what their roles in the corporation are. Indeed, the DGCL draws very limited distinctions between stock and non-stock corporations, and between publicly held and private corporations, none of which are applicable here. *See, e.g.*, 8 Del. C. § 114(a) ("[T]he provisions of this chapter . . . shall apply to nonstock corporations."). Where there are distinctions, such as in appraisal rights if stock is listed on a national securities exchange, 8 Del. C. § 262(b)(1)(i), they have nothing to do with the issues presented in the Plaintiffs' Motion.

26. Plaintiffs next posit that the Amended Bylaw is not reciprocal, but that the *ATP Tour* bylaw is. But contrary to Plaintiffs' position, the portion of

the bylaw quoted in the Court's *ATP Tour* opinion does not shift fees reciprocally. Moreover, there is a form of reciprocity anyway, even if it is not set forth in the bylaw itself, because a stockholder who is successful in a derivative or class action filed in this Court will almost certainly be awarded a reasonable fee in an amount determined by the Court. *See, e.g.*, *Carlson v. Hallinan*, 925 A.2d 506 (Del. Ch. 2006) ("The Delaware courts award attorneys' fees in common fund cases first because the doctrine's 'underpinnings . . . lie in equity's desire to assure that persons who benefit from a lawsuit without contributing to its costs are not unjustly enriched at the successful litigant's expense.'") (quoting Donald J. Wolfe, Jr. & Michael A. Pittenger, CORPORATE & COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 13-3[c]). Stockholders who succeed in derivative or class litigation against a Delaware corporation have long been awarded attorneys' fees. The Amended Bylaw thus does not create a regime lacking in reciprocity; rather, it alters the current non-reciprocal regime by offering the possibility of reciprocity.

27. Third and fourth, Plaintiffs argue that the Amended Bylaw applies retroactively to litigation that has been pending for more than a year, since before the Amended Bylaw was adopted. While issue might appropriately be joined on that argument if the question were as-applied validity, there is nothing in the three-part *ATP Tour* test that suggests that retroactivity could make the

Amended Bylaw facially invalid. The Hemispherx Board is authorized by the certificate of incorporation to act with respect to bylaws, and "stockholders will be bound by bylaws adopted unilaterally" by the Board. *ATP Tour*, 91 A.3d at 560 (quoting *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 956 (Del. Ch. 2013)). Accordingly, the Amended Bylaw is on its face enforceable against stockholders who purchased stock before it was adopted, as well as against stockholders who had already commenced litigation at the time of enactment.

28. Fifth, Plaintiffs state that the express applicability of the Amended Bylaw to class and derivative litigation and federal securities actions is problematic. Although the Amended Bylaw does contain an express reference to such actions, it is not in substance any different in that respect from the bylaw in *ATP Tour*, which applied to the initiation or assertion of any claim, 91 A.3d at 556, a far-ranging description that inevitably includes class actions, derivative actions, and federal securities actions. The express versus implicit distinction between the two different bylaws has no significance here.

29. Sixth, Plaintiffs point out that the Amended Bylaw "imposes a bond requirement." Under the three-part test established in *ATP Tour*, the bond requirement does not make the Amended Bylaw facially invalid. The surety requirement is similar to statutory surety requirements that exist in other jurisdictions. For example, New York employs a statutory surety system that

permits a corporation to require a derivative plaintiff who holds less than 5% of any class of the corporation's outstanding stock to post surety for the defendants' anticipated expenses, including attorneys' fees. New York Business Corporation Law § 627.

30. Hemispherx wishes to make one concluding point about the meaning of the Amended Bylaw. Plaintiffs argue that the Amended 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 the case on a contingent basis, with liability for Defendants' fees and costs" (Mot. ¶ 6). Plaintiffs are correct that the Amended Bylaw applies against "any other person who joins with the Claimant, offers substantial assistance to the Claimant, or has a direct financial interest in any Claim . . . ." The very same words appear in the bylaw in the *ATP Tour* case, which apparently did not undermine the facial validity of that bylaw. But Plaintiffs are wrong to argue that the Amended Bylaw applies to counsel for a stockholder, and Hemispherx represents to the Court that it will neither interpret the Amended Bylaw to encompass counsel nor pursue a stockholder's counsel (including Plaintiffs' counsel here) to recoup litigation

expenses because a stockholder client of such counsel failed to substantially achieve its desired relief.[1]

It is Premature to Consider Any As-Applied Challenge to the Amended Bylaw

31. Although the Amended Bylaw is facially valid, the Plaintiffs have a right to challenge it as applied, if they choose to do so. The *ATP Tour* Court recognized that "the enforceability of a facially valid bylaw may turn on the circumstances surrounding its adoption and use." 91 A.3d 559. Whether a bylaw is enforceable as applied depends on the manner in which it was adopted and the circumstances under which it is invoked. *Id.* at 558. "Legally permissible bylaws adopted for an improper purpose are unenforceable in equity." *Id.* at 560.

32. To reach a conclusion about such matters, though, the Court needs an evidentiary record. That would presumably require the parties to engage in discovery about the timing, language, context, purpose, and effects of the Amended Bylaw as a predicate to their presentation of the matter to the Court in a trial.

[1] However, if a stockholder's lawyer violated another rule (*e.g.*, Court of Chancery Rule 11), or engaged in champerty, maintenance, or other wrongful conduct in connection with a stockholder's claim against the Company, such action would constitute an independent basis for potential liability by such counsel, and Hemispherx reserves its right to pursue appropriate sanctions in the event of such separate conduct.

33. The *ATP Tour* Court observed that "fee-shifting provisions are not *per se* invalid." 91 A.3d at 560. "[A]n intent to deter litigation would not necessarily render the bylaw unenforceable in equity." *Id.* Given Hemispherx's desire to deter expensive and unjustified litigation, it would appear to be likely that the Amended Bylaw would be found valid as applied, but Hemispherx acknowledges that that is a matter for another day.

34. Plaintiffs assert that they "are not restricted to challenging the 'facial validity' of the [Amended] Bylaw" (Mot. ¶ 11), yet because there has been no development of the factual record, the only challenge that they can now make is a facial challenge. Even without having had any discovery on Hemispherx's intent, plaintiffs hypothesize that "[t]he 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" (Mot. ¶ 8). That is not a fair characterization of Hemispherx's intent in adopting the Amended Bylaw, but if Plaintiffs wish to present an as-applied challenge, the parties must engage in discovery and then present evidence to the Court, and Hemispherx has no objection to the launching of such discovery. But it would deprive Hemispherx of its right to a hearing if an as-applied ruling were made on the present record.

35. For those reasons, any ruling at this time on the validity of the Amended Bylaw as applied would be premature.

Plaintiffs' Motion Is Not Ripe

36. The Amended Bylaw has not been applied in any sense of the word. The litigation has not ended; it cannot yet be determined whether Plaintiffs have failed to obtain a judgment on the merits that substantially achieves the remedy that they seek; Hemispherx has not yet decided whether it will seek to shift fees to Plaintiffs or in what amount; Hemispherx has not in fact sought to shift any of its fees to Plaintiffs; the Court has not been given an opportunity to rule on any such request; and it is not yet procedurally possible for either party to seek Supreme Court review of any ruling by this Court. Plaintiffs' entire argument about harm is hypothetical, and it will remain hypothetical unless and until Hemispherx attempts to enforce the Amended Bylaw against them. As a result, Plaintiffs are limited to a facial challenge to the Amended Bylaw, and their Motion is not ripe. *Stroud v. Grace*, 606 A.2d 75, 96 (Del. 1992) ("The validity of corporate action under [a bylaw] must await its actual use.").

37. If the litigation went forward to conclusion, there would be three junctures at which the Court would act as gatekeeper to determine the validity and enforceability of the Amended Bylaw, thus protecting Plaintiffs against arbitrary application of the bylaw. First, fee-shifting may occur only if the

Plaintiffs fail to obtain a merits judgment that substantially achieves the remedy that they seek. If the parties cannot agree whether that standard has been met, the Court must make the determination. Next, assuming that the Plaintiffs had not substantially obtained the remedy that they seek, the Court would need to decide whether the Amended Bylaw is enforceable against the Plaintiffs, and if so, in what amount. Finally, if Hemispherx sought a bond from the Plaintiffs, on the ground that they own far less than 5% of Hemispherx's issued and outstanding stock, Plaintiffs could ask the Court to determine whether surety had to be provided, and if so, in what amount. Plaintiffs thus have ample protection, afforded by the Court, against any improper use of the Amended Bylaw.[2]

Plaintiffs' Alternative Request for Dismissal of this Action

38. In the event the Court denies Plaintiffs' motion to invalidate the Amended Bylaw, or elects not to rule on the Amended Bylaw at this time, Hemispherx supports the alternative relief that Plaintiffs seek, namely dismissal of this action. The merits reason for dismissal is set forth in the SLC's Opening Brief

[2] Although Plaintiffs argue that the Amended Bylaw applies retroactively (Mot. ¶¶ 7, 10(iii)), that is not Hemispherx's intent. If one hypothesized a counter-factual scenario in which Hemispherx sought to apply it retroactively, Plaintiffs could include the retroactivity issue in an as-applied challenge to the Amended Bylaw, and the Court would then become involved at a fourth juncture.

in support of its Motion to Dismiss, but if Plaintiffs are willing to voluntarily dismiss the action, Hemispherx does not object.[3]

CONCLUSION

39. For the foregoing reasons, Hemispherx respectfully requests that the Court deny Plaintiffs' Motion to invalidate amended Section 5.07 of the Hemispherx Bylaws, or, in the alternative, grant Plaintiffs' motion to dismiss this action in its entirety.

Dated: August 8, 2014

Respectfully submitted,

/s/ M. Duncan Grant

M. Duncan Grant (Del. Bar No. 2994)
James H. S. Levine (Del. Bar No. 5355)
PEPPER HAMILTON LLP
Hercules Plaza, Suite 5100
1313 Market Street
P.O. Box 1709
Wilmington, DE 19899-1709
302.777.6500
grantm@pepperlaw.com
levinejh@pepperlaw.com

Attorneys for Nominal Defendant Hemispherx Biopharma, Inc.

OF COUNSEL:

Robert L. Hickok
Gay Parks Rainville
Michele C. Zarychta
PEPPER HAMILTON LLP
3000 Two Logan Square
Eighteenth and Arch Streets
Philadelphia, PA 19103
215.981.4000
hickokr@pepperlaw.com
rainvilleg@pepperlaw.com
zarychtam@pepperlaw.com

[3] The undersigned counsel are also counsel to the individual defendants in this action, who also support the alternative relief sought by Plaintiffs, namely dismissal of the action in its entirety.

CERTIFICATE OF SERVICE

I hereby certify that on August 8, 2014, the foregoing *Response of Nominal Defendant Hemispherx Biopharma, Inc. to Plaintiffs' Motion to Invalidate Retroactive Fee-Shifting and Surety Bylaw or, in the Alternative, to Dismiss and Withdraw Counsel*, was filed electronically via *File & ServeXpress*, which will provide notice of such filing to the following counsel of record:

Paul A. Fioravanti, Jr., Esq.
Patrick W. Flavin, Esq.
Prickett, Jones & Elliott, P.A.
1310 King Street
Wilmington, DE 19801

Michael P. Kelly, Esq.
Andrew S. Dupre, Esq.
Daniel J. Brown, Esq.
McCarter & English, LLP
Renaissance Centre
405 N. King Street, 8th Floor
Wilmington, DE 19801

/s/ James H. S. Levine
James H. S. Levine (Del. Bar No. 5355)