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Case No. 8559-VCN

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

RED OAK FUND, L.P., Plaintiff, v. DIGIRAD CORPORATION, JEFFREY E. EBERWEIN, CHARLES M. GILLMAN, JOHN M. CLIMACO, JAMES B. HAWKINS, and JOHN W. SAYWARD, Defendants.	)	C.A. No. 8559-VCN

PLAINTIFF'S ANSWERING BRIEF IN OPPOSITION TO MOTION TO DISMISS

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SUMMARY OF ARGUMENT

A § 225 case is designed to be a summary proceeding to address irregularities in an election of directors and protect the voting franchise of shareholders. As stated in *Hewlett v. Hewlett-Packard Co.*, 2002 WL 549137, at *9 (Del. Ch. Apr. 8, 2008), the Court's power under § 225 includes the "power to determine the validity of votes cast. To the extent . . . management procured proxies by disclosing material information that it knew to be false, . . . the plaintiffs' disclosure claim is cognizable in a proceeding under § 225(b)." *See also Zaucha v. Brody*, 1997 WL 305841, at *4 (Del. Ch. June 3, 1997) (addressing disclosure claims affecting the validity of consents in a § 225 action), *aff'd*, 697 A.2d 749 (Del. 1997). In other words, § 225 protects stockholder franchise rights including their "right to fairly conducted election of directors …." *Portnoy v. Cryo-Cell Int'l, Inc.,* 940 A.2d 43*,* 81 (Del. Ch. 2008).

Now, in an attempt to try the case on paper before Red Oak is afforded its right to discovery, Defendants have filed a Motion to Dismiss that rehashes arguments previously made to and rejected by this Court when considering Plaintiff's Motion to Expedite. Specifically, Defendants contend, as they did in their opposition to the Motion to Expedite [Trans. ID 52481592], that this case should be dismissed because, according to Defendants (1) the mere "prediction" of an outcome of a proxy contest does not violate Delaware or federal law; (2) their improper voting of treasury shares was never disclosed; (3) Red Oak's Verified Complaint fails to identify the specific shareholders that may have changed their vote or abstained from voting; (4) the negative financial information

included in Digirad's Form 10-Q, filed one day after the election. was either immaterial or had previously been disclosed; and (5) Defendants misconduct and misleading disclosures were not "outcome determinative."

As before, each of Defendants arguments is based on distortions of the facts alleged in Plaintiff's Verified Complaint [Trans. ID 52303940] and the inferences to be drawn from those facts. First, Red Oak has not merely alleged that Defendants "predicted" an outcome of a proxy contest. To the contrary, Red Oak alleged that Defendants made claims of sure victory, which numerous decisions and federal regulatory guidance confirm is a material misrepresentation. Red Oak alleges that those claims were particularly egregious here because in truth the election was very close, because Digirad improperly disclosed the results of preliminary non-public voting returns to certain shareholders, and because Digirad knowingly misrepresented the results of those non-public voting returns by incorporating treasury shares it had itself improperly voted. In addition, Digirad suggested in proxy materials that the company was experiencing "improved results" when it knew the opposite was true and delayed disclosure of the company's actual negative financial results until one day *after* the election. These verified factual allegations – all of which should be taken as true for the purposes of this Motion to Dismiss – are clearly sufficient to support a "reasonably conceivable" § 225 claim.

Defendants also argue that the Complaint should be dismissed because the alleged conduct was not "outcome determinative." As a legal matter, however, no such requirement exists under § 225 to plead that the improper or inadequate disclosures

related to an election were outcome determinative. To the contrary, Red Oak need allege, as it has, that Digirad affected the integrity of the election by making misrepresentations that were material. A disclosure is material if it would be viewed by a reasonable investor as altering the total mix of information made available. The verified facts in the Complaint, and basic common sense confirm any reasonable investor would consider how others were allegedly voting as altering the "total mix" of information available. And in any event, Red Oak did plead that Digirad's misconduct was outcome determinative.

For these reasons, and other reasons set forth in detail below, Defendants' Motion to Dismiss should be denied.

ARGUMENT

I. DEFENDANTS' BRIEF DISTORTS THE APPLICABLE STANDARD OF REVIEW.

Defendants contend that the Complaint fails to state a claim on which relief can be granted. *See* Ct. Ch. R. 12(b)(6). In Delaware, however, the pleading standards for purposes of a Rule 12(b)(6) motion "are minimal." *See In re China Agritech, Inc*., 2013 WL 2181514, at *23 (Del. Ch. May 21, 2013).

> When considering a defendant's motion to dismiss, a trial court should accept all well-pleaded factual allegations in the Complaint as true, accept even vague allegations in the Complaint as "well-pleaded" if they provide the defendant notice of the claim, draw all reasonable inferences in favor of the plaintiff, and deny the motion unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof.

(*quoting Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 536 (Del. 2011)). Thus, the operative test is one of "reasonable conceivability," *China*, 2013 WL 2181514, at *24, a test that is more lenient than the federal "plausibility" pleading standard, which instead invites judges to "determin[e] whether a complaint states a plausible claim for relief" and "draw on . . . judicial experience and common sense." *Id*. In Delaware, a complaint will not be dismissed for failure to state a claim unless it appears with reasonable certainty that, under <u>*any*</u> set of facts that <u>*could*</u> be proven to support the claim, the plaintiff would not be entitled to relief. *See In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 326 (Del. 1993); *Sample v. Morgan*, 914 A.2d 647, 662 (Del. Ch. 2007). In assessing the viability of a Complaint under Ct. Ch.. R.

12(b)(6), the Court must take all well-pled factual allegations as true and view all inferences therefrom in a light most favorable to the plaintiff. *See McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000); *Tri-Star*, 634 A.2d at 326. An allegation is well-pled if it puts the opposing party on notice of the claim being brought against it. *See VLIW Tech., LLC v. Hewlett-Packard Co.*, 840 A.2d 606, 611 (Del. 2003).

Red Oak's Verified Complaint easily meets the standards for surviving a motion to dismiss. However, Defendants Brief distorts the accepted "reasonable conceivability" test in an attempt to apply a more stringent standard. For example, Defendants cite *Lewis v. Aronson*, 466 A.2d 375 (Del. Ch. 1983), *rev'd on other grounds*, 473 A.2d 805 (Del. 1984) and *Grobow v. Perot*, 539 A.2d 180 (Del. 1988) for the proposition that the Court need not accept conclusory allegations without additional specific allegations of fact in support. *See* Defs. Br. 4. While Red Oak does not deny that mere conclusory allegations without underlying facts can and should be scrutinized, the cases cited by Defendant for this rather benign proposition involved claims under Court of Chancery Rule 23.1, where the standard for pleading demand futility is "more stringent" than the standard under Rule 12(b)(6). *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009). More importantly, even a cursory review of the detailed factual allegations in Red Oak's Verified Complaint confirms that there is nothing "conclusory" about the specific allegations of misconduct or the materiality of Defendants' improper and misleading disclosures. As such, Defendants mantra that this Court can disregard conclusory allegations is immaterial.

Similarly, Defendants' Brief attempts to cloud the applicable 12(b)(6) standards by including twenty attachments totaling over 400 pages. Defendants contend that the Court should consider the attached proxy solicitation material and SEC filings "in analyzing the sufficiency of the Complaint." Defs. Br. 15. While Red Oak does not dispute that a court *may* in appropriate circumstances consider matters outside the pleadings if they are not relied upon for the truth of the matter asserted, Defendants argument disregards the allegations in the Verified Complaint at issue, which relate to (1) improper **oral** disclosures by the Defendants and their representatives, and (2) misrepresentations and omissions concerning the company's negative first quarter financial performance. Defendants' decision to laboriously cite and analyze irrelevant written proxy materials is an attempt to shift focus away from the relevant issues in this case.

Ultimately, the crux of their argument is that Defendants dispute the substance and materiality of the alleged improper disclosures. In other words, Defendants contend that Red Oak's § 225 claim is either factually inaccurate or implausible. However, neither argument is appropriate at this stage of the proceedings. In fact, under Delaware's "reasonable conceivability" test, a trial court commits reversible error by assessing plausibility. *See China,* 2013 WL 2181514, at *23. *See also Cambium Ltd. v. Trilantic Capital P'rs III L.P.*, 36 A.3d 348, 2012 WL 172844, at *2 (Del. Jan. 20, 2012) (TABLE) ("The Court of Chancery erred by applying the federal 'plausibility' standard in dismissing the amended complaint.").

II. DEFENDANTS' FALSE AND MISLEADING CLAIMS TO SHAREHOLDERS OF "LANDSLIDE" ELECTION RESULTS WERE MATERIAL AND THEREFORE ACTIONABLE UNDER §225.

Notably, Defendants acknowledge that material false or misleading statements may be actionable under §225. Defs. Br. 17. Defendants argue, however, that representations that the election was already a "landslide" and was "all sewn up" were either (1) not false or misleading or, (2) if false and misleading, were not material. Defs. Br. 18-28. Defendant's premature argument on the merits is based largely on evasion of the actual allegations of the Verified Complaint. Defendants' argument also disregards the applicable standard for materiality under Delaware law, which is whether the information would have been viewed by "a reasonable investor would view as significantly altered the 'total mix' of information made available." *See Zaucha,* 1997 WL 305841, at *5 *(citing Rosenblatt v. Getty Oil Co.,* 493 A.2d 929, 944 (Del. 1985)).

A. Defendants Did More than Merely "Predict" the Election Outcome, They Knowingly Reported False Information Regarding the Election Results.

Defendants attempt to minimize the materiality of their false and misleading statements to shareholders by arguing that "a simple prediction of the results of a proxy context" does not violate Delaware or federal law.[1] Defendants also claim that the increased vote tally created by the improper vote of the treasury shares was immaterial because the votes were not reported to shareholders. *See* Defs. Br. 23.

[1] Notably, Defendants' position is directly contrary to the position they took during the election. As alleged in the Verified Complaint, on April 29, 2013, Digirad's CFO sent an email to Red Oak warning Red Oak that making statements to investors about the status of the vote would "constitute predictions about the results of the solicitation, in clear violation of Rule 14a-9." *See* Verified Complaint¶ 40.

The Verified Complaint alleges that Defendants did more than merely "predict" the outcome of an election. The Verified Complaint ¶ 38 specifically alleges that Digirad repeatedly reported to shareholders non-public preliminary tallies of votes that it knew to be inflated by its improper instruction to Raymond James to vote the company's treasury shares in favor of the management slate. Defendants' mere denial of the allegations of the Verified Complaint is not a basis to dismiss the Verified Complaint.[2]

Defendants' Brief does not dispute the proposition that claims made prior to a meeting regarding the results of a proxy solicitation would violate a board's fiduciary duties to its shareholders. Instead, Defendants argue that in this particular case, their claims of a landslide, in which they disclosed non-public preliminary voting tallies inflated by their own improper voting of treasury shares, were merely harmless "predictions" that did not violate Rule 14a-9 or their fiduciary duties.

As the Company acknowledged during the election itself, however, "[c]laims made prior to a meeting regarding the results of a proxy solicitation" are expressly suspect under Rule 14a-9. 17 C.F.R. § 240.14a-9. One effect of such claims is that "the average shareholder would not give the proxy statement careful consideration because the [vote] would appear to be a foregone conclusion." *Gould v. Amer. Hawaiian S.S. Co.,* 331 F. Supp. 981, 993 (D. Del. 1971). *Cf. Edelman v. Salomon*, 559 F. Supp. 1178, 1186 (D. Del. 1983) (misrepresentations that appear to make voting "a futile gesture . . . will

[2] Red Oak alleges that the improper vote of treasury shares was knowingly directed by Digirad. Complaint ¶ ¶36, 32. Defendants assert without support that the treasury shares were invalidly voted due to "Raymond James' mistake." Defs.' Br. 23. Again, Defendants' lawyers' contradictions of the verified allegations are of no import.

not provide a true reflection of the [shareholders'] desires…."). The Verified Complaint alleges that Digirad's Chairman Jeffrey Eberwein (Compl. ¶¶ 35-36), Digirad's proxy solicitor InvestorCom (*id*. ¶¶ 34, 39) and multiple other representatives (*id*.) made precisely such improper claims that the contest was "not even close" and was "a landslide." *Id*.¶ 36. The fact that Defendants intentionally premised their claims of certain victory on non-public preliminary information, compounded by the fact that they based their claims in part on voting instructions for treasury shares they *knew* could not properly be voted, further illustrates the violation and the breach of duty. *See Gould*, 331 F. Supp. at 991. These verified allegations show at least a "colorable claim" that Defendants violated their fiduciary duties to protect the voter franchise.[3]

Defendants argue that *Gould* and *Edelman* are distinguishable because both deal with allegations of false statements. Defs. Br. 22. To the contrary, both cases are directly on point. As in *Gould* and *Edelman*, Defendants here made false statements when they knowingly broadcast the results of non-public vote tallies skewed by the company's improper voting of treasury shares.

Defendants' Brief also seeks to diminish the holdings of the United States District Court for the District of Delaware in *Gould* and *Edelman* in favor of two Southern District of New York cases that supposedly tolerate conduct like Digirad's, but Defendants are mistaken. Defendants cite *Mgmt. Assistance Inc v. Edelman,* 584 F.

[3] Defendants repeatedly argue that their attempt to vote the company's treasury shares in their favor was immaterial because the Inspector of Elections uncovered their tactic and disallowed the votes. Defendants again miss the point. Red Oak alleges that Defendants knowingly inflated the voting tallies they wrongly disclosed to shareholders in their effort to claim the close election was a "landslide" and a foregone conclusion.

Supp. 1016 (S.D.N.Y. 1984), yet that case confirms that "claims of sure victory [are] potential violations of the rule." *Id*. at 1020. It is difficult to imagine more blatant claims of "sure victory" than those at issue here. *Id.* Where the federal laws mandate disclosure, Delaware law requires that any disclosure made be full and fair. *Unanue v. Unanue*, 2004 WL 5383941, at *9 (Del. Ch. Nov. 3, 2004, *revised*, Nov. 9,2004). *See also Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992); *Zirn v. VLI Corp*., 681 A.2d 1050, 1058 (Del. 1996) ("The goal of disclosure is, … to provide a balanced and truthful account of those matters which are discussed in a corporation's disclosure materials."); *Hoch v. Alexander,* 2011 WL 2633722, at *6 (D. Del. July 1, 2011) ("Hoch has properly pled that a material misstatement interfered with the voting rights of shareholders and that the false proxy statement breached Defendants' duties of loyalty and good faith ….") In fact, as explained in *Kennecott Copper Corp. v. Curtiss-Wright Corp*., 449 F. Supp. 951 (S.D.N.Y. 1978), a case cited by Defendants, Rule 14a-9 may be "violated by a claim of sure victory calculated to induce wavering shareholders to jump upon an apparently victory-bound bandwagon." *Id*. at 960. Again, Red Oak's Verified Complaint alleges that this is exactly what Defendants and their representatives did.

Further, it bears emphasis that the issue here is not to resolve Red Oak's claims under § 225 on the merits, but to address whether Plaintiff has pled a "reasonably conceivable" claim for relief. Notably, most of the cases cited by Defendants do not evaluate the merits of the Rule 14a-9 violation at issue until *after* discovery had occurred. *See Jewelcor Inc. v. Pearlman*, 397 F. Supp. 221, 227 (S.D.N.Y. 1975) (noting "extensive discovery" had taken place); *Gould*, 331 F. Supp. at 984, 999 (decision on

summary judgment after documentary and deposition discovery had occurred). Likewise, discovery is appropriate here, and the Motion to Dismiss should be denied.

B. The False and Misleading Claims were Made to Multiple Shareholders.

Defendants' Brief next argues that Defendants' claims of certain victory could not have been material because those claims supposedly were made to only one shareholder. *See* Defs. Br. 20 (the only specific allegation in the Complaint along these lines is that "Digirad '***predicted*** the outcome' of the Election to a *single shareholder* – Somerset.*"*)

First, Defendants' contention is false. The Verified Complaint ¶ 34 specifically alleges that

> Multiple representatives of the Management Slate, including its proxy solicitor InvestorCom, repeatedly represented to shareholders that management was assured of winning the election and maintaining its power over the company (emphasis added).

Somerset Capital is merely cited in the Verified Complaint as *one* example of Digirad's improper conduct. Red Oak need not plead all its evidence at the notice pleading stage. The allegation that numerous defendants (and Digirad's proxy solicitor) made such claims to multiple shareholders is well-pled and must be accepted as true for purposes of determining whether Plaintiff's § 225 claim is "reasonably conceivable."

Second, Defendants' argument misstates the materiality issue, which is not whether the information resulted in a changed vote for a particular shareholder, but rather whether there was "a 'substantial likelihood that the disclosure of the [the additional information] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available' to the shareholders." *Hewlett*, 2002

WL 549137, at *9. As noted in *Edelman*, "it is not important whether or not the complaining stockholders were deceived -- they could suffer equally damaging injury to their corporate interests merely because other shareholders were deceived in violation of federal law. Accordingly, they should be entitled to protect themselves against such violations to the same extent as if they, themselves, were the direct victims of the unlawful deception . . . ." *Edelman,* 559 F. Supp. at 1185. Here, the Verified Complaint alleges that numerous Defendants and their agents made claims regarding the outcome of the solicitation to numerous shareholders, and that the false claims were material to shareholders.

C. Defendants are Wrong When they Suggest that Their Improper Conduct was Immaterial Because Defendants Did not Know the Beneficial Owners of the Stock Held in Street Name.

Defendants contend that their claims to shareholders could not have been material because Defendants did not know the beneficial owners of stock held in "street name." Defs. Br. 16. First, whether Defendants knew some or all of the beneficial owners of stock held in street name is a matter of factual dispute, and cannot appropriately be resolved by a Motion to Dismiss. As such, Defendants' lawyers' denial of express allegations in the Verified Complaint, including the allegation that that Mr. Eberwein told shareholders he "knew which shareholders had voted and who they voted for" (Complaint ¶ 36), militates against resolving the case as a matter of law, not in favor of it. Second, Defendants' argument is simply wrong. It is widely known that proxy solicitors, such as those utilized by Digirad in its contest with Red Oak, are hired precisely to identify, contact and track the votes of many beneficial owners. *See* R. Franklin Balotti,

et al., *Meetings of Stockholders* § 7.8, at 7-27 to 7-28, § 7-29, at 7-31 (3d ed. 2011); Concept Release on the U.S. Proxy System, Securities Act Release No. 24-62495 (to be codified at 17 C.F.R. §§ 240, 270, 274 and 275 (July 14, 2010)), available at http:// www.sec.gov/rules/concept/2010/34-62495.pdf, at 23) ("issuer's sometimes hire third-party proxy solicitors to identify beneficial owners holding large amounts of the issuers' securities and to telephone shareholders . . . .").

D. Claims of Sure Victory Are Improper Regardless of the Company's Size.

Defendants take issue with Red Oak's allegation that claims regarding the outcome of a proxy contest are particularly inappropriate in the case of microcap companies. While it is must be taken as true, as alleged in Red Oak's Verified Complaint, that one reason a shareholder in a microcap company may be influenced by an improper or misleading proxy solicitation by management is because information regarding a microcap company's operations is typically less available to investors, s*ee* Complaint ¶¶ 21-24, the materiality of Defendants' improper conduct is not dependent upon that fact. Defendants' attempts to influence voting by falsely claiming a "landslide" victory are wrong and actionable regardless of the company's size.

Defendants' contention that any desired communications between shareholders and management would necessarily relate to "illegal or immaterial inside information" is absurd. Red Oak's Verified Complaint explains that microcap companies generally receive little or no market research or other investment coverage (which Defendants do not dispute). According to those accepted allegations, shareholders who contact

microcap companies are merely doing what market analysts often do with larger-cap companies. Shareholders may contact management for a myriad of reasons, such as to obtain information about the industry in general, competitors, products and many other things. Management has no obligation to accept or even return phone calls from every shareholder who may seek such information. Red Oak respectfully suggests that Digirad is not as naïve as it pretends in suggesting that anyone who communicates with a company's management must be committing securities fraud.

In any event, (a) Red Oak has alleged materiality, (b) Red Oak has explained the heightened materiality in the context of a microcap company, (c) Rule 14a-9 strongly suggests the materiality of false claims concerning the outcome of a proxy solicitation, and (d) Red Oak alleged a close election decided by only 6% of the company's outstanding shares. These all confirm that it is "reasonably conceivable" that the false claims directly impacted the election, and were at a minimum material. In fact, about 25% of Digirad shareholders did not cast votes in the election. If even a fraction of those shareholders failed to vote because Digirad's false claims of a landslide victory convinced them the result was "a foregone conclusion," those statements were undeniably material.

III. DEFENDANTS FAILED TO TIMELY DISCLOSE MATERIAL NEGATIVE FINANCIAL INFORMATION, WHILE AT THE SAME TIME TOUTING IMPROVED RESULTS.

Defendants' improper conduct was not limited to their false disclosures regarding the results of the proxy contest. Red Oak also specifically alleges that Defendants improperly withheld information regarding the company's financial results until one day

after the election in order to maximize management's chances of victory. Defendants' Brief does not deny that Digirad's management issued its Form 10-Q one business day after the annual meeting. Instead, the brief argues (1) that any delay in disclosing negative financial information was immaterial because the 10Q was not untimely; and (2) that the negative financial information disclosed after the election "had already been disclosed on multiple occasions."

Initially, the timeliness of the Digirad's filing of its 10-Q is a red herring. Whether the Company's 10-Q filing was due before or after the election misses the point. The issue is whether the Company should have disclosed material adverse financial information in its possession before the election. Red Oak's complaint is not that the 10-Q should have been filed earlier; it is that negative financial information known by management before the election should have been disclosed before the election. The need for timely disclosure was also heightened by the fact that the management slate's "fight letter," which Defendants attached to their brief, actually touted the upward movement in the company's stock price *during the same quarter.* *See* Ex. E to Defs. Br. 3. Red Oak is entitled to explore why Digirad focused on positive stock price movements in its proxy disclosures, but delayed disclosure of its substantially negative financial performance during the same time period.

Further, as a factual matter, Defendants' claim that the negative financial information was actually disclosed before the election is false or, at best, subject to reasonable dispute. Defendants rely on Digirad's Form 10-K, which was filed in March 2013, and various other SEC filings and pre-election proxy materials, for the proposition

that shareholders were already aware that Digirad "would incur charges" as part of the restructuring plan being debated between the two contestant slates. Based on these disclosures, Defendants contend that shareholders were aware of certain losses attributable to the restructuring that were later reported in the 10-Q. Once again, Defendants are missing the point. The losses attributable to restructuring were not the only or even most significant negative financial information that was known by management but withheld until after the election. For example, the following additional information was known before the election but not revealed until May 6, 2013, one day after the election: (1) that the company's net ***revenues*** were down year over year, and sequentially; (2) that the company's overall gross margin was down 24.3%, year over year; (3) that the adjusted net loss ***excluding*** the restructuring costs $1.405 M in the first quarter, which was up from $1.282M the prior year; and (4) that the general and administrative expenses as a percentage of revenue increased despite the fact that the new directors had been in place for a full year. *See* Form 10-Q dated May 6, 2013 attached as Ex. A to Defs. Br.

Defendants' contention that the shareholders were already fully aware of the negative financial information released on May 6, 2013 is a factual dispute that cannot be resolved in this Motion to Dismiss. For the purposes of this motion, Red Oak's Complaint includes a verified and well-pled allegation that negative financial information was not disclosed. Defendants' attempt to focus attention on only one aspect of the financials, *i.e.,* the losses attributable to restructuring, distorts Plaintiff's argument. Moreover, Defendants have not and cannot explain the suspicious timing of the financial

disclosures, the importance of which is magnified when combined with Digirad's other actions to impair the voting franchise of Digirad shareholders.

IV. RED OAK NEED NOT PLEAD THAT DIGIRAD'S MISCONDUCT WAS "OUTCOME DETERMINATIVE," BUT IN ANY EVENT IT HAS SO PLED.

Defendants argue, as they did in their opposition to the Motion to Expedite Discovery, that Red Oak's § 225 claims should be dismissed because the alleged improper conduct was not, according to Defendants, "outcome determinative." First, there is no requirement under § 225 that the inadequate or improper disclosure must necessarily be "outcome determinative." Rather, the relevant issue is whether the inadequate or improper disclosure was material. Indeed, Defendants' Brief concedes that the issue here is materiality. See Defs. Br. 17-18. Second, contrary to Defendants argument, the improper conduct in this case ***was*** outcome determinative. As alleged in the Verified Complaint, but for the misrepresentations, omissions and improper conduct, "the Management Slate would not have been elected." *See* Verified Complaint ¶46.

A. There is No Requirement under § 225 that Plaintiff Establish that the Inadequate or Improper Disclosure was Outcome Determinative.

Relying on four cases, Defendants argue that an actionable § 225 claim requires specific allegations that the improper or inadequate disclosures at issue were "outcome determinative." However, none of the four cases cited by Defendants actually support their position.

First, relying on a quote from *Zaucha*, 1997 WL 305841, at *5. Defendants state that the relevant question here "is not simply whether there was a disclosure violation, but whether any such violation warrants setting aside the result." *See* Defs. Br. 29.

Defendants then falsely suggest that under *Zaucha* a § 225 plaintiff must allege with specificity that any alleged improper disclosures were outcome determinative in order to survive a motion to dismiss. Contrary to Plaintiff's argument, the *Zaucha* Court did not even discuss the pleading requirements for a § 225 claim. The decision was the result of a trial on the merits. More importantly, in reaching its conclusion after trial that a new election was unwarranted, the court in *Zaucha* focused on the trivial nature of the violations themselves. The Court held that minor disclosure violations in plaintiff's consent solicitation did not justify putting the already financially troubled corporation to the expense of a second solicitation**.** *Id.* at *8. The Court also found that the consent solicitation was fundamentally fair and that the result represented the well-informed judgment of the shareholders. *Id.* Thus, at best, the *Zaucha* decision merely confirms the unremarkable proposition that this Court has the discretion not to set aside an election where only trivial disclosure violations are proved after trial.

The second case cited by Defendants, *Kurz v. Holbrook*, 989 A.2d 140 (Del. Ch. 2010), *aff'd in part and rev'd in part sub nom. Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010), is equally unpersuasive. *Kurz* did not involve improper or inadequate disclosures at all; the case concerned allegations of vote buying. Consistent with this Court's more modern approach to vote buying, Vice Chancellor Laster stated that "vote buying should merit review only if it is disenfranchising, in the sense of actually affecting the outcome of the vote." *Id.* at 178. This case is not about vote buying and the "outcome determinative" language in *Kurz* has no application here.

The third case, *A.R. Demarco Enters., Inc. v. Ocean Spray Cranberries, Inc.*, 2002 WL 31820970, at *7 (Del. Ch. Dec. 4, 2002) concerned a § 225 claim where the complaint failed to assert *any* flaws that would call the election into question. *Id*. Unlike here, no improprieties in the election process were alleged, nor was it alleged that the opposition slate in fact won the election. *Id*. Rather, the only allegation was that an immaterial number of votes (2%) were miscounted. The Court concluded that the alleged minor miscount could not have affected the vote because the management slate received 95% of the votes.

The last case, *Hewlett*, 2002 WL 549137, actually held that the plaintiff had a cognizable § 225 claim because he alleged that management procured proxies by "disclosing material information that it knew to be false." *Id.* at *9. As such, *Hewlett* makes clear that the standard is materiality, and not whether the particular misrepresentation or omission is outcome determinative. The "[M]ateriality standard is an objective one, measured from the point of view of the reasonable investor. It does not contemplate the subjective views of the directors, nor does it require that the information be of such import that its relevation would cause an investor to change his vote." *Zirn v. VLI Corp.*, 621 A.2d 773, 779 (Del. 1993).

Simply put, Defendants contention that a § 225 Plaintiff must allege precisely which and how many shareholder votes were affected by the improper or inadequate disclosure has no merit. No such requirement exists.

B. Even if an "Outcome Determinative" Test Did Exist, Red Oak Pled Sufficient Allegations to Meet the Alleged Test.

As noted above, Red Oak did plead that Digirad's misconduct was outcome determinative. The Verified Complaint ¶ 46 alleges that the election "lacked validity and integrity" and that "[b]ut for the individual defendants' misrepresentations, omissions and improper conduct – all in violation of the fiduciary duties – the Management Slate would not have been elected." Of course, as noted above, under the liberal notice pleading standard, Red Oak is not required to plead evidence. It is only required to provide a well-pleaded "short and plain statement of the claim showing that [it] is entitled to relief." *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 140 (Del. 1997) (quoting Ct. Ch. R. 8(a)).

Red Oak's allegations are quite similar to those in *Portnoy,* where the plaintiff claimed "that the election results should be overturned because the Management Slate would not have been elected had the … alleged breaches of duty not occurred." 940 A. 2d at 65. The facts pled in the Verified Complaint and the reasonable inferences drawn from them support Red Oak's contention that the Defendants' would not have been elected but for their misconduct. Statements about the outcome of elections are actionable because they make it appear that the outcome of the election is a foregone conclusion. *Gould*, 331 F. Supp. at 992.

V. RED OAK'S AMENDED ALLEGATIONS REGARDING DIGIRAD'S FAILURE TO DISCLOSE ITS PLANS TO ADOPT A RIGHTS PLAN STATES A CLAIM FOR RELIEF.

Red Oak filed an Verified Amended Complaint on June 13, 2013 that added allegations concerning Digirad's failure to disclose its plans to adopt a restrictive rights

plan, or "poison pill," before the election. [Trans. ID 52829508]. On June 18, 2013, Digirad moved to strike that amendment as supposedly constituting a "supplement" rather than an amendment ("Mot. to Strike") [Trans. ID 52896696]. Red Oak filed its opposition to Digirad's Motion to Strike on June 20, 2013. [Trans. ID 52926909]. Digirad's Motion to Strike also argued that the amended allegations fail to state a claim even if the amended complaint is procedurally proper. Digirad is incorrect.

Defendants argue that their failure to disclose that they intended to adopt a rights plan during the proxy contest was immaterial because it would not have altered the "total mix" of information available to stockholders. Mot. to Strike ¶¶ 16-18.[4] The only authority cited by defendants is *Coates v Netro Corp.*, 2002 WL 31112340 (Del. Ch. Sept. 11, 2002). *Netro*, however, is not on point because it did not involve disclosures in connection with a board election. Rather, Netro involved disclosure violations in a proxy statement soliciting shareholder approval for a redomestication merger pursuant to which a California corporation became a Delaware corporation. One and one-half months after the merger the Delaware company adopted a poison pill plan. Plaintiff alleged that the redomestication proxy statement failed to disclose the defendants' intent to adopt the poison pill. The court dismissed this disclosure claim because there was no evidence alleging that the defendants intended to adopt the poison pill at the time of the merger and the merger had nothing to do with the poison pill. Here, in contrast, defendants' stockholders were voting for directors, and not a redomestication merger. The directors'

[4] Defendants' argument about materiality is again at war with its own proposition that misrepresentations must be "outcome determinative" to be actionable under § 225. As explained above, there is no such test. The issue is materiality.

intention to adopt a poison pill had everything to do with whether they should be elected. As the amended complaint alleges, typically many shareholders oppose the adoption of poison pills (Am. Compl. ¶ 47). Indeed, proxy advisory firms often scrutinize boards that adopt poison pills without stockholder approval.[5] Moreover, unlike *Netro* where no reason for the disclosure was alleged in the complaint, plaintiff alleges that the reason that defendants should have disclosed their intention to adopt the poison pill and its contents because shareholders do, typically, oppose poison pills. Amended Complaint ¶ 47. Moreover, the Amended Complaint alleges that stockholders would have wanted to know that the poison pill did not prevent Digirad's directors from acquiring additional stock or that it exempted them in certain circumstances from the poison pill. Id. at ¶¶46-47.

Defendants also argue that the potential for the adoption of a rights plan was "plain for all to see," thereby excusing their failure to disclose that they were considering and intended to adopt a rights plan. Mot. to Strike ¶ 19. This argument should be rejected for several reasons. First, the "potential" for adopting a rights plan is a far cry from doing so. Second, Defendants rely on a July 3, 2012 Form 8-K which contains a 2012 standstill agreement. Neither the standstill agreement nor the 8-K is referred to in any way in the original Complaint or the Amended Complaint. Defendants' argument that during the proxy contest Digirad made statements that it intended to utilize its NOL's to increase its cash flow is meritless. Nothing in these statements remotely suggests that

[5] See ISS 2013 U.S. Proxy Voting Policies and Procedures, Frequently Asked Questions at p.10, April 2013 available at http:\\www.issgovernance.com\files\2013ISSFAQ_Policies.

Digirad was intending to adopt a poison pill. Finally, Defendants' argument that Red Oak's principal, Mr. Stanberg, is in no position to challenge the poison pill because he sits on the boards of two other companies that have similar rights plan is meritless because once again Defendants rely on information that is not within the four corners of the Complaint or the Amended Complaint. In any event, those supposed facts, even if true, obviously would not excuse Digirad from concealing its plan to adopt a management-friendly rights plan immediately after the annual meeting.

CONCLUSION

Defendants' arguments in favor of its Motion to Dismiss are meritless and ignore Delaware's lenient pleading standards to survive a motion to dismiss. Notwithstanding the numerous factual disputes articulated in Defendants' Brief, Red Oak's Verified Complaint and Amended Complaint set forth a reasonably conceivable set of circumstances susceptible of proof in support of its § 225 claim. Accordingly, Defendants' Motion to Dismiss should be denied and this case should move forward with discovery and trial.

Dated: June 21, 2013

PRICKETT, JONES & ELLIOTT, P.A.

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CERTIFICATE OF SERVICE

I hereby certify that on this 21st day of June, 2013, I caused a copy of the foregoing **PLAINTIFF'S RESPONSE IN OPPOSITION TO MOTION TO DISMISS** to be served through File & ServeXpress upon the following counsel of record:

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