IN THE SUPREME COURT OF THE STATE OF NEVADA

PARAMETRIC SOUND CORPORATION, TB HOLDINGS, INC., KENNETH POTASHNER; ELWOOD NORRIS; SETH PUTTERMAN; ROBERT KAPLAN; ANDREW WOLFE; and JAMES HONORE,

Petitioners,

vs.

THE EIGHTH JUDICIAL DISTRICT COURT, in and for the County of Clark, State of Nevada, and THE ELIZABETH GONZALEZ, District Judge,

Respondents,

and

VITIE RAKAUSKAS, individually and on behalf of all others similarly situated, and Intervening Plaintiffs RAYMOND BOYTIM and GRANT OAKES,

Real parties in interest.

No. 66689

District Court No. A-13-686890-B
Dept. No. XI

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SUPPLEMENTAL BRIEF OF REAL PARTIES IN INTEREST

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I. INTRODUCTION

Defendants avoid most of the Court's two-part request and instead, attempt to re-argue their appeal. Plaintiffs believe that responsive and sensible answers to this Court's specific questions, not unresponsive and heated rhetoric, will assist the Court in adopting an appropriate standard for this and subsequent cases. First, in *Cohen*, the Supreme Court applied the direct harm test and reached the correct result. The direct harm test makes sense, because it seeks to match standing with the injury suffered. Continued application of the direct harm test will thus align corporate law with Nevada standing jurisprudence in general. Courts applying the direct harm test uniformly allow stockholders of an acquired/target corporation to directly challenge the merger, just as this Court held in *Cohen*. Further, continued application of the direct harm test will not increase the likelihood of claims against directors. The right to bring a direct claim only confers standing, not success, and the substantive barriers to proving director liability in Nevada's statutory scheme are already stiff.

Next, Defendants avoid the Court's second question by advocating for a general rule that affords dilutive transactions special treatment under the law. To the contrary, "although some discrepancies exist in the case law, most courts have properly considered . . . actions to . . . prevent the improper dilution of voting rights" as direct claims. American Law Institute ("ALI"), Principles of Corporate Governance, §7.01 at 17-18.[1] Claims involving stockholder dilution do not warrant a separate category of treatment. Courts should – and generally do – analyze dilution claims similar to any other transaction. If the plaintiff stockholders are disproportionately and directly harmed as a result of the dilutive transaction, the claims are direct. If the corporation itself is the only entity harmed, the claims are derivative. And perhaps most importantly, if the people who benefited from the dilutive share issuance would

[1] All relevant portions of the ALI , Principles of Corporate Governance are attached to Real Parties in Interest's Appendix Volume I (RPI001-19), submitted herewith.

receive the lion's share of a lawsuit's recovery in a derivative claim, the claim is definitely direct.

In sum, the joint aims of a test for standing, in any legal context, should be to compensate the injured party and avoid compensating uninjured parties. No test for standing should seek to compensate, even in part, those who brought about the injury. The direct harm analysis, also adopted by the ALI Principles of Corporate Governance, correctly seeks to match the injury to the claimant, thus ensuring that injured parties are compensated for the harm and uninjured parties are not. The direct injury definition of the direct/derivative distinction squarely fits with basic principles of standing and fairness under Nevada law. Continued application of the direct harm test, just as this Court did in *Cohen* and the District Court did in this case, will meet these objectives and will provide a fair, sensible, and clear framework for all Nevada courts when addressing direct/derivative cases in the future. Here, the District Court properly applied the direct harm test as articulated in *Cohen* and correctly determined that the Complaint alleges direct harm to the plaintiff stockholders.

II. DIRECT HARM, SPECIAL INJURY, AND DUTY OWED – ANALYSIS, COMPARISON TO *COHEN*, AND RECOMMENDATION FOR NEVADA

This section addresses part one of the Court's September 3, 2015 Order: "First, the parties should address how the test articulated in *Cohen v. Mirage Resorts, Inc.*, 119 Nev. 1, 62 P.2d 720 (2003), compares to the three primary tests – direct harm, special injury, and duty owed – other jurisdictions use to distinguish direct suits from derivative suits. This analysis should include a critique of the tests, the effect, if any, the tests have on opening litigation floodgates against directors, and fairness considerations regarding whether shareholders or surviving entities are entitled to monetary judgments. Further, the parties should recommend the test best for Nevada to use to distinguish direct suits from derivative suits and articulate what facts must be alleged to sustain a direct shareholder lawsuit at the pleading stage."

A. Description and Analysis of the Three Tests

1. The Direct Harm Test

a. The Direct Harm Test Defined

Under the direct harm test, which is applied in a majority of jurisdictions across the country, a claim is direct if the plaintiff has "suffered harm independent of any injury to the corporation that would entitle him to an individualized recovery." *Feldman v. Cutaia*, 951 A.2d 727, 732 (Del. 2008).[2] To assert a direct claim, the plaintiff must "demonstrate[] that he or she can prevail without showing an injury to the corporation." *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004) (quoting *Agostino v. Hicks*, 845 A.2d 1110, 1122 (Del. Ch. 2004)). Harm to the corporation, however, does not preclude direct harm to the stockholder. *Protas v. Cavanagh*, No. 6555-VCG, 2012 Del. Ch. LEXIS 88, at *17-*18 (Del. Ch. May 4, 2012). The same transaction may inflict both derivative and direct harm on a stockholder, so long as the stockholder base "suffered a harm that was unique to them and independent of any injury to the corporation." *Gentile v. Rossette*, 906 A.2d 91, 102-03 (Del. 2006).

While the direct harm test has been around for decades,[3] in 2004, the Delaware Supreme Court articulated the test as follows: "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Tooley*, 845 A.2d at 1033. Many keystone jurisdictions now apply the two-part direct harm test as articulated in *Tooley*, in addition to Delaware. New

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[2] Unless otherwise noted, all emphasis is added, and citations and footnotes are omitted.

[3] *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969) ("The individual wrong necessary to support a suit by a shareholder need not be unique to that plaintiff. The same injury may affect a substantial number of shareholders. If the injury is not incidental to an injury to the corporation, an individual cause of action exists.").

York applies *Tooley*. *See, e.g.*, *Yudell v. Gilbert*, 949 N.Y.S.2d 380, 381 (N.Y. App. Div. 1st Dep't 2012) ("we adopt the test the Supreme Court of Delaware developed in *Tooley*"). California and Pennsylvania do too. *See, e.g.*, *New York City Emples.' Ret. Sys. v. Jobs*, 593 F.3d 1018, 1022 (9th Cir. 2010) (applying *Tooley* to California corporation); *Hill v. Ofalt*, 85 A.3d 540, 548 (Penn. Super. 2014) (applying *Tooley* to Pennsylvania corporation).

b. Analysis of the Direct Harm Test

The direct harm test has two significant advantages: (1) the direct harm test makes the most conceptual sense; and (2) it is straightforward and easy to apply. First, the direct harm test makes sense conceptually because it seeks to match direct or derivative ***standing*** with ***the injury*** suffered. And, of course, standing is traditionally a matter of injury regardless of the legal context. *See, e.g.*, *Elley v. Stephens*, 104 Nev. 413, 416, 760 P.2d 768, 770 (1988) ("In the context of an action of the type here present, a requirement of standing is that the litigant personally suffer injury that can be fairly traced to the allegedly unconstitutional statute and which would be redressed by invalidating the statute."); *Allum v. Valley Bank*, 109 Nev. 280, 283, 849 P.2d 297, 299 (1993) ("It is well-settled that to have standing as a RICO plaintiff, one's injury must flow from the violation of a predicate RICO act."); *Kirkpatrick v. Eighth Judicial Dist. Court*, 118 Nev. 233, 241, 43 P.3d 998, 1004 (2002) ("To establish standing [to challenge whether plaintiff received due process], [plaintiff] must show that he has suffered an injury in fact, that there is a causal connection between the injury and the conduct complained of, and that it is likely that the injury will be redressed by a favorable decision."). Continued application of the direct harm test aligns standing in corporate claims with Nevada standing jurisprudence in general.

Second, the direct harm test is clear and straightforward. The court in *Tooley* explained that the direct harm test's "simple analysis is well imbedded in our jurisprudence . . . ." *Tooley*, 845 A.2d at 1035. Other courts agree. *See, e.g.*, *Yudell*, 949 N.Y.S.2d at 381 (*Tooley* "has the added advantage of providing a clear and simple framework to determine whether a claim is direct or derivative"). Commentators agree as well. *See, e.g.*, Kleinberger, Daniel S., *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 Baylor L. Rev. 63, 88 (2006); Olson, Zachary D., *Direct or Derivative: Does It Matter After Gentile v. Rossette?*, 33 Iowa J. Corp. L. 595, 607 (2008).

2. The Special Injury Test

a. The Special Injury Test Defined

Under the special injury test, "'[a] special injury is a wrong that is "separate and distinct from that suffered by other shareholders, . . . or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation.'"" *Tooley*, 845 A.2d at 1035 (quoting *Moran v. Household Int'l. Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1986)); *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 330 (Del. 1993). Courts apply the special injury test to the plaintiff vis-à-vis other shareholders as opposed to evaluating the plaintiff's injury in relation to the corporation itself. *See, e.g.*, *Ring v. Kaplan*, Nos. A11-804, A11-969, 2012 Minn. App. Unpub. LEXIS, at *11 (Minn. Ct. App. Mar. 9, 2012) ("The determinative question is whether the injury was 'separate and distinct from the injury to other persons in a similar situation as the plaintiff.'"). The special injury test still appears in some states, including Georgia, Illinois, and Florida.[4]

[4] *See, e.g.*, *Barnett v. Fullard*, 306 Ga. App. 148, 152, 701 S.E.2d 608, 612 (Ga. App. 2010); *Rhombus Asset Mgmt. v. Pawlan Law, LLC*, 2014 IL App (1st) 122350-U, ¶75 (Ill. App. 1st Dist. 2014). Florida is an outlier jurisdiction and, strangely, requires that a plaintiff meet the special injury test ***and*** the direct harm test before bringing a direct claim. *See, e.g.*, *Dinuro Invs., LLC v. Camacho*, 141 So. 3d 731, 735 (Fla. Dist. Ct. App. 2014). Florida's test thus incorporates the illogical and inconsistent results of the special injury test in full.

b. Analysis of the Special Injury Test

In theory, the special injury test is simple and would ask one question: is this the only corporate stockholder with the same injury? If yes: direct claim. If no: derivative claim. But in practice, the special injury test is confusing and inconsistent. *See, e.g.*, Kleinberger, 58 Baylor L. Rev. at 93 ("The special injury rule is just as easily stated, but far more difficult to apply."); *Tooley*, 845 A.2d at 1035, 1038-39 ("The 'special injury' concept . . . can be confusing in identifying the nature of the action. . . . [S]ome cases have complicated [the direct/derivative analysis] by injection of the amorphous and confusing concept of 'special injury.'")). Despite its focus on "special injury" to the individual plaintiff, courts applying the special injury test frequently allow direct claims to proceed when all stockholders suffer the same injury. *See, e.g.*, *Harrington v. Batchelor*, 781 So. 2d 1133, 1135 (Fla. Dist. Ct. App. 2001) (allowing a shareholder to bring a direct suit for a breach of a shareholders' agreement, despite the fact that all shareholders would be affected in the same way by the breach); *see also, e.g.*, *Boyer v. Wilmington Materials, Inc.*, 754 A.2d 881, 903 (Del. Ch. 1999) (allowing a shareholder to bring a direct claim based on a special injury when other shareholders sold the corporation's assets). Similarly, under the special injury test, oppression of stockholders or interference with the right to vote is still a direct claim, even if all other stockholders suffered the same injury. *See Loewen v. Galligan*, 130 Or. App. 222, 228, 882 P.2d 104, 111 (Or. Ct. App. 1994) ("A special injury is established where . . . the wrong involves . . . the right to vote."). These paradoxical results – requiring special injury in name but not in practice – have caused the test to fall out of favor in many states.

The special injury test is also inherently illogical. It is true that when a shareholder's injury is derivative of corporate injury, all shareholders should usually have the same injury in common. But it does not logically follow that whenever shareholders have a common injury, then shareholders necessarily suffered their injury derivatively of the corporation. The special injury test assumes just that and "mistake a necessary condition for a sufficient one. '[A] direct, individual claim of stockholders that does not depend on harm to the corporation can also fall on all stockholders equally, without the claim thereby becoming a derivative claim.'" *AHW Inv. P'ship v. CitiGroup Inc.*, 980 F. Supp. 2d 510, 516-17 (S.D.N.Y. 2013). For a more detailed explanation of the logical problems inherent in the special injury test, *see* Kleinberger, 58 Baylor L. Rev. at 99-104. In short, "[w]ithout conceptual contortions, the special injury rule can produce some very bad results, especially where the plaintiffs claim breach of disclosure duties, improper dilution, or denial of voting rights." *Id.* at 99-100.

3. The Duty Owed Test

a. The Duty Owed Test Defined

The duty owed test requires the court to determine two things: first, whether a duty was breached, and second, to whom that duty was owed:

> [Under the duty owed test], what differentiates a direct from a derivative suit is neither the nature of the damages that result from the defendant's alleged conduct, nor the identity of the party who sustained the brunt of the damages, but rather the source of the claim of right itself. If the right flows from the breach of a duty owed by the defendants to the corporation, the harm to the investor flows through the corporation, and a suit brought by the shareholder to redress the harm is one 'derivative' of the right retained by the corporation. If the right flows from the breach of a duty owed directly to the plaintiff independent of the plaintiff's status as a shareholder, investor, or creditor of the corporation, the suit is "direct."

Stegall v. Ladner, 394 F. Supp. 2d 358, 364 (D. Mass. 2005).

The duty owed test means that the court determines the source of the right from "the corporation's articles of incorporation, state law, agreements among shareholders, or between the corporation and its shareholders." *G & N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227, 234-35, 237 (Ind. 2001). In a breach of fiduciary duty case, the analysis under the duty owed test is simple: is the fiduciary duty owed to the corporation (derivative claim) or is the fiduciary duty owed to the stockholders (direct claim)? *Id.*

The duty owed test is the least used test of the three, but some states, including Indiana, still use a duty owed analysis. *Id.*

b. Analysis of the Duty Owed Test

The duty owed test has one distinct advantage: especially with respect to Limited Liability Companies ("LLCs"), the duty owed test provides the greatest freedom of contract for shareholders and corporate management, allowing shareholders and corporate management to explicitly define whether and when to allow direct suit. It also allows legislatures and courts to clearly define the constituents to whom duties are owed. *See, e.g.*, NRS 78.138 ("Directors and officers: . . . liability to corporation and stockholders"); *Shoen v. Sac Holding Corp.*, 122 Nev. 621, 632, 137 P.3d 1171, 1178 (2006) ("the duty of loyalty requires the board and its directors to maintain, in good faith, the corporation's and its shareholders' best interests over anyone else's interests"). On the other hand, "[g]iven the loose way in which some [other] courts (and legislatures) describe the fiduciary duty of entity managers, the duty owed or rights infringed approach provides a bad lens through which to see the direct/derivative distinction." Kleinberger, 58 Baylor L. Rev. at 108-10. As a result, if the legislature, courts, or Articles of Organization of an LLC do not clearly specify to whom duties are owed, the duty owed test – if applied by itself – can result in inconsistent results. For that reason, if it is applied, the duty owed test is best utilized in conjunction with another test, rather than as a standalone basis to determine matters of standing.

4. Transactions Involving the Deception of Stockholders

One category of wrong warrants separate discussion in light of its identical treatment across all three tests. Courts widely recognize that transactions accomplished through the deception of stockholders are ill-suited for derivative treatment.[5] Where insiders cause the corporation to issue misrepresentations or non-disclosures to the stockholders in order to push through a deal that is disproportionately beneficial to the insiders, it does not make sense for the corporation to bring the claim – the misrepresentations are made about the corporation, not to the corporation. Kleinberger, 58 Baylor L. Rev. at n.155. Consequently, "[w]ithin all three [tests], if a shareholder claims that the corporation, directors, or controlling shareholder infringed upon the shareholder's voting rights, courts will allow the claim to be direct no matter which test is applied." Thompson, Elizabeth J., Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigations?, 35 Iowa J. Corp. L. 215, 235 (2009); *see, e.g.*, *Tri-Star Pictures*, 634 A.2d at 332 (special injury); *In re Ebix, Inc. S'holder Litig.*, No. 8526-VCN, 2014 Del. Ch. LEXIS 132, at *48 (Del. Ch. July 24, 2014) (direct harm); *Boehm*, 743 N.E.2d at 234 (duty owed). Put simply: "Where a shareholder has been denied one of the most critical rights he or she possesses – the right to a fully informed vote – the harm suffered is almost always an individual, not corporate, harm." *Ebix*, 2014 Del. Ch. LEXIS 132, at *48.

B. *Cohen* Employs the Direct Harm Test

The parties agree that *Cohen*'s analysis most closely resembles the direct harm test. *Cohen* dismissed derivative claims that: "[1] seek damages [on behalf of the corporation] for wrongful conduct [2] that caused harm to the corporation." 119 Nev. at 19. That phrase captures the *Tooley* test in reverse order. *Cohen* also used the

[5] *See, e.g.*, *Calamore v. Juniper Networks Inc.*, 364 F. App'x 370, 371 (9th Cir. 2010) ("[A] claim that shareholders were deprived of the right to a fully informed vote is direct under state law."); *Jobs*, 593 F.3d at 1022 (holding that a shareholder had a direct claim when it was deprived of the right to a fully informed vote because the injury "is independent of any injury to the corporation and implicates a duty of disclosure owed to shareholders"); *In re Bank of Am. Corp. Sec., Derivative & ERISA Litig.*, 757 F. Supp. 2d 260, 344 (S.D.N.Y. 2010) (holding that a breach of fiduciary duty claim based on a failure to disclose that deprived the shareholders of their right to cast an informed vote was a direct claim); *In re Cencom Cable Income Partners, L.P. Litig.*, No. 14634, 2000 Del. Ch. LEXIS 10, at *12 (Del. Ch. Jan. 27, 2000) ("Inadequate disclosures bearing on individual investors' right to cast a fully informed vote constitute direct claims.").

following language, which mirrors the direct harm test: "***A former shareholder does, however, have standing to seek relief for direct injuries that are independent of any injury suffered by the corporation***." *Id.* at 19. *Cohen* explained that claims alleging damages to stockholders resulting from an improper merger are direct, but if a complaint "seeks damages for wrongful conduct that caused harm to the corporation, it is derivative and should be dismissed." *Id.* Again, that language seeks to match the injury to the claimant, just like the direct harm test.

The *Cohen* decision also relies on the Delaware Supreme Court's holding in *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1246 (Del. 1999) for the proposition that claims involving mergers are direct. *Cohen* cites to *Parnes* six times, including the following crucial passage: "***Therefore, if the complaint alleges damages resulting from an improper merger, it should not be dismissed as a derivative claim***." *Cohen,* 119 Nev. at 19, 70, 73-76. This was not a novel holding. Despite defendants' protests to the contrary, this notion is now well accepted in direct harm jurisdictions:

> [T]he Plaintiff directly challenges the merger, and alleges that the merger was invalid due to the fact that a majority of the Board was interested or lacked independence. As such, it is a clear case of a direct claim. . . . the alleged wrong here was suffered by the shareholders, whose company was sold in an allegedly tainted transaction.

N.J. Carpenters Pension Fund v. infoGROUP, Inc., No. 5334-VCN, 2011 Del. Ch. LEXIS 147, at *41 (Del. Ch. Sept. 30, 2011). While *Parnes* predated *Tooley*, the Delaware Supreme Court held that *Parnes* squared with the *Tooley* analysis. *Tooley*, 845 A.2d at 1039 ("The proper analysis has been and should remain that stated in . . . *Parnes*. That is, a court should look to the nature of the wrong and to whom the relief should go.").

Cohen, *infoGROUP*, and *Parnes* are entirely consistent with the prevailing understanding of the direct harm test's application to mergers:

> [Under the direct harm test], [c]laims that management has sold out too cheaply in a merger are also examples of direct claims. Even assuming

> actionable mismanagement, the entity has suffered no injury. The consideration runs to the owners, not the entity, so any consideration "left on the table" would not have benefited the entity. The harm, therefore, is not only first, but also exclusively, to the owners. Any other conclusion would produce absurd results.

Kleinberger, 58 Baylor L. Rev. at 90-91. The inconsistency in Defendants' Supplemental Brief is plain – if they advocate that the direct harm test should apply, they should not turn their back on it and simultaneously argue that merger claims should be derivative. As proponents of the direct harm test, Defendants fail to confront the fact that direct harm jurisdictions uniformly allow stockholders of the acquired/target corporation to bring a direct claim challenging the merger. *See, e.g.*, *Cohen*, 119 Nev. at 19; *infoGROUP, Inc.*, 2011 Del. Ch. LEXIS 147, at *41; *Parnes*, 722 A.2d at 1246; Kleinberger, 58 Baylor L. Rev. at 90-91.

Cohen also contains ambiguity, however. *Cohen* cited to *Parnes* to support one curious sentence (highlighted in bold) which appears to resemble the special injury test: "A claim brought by a dissenting shareholder that questions the validity of a merger as a result of wrongful conduct on the part of majority shareholders or directors is properly classified as an individual or direct claim. ***The shareholder has lost unique personal property – his or her interest in a specific corporation.***" *Cohen*, 119 Nev. at 19.[6] The practical import of this sentence is unclear – it is not a legal concept addressed in the *Parnes* opinion. What is clear, however, is that the facts of *Cohen* establish that this sentence was not intended as a veiled adoption of the special injury test. Because all of the stockholders in *Cohen* were cashed out and lost their interest in the specific corporation, the plaintiff in *Cohen* did not in fact suffer an injury "unique" or "special" from the rest of the stockholder class. Moreover, the

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[6] Defendants argue that this sentence "***is*** the [d]irect [h]arm test," yet they point to no direct harm decision that requires the loss of "unique personal property." Petitioners' Supplemental Brief in Support of Petition for Writ of Mandamus, or, in the Alternative, Writ of Prohibition ("Supplemental Brief") at 17-18 (emphasis in original), nor do they explain how that phrase is consistent with the direct harm test.

sentence could not have been intended to limit direct claims to those only challenging a cash-out merger, as defendants contend. In support of that sentence, *Cohen* also cites *Smith v. Gray*, 50 Nev. 56, 68, 250 P. 369, 373 (1926), which addressed a claim involving a stock-for-stock merger that would carry surviving ownership in the acquiring company. In those circumstances, the *Smith* court recognized:

> Undoubtedly it is the law that, where the majority stockholders are oppressively and illegally pursuing a course, in the name of the corporation, which is in violation of the rights of the minority, and which can only be restrained by the aid of a court of equity, a stockholder may sue in equity on behalf of himself and other stockholders who may come in for appropriate relief.

Id. at 68-69 (citing 3 Pomeroy Eq. Jur. §1090 (4th ed.); Clark & Marshall, *Private Corporations*, §536 at 1661). While *Cohen* "waxes and wanes" and no doubt includes inconsistent language, the force of its analysis closely resembles the direct harm test.

C. Litigation Floodgates and Fairness Concerns

1. Tests for Standing Do Not Invite More Litigation - It Is the Substantive Statutory Scheme that Matters

We are aware of no study that directly compares the likelihood of litigation against directors to the direct/derivative tests employed in a jurisdiction. One study analyzed a related issue and concluded that "it is difficult to distinguish which specific test leads to the most shareholder success." Thompson, 35 Iowa J. Corp. L. at 234. In sum:

> While courts in Delaware, Illinois, and Indiana apply different standards to determine whether a claim is direct or derivative, the results tend to be similar. The reason for this is that courts in these three states have blurred the lines among the tests. While each jurisdiction claims to apply one test, all three jurisdictions alternate among the language of all three. It is this lack of distinction in actual application that causes similar results.

Id. at 235.

Nevada's continued application of the direct harm test will not open the floodgates for claims against directors. The right to bring a direct claim only confers standing, it does not confer success. The barriers to proving director liability in

Nevada's statutory scheme are stiff – these barriers dis-incentivize stockholders from bringing weak claims, regardless of whether they have standing to bring them. Nevada still presumes that directors act in good faith and on an informed basis. NRS 78.138(3). Nevada also allows directors to rely on other directors, officers, or employees in performing their duties. NRS 78.138(2)(a). And Nevada employs a strict limitation on director liability unless stockholders prove not only a breach of duty, but also that "[t]he breach of those duties involved intentional misconduct, fraud or a knowing violation of law." NRS 78.138(7)(b). According to the Defendants in this case, "'[d]irectors and officers may be held liable . . . only if their behavior was so egregious that it involved ***both*** a breach of the duty of loyalty ***and*** intentional misconduct, fraud, or a knowing violation of the law.'" *See* PA072 (emphasis in original).[7] The Complaint in this case met that burden and Defendants do not now contend otherwise. Where this extreme "egregious" behavior exists, it promotes no useful social policy to encourage insider malfeasance by dismissing the case based on a purported lack of standing.

Nevada's corporate code contains built-in provisions that also dam any merger related floodgates Defendants claim to have opened in other jurisdictions with more permissive liability schemes. Most notably, Nevada provides more discretion for directors to carry out their duties in a merger/change of control transaction than, for example, Delaware or California. Nevada employs a "constituency statute," unlike Delaware and California, which do not. *Compare* NRS 78.138(4) (allowing directors to consider multiple interests including the employees, suppliers, the community, and society) *with Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182, 185 (Del. 1986) ("The duty of the board had thus changed [in a sale process]

[7] Defendants contradict their arguments in the trial court and now claim that directors and officers of Nevada corporations are subject to "wide-ranging personal liability under direct claims brought by shareholders." Supplemental Brief at 19.

from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."); *Southern Union Co. v. Southwest Gas Corp.*, 180 F. Supp. 2d 1021 (D. Ariz. 2002) (applying *Revlon* to California corporation). Thus, Defendants point out that while 93% percent of all M&A deals announced in 2014 valued at over $100 million resulted in litigation, Defendants fail to mention that ***Nevada did not make the list of the top five states in which cases are brought nor is Nevada even mentioned in the leading report on the issue***. *See* Olga Koumrian, *Shareholder Litigation Involving Acquisitions of Public Companies,* Review of 2014 M&A Litigation, Cornerstone Research, Inc. (2015).[8] Yet merger-related claims have been direct in Nevada since this Court issued *Cohen* in 2003. Defendants agree that Nevada has a "unique legislative policy to treat change in control transactions (such as mergers) with the same deference provided to any other business decision adopted by a corporation's board of directors." Supplemental Brief at 19. Defendants err, however, when assuming that the conferral of standing relaxes the substantive standard of liability.

2. Fairness Considerations of Monetary Judgments

Defendants do not address this issue. They would surely agree, however, that the joint aims of any test for standing should be to: (a) compensate the injured party; and (b) avoid compensating uninjured parties. No court should intentionally adopt a test for standing that works to compensate, even in part, those who brought about the injury. Doing so would violate the maxim that the law does not permit a person to profit from her own wrong. *See, e.g., Igbinovia v. State,* 111 Nev. 699, 712, 895 P.2d 1304, 1312 (1995) ("a wrongdoer will not be allowed to profit from his or her own wrongdoing"); *Thompson v. Orcutt*, 257 Conn. 301, 316, 777 A.2d 670, 679-80 (Conn. 2001) ("'No one shall be permitted to profit by his own fraud, or to take

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[8] *Available at*: www.cornerstone.com/Shareholder-Litigation-Involving Acquisitions-2014-Review.pdf.

advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime. These maxims are dictated by public policy, [and] have their foundation in universal law administered in all civilized countries. . . .'").

The direct harm test accomplishes these objectives by matching the harm to the injury. To illustrate this point, Kleinberger posits the following example:

> Entity A agrees to be merged into Entity B. The managers of Entity A are grossly negligent in their "due diligence" and negotiating tactics and agree to a price far below any reasonably "fair" level. The gross negligence comes to light only after the merger has become effective. If the claims are derivative, they have transferred by operation of law to Entity B, the surviving entity which was benefited rather than harmed by the breach of the duty of care committed by the managers of Entity A.

Kleinberger, 58 Baylor L. Rev. at 91. Kleinberger calls this an "absurd result." *Id.*[9]

Now assume in Kleinberger's hypothetical that the managers of Entity B willfully aided and abetted the breaches of fiduciary duty by Entity A managers. The recovery on a derivative claim would be even more unfair. A derivative claim would not only doubly benefit Entity B, but it would also reward its managers for injury-causing malfeasance. Entity A's former stockholders, the ones who were harmed, would receive a pittance, even if they retained an interest in the surviving corporation. "And that's wrong. That is not the way that corporate law is supposed to work. Corporate law is supposed to give the benefit of the – of justice – to the people who were wronged." Exhibit 1 to Supplemental Brief, Tr. of Oral Arg., *In re Parametric Sound Corp.*, Case No. 6689 (Nev. Sept. 1, 2015) at 20:13-16.

D. A Recommendation for Nevada

Nevada should continue to apply the direct harm test, just as it did in *Cohen*. As a framework to apply the direct harm test, the *Tooley* – two-part test makes sense,

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[9] Among other positions, Kleinberger is currently a reporter for the Uniform Law Conference Drafting Committee on Series of Unincorporated Business Entities and is a member of the Executive Council, Business Law Section, Minnesota State Bar Association. *See http://web.wmitchell.edu/biography/daniel-kleinberger/.*

is recommended by Defendants, and is followed in multiple jurisdictions. But should the Court wish to adopt a slightly different framework that reaches the same results by incorporating both the direct harm and the duty owed tests, the ALI, Principles of Corporate Governance, Analysis and Recommendations, recommends the following test:

> **Direct and Derivative Actions Distinguished**.
>
> (a) A derivative action may be brought in the name or right of a corporation by a [stockholder] to redress an injury sustained by, or enforce a duty owed to, a corporation. An action in which the holder can prevail only by showing an injury or breach of duty to the corporation should be treated as a derivative action.
>
> (b) A direct action may be brought in the name and right of a holder to redress an injury sustained by, or enforce a duty owed to, the holder. An action in which the holder can prevail without showing an injury or breach of duty to the corporation should be treated as a direct action that may be maintained by the holder in an individual capacity.
>
> (c) If a transaction gives rise to both direct and derivative claims, a holder may commence and maintain direct and derivative actions simultaneously, and any special restrictions or defenses pertaining to the maintenance, settlement, or dismissal of either action should not apply to the other.
>
> (d) In the case of a closely held corporation [under chapter 78A of NRS] the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.

RPI003-04. The ALI also explains that "Section 7.01 can be implemented by judicial decision." RPI004.[10]

The ALI provides several examples of the facts that can be pleaded to support a direct claim for relief in the reporter's comments, which are authoritative and "express the views of the Institute." *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, No. 11-

[10] The ALI, Principles of Corporate Governance pre-dates *Tooley* and thus mentions the special injury test, but it references the test as an optional addition to permit direct claims, not to exclude them. RPI005.

17187, 2015 U.S. App. LEXIS 7027, at *59-*62 (9th Cir. Cal. Apr. 28, 2015) (relying on ALI comments to Principles of Corporate Governance, §7.01). With the support of significant case law, the ALI explains that "[t]he following claims are among those that have been treated as giving rise to direct actions by the majority of modern decisions:

> A. A claim to dividends.
>
> B. The right to inspect corporate books and records.
>
> C. The right to vote.
>
> D. A claim that a transaction will improperly dilute the shareholder's proportionate interest in the corporation or violate preemptive rights.
>
> E. Claims that corporate officials sought to "entrench" themselves or manipulate the corporate machinery so as to frustrate plaintiff's attempt to secure representation or obtain control.
>
> F. A claim that proposed corporate action should be enjoined as ultra vires, fraudulent, or designed to harm a specific shareholder illegitimately.
>
> G. A claim that minority shareholders have been oppressed or that corporate dissolution or similar equitable relief is justified.
>
> H. Claims that a proposed corporate control transaction, recapitalization, redemption, or similar defensive transaction unfairly affects the plaintiff shareholder.
>
> I. Actions to prevent oppression of, or fraud against, minority shareholders."[11]

RPI004-05, 012-14. Subsection "H" is consistent with the rule stated in *Cohen*, *Parnes*, and *infoGROUP* that "if the complaint alleges damages resulting from an improper merger, it should not be dismissed as a derivative claim." *Cohen*, 119 Nev. at 19, 70, 73-76.

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11 This item appears in the earlier list in ALI §7.01 comment c at RPI004-05.

III. WHETHER SHARE DILUTION CLAIMS CAN BE BROUGHT DIRECTLY OR DERIVATIVELY AND THE NECESSARY CONDITIONS FOR DIRECT CLAIMS

This section addresses part two of the Court's order: "Second, the parties should address whether share dilution claims can be brought directly or derivatively. If direct suits are sometimes permissible, the analysis should consider what conditions are necessary to allow a direct suit based on dilution." September 3, 2015 Order at 2.

Defendants advocate a "general rule" that "dilution claims are derivative only," Supplemental Brief at 19, but according to the ALI, "although some discrepancies exist in the case law, most courts have considered . . . the following as direct actions: . . . actions to . . . prevent the improper dilution of voting rights." RPI 004-05. Such actions are not the same as a so-called "diminution in value" claim, where defendants focus much attention. Supplemental Brief at 22-24. In a transaction that involves an unfair exchange ratio, like the Merger at issue here, the distinction is best described as follows:

> Under the facts plaintiff alleges, the overall value of [the corporation] at the time of merger was unaffected by defendants' actions since its purchase price was fixed irrespective of the number of shares outstanding. An increase in the number of outstanding shares arguably lessened the value of each share and was equivalent to a decline in stock price. Defendants avoided any loss of value through their purchase of additional shares, while ***plaintiff and other minority shareholders bore the burden of the lost ownership percentage. However, in contrast to diminution in value cases, neither [merging party] suffered any corporate injury as a whole, even though the diminished value of each individual share could arguably be calculated. . . . [Thus], "a shareholder has a direct right to attack a corporate transaction which dilutes his proportionate ownership***."

Lochhead v. Alacano, 697 F. Supp. 406, 411-12 (D. Utah).

Where a share issuance disproportionately harms a stockholder base, the claim is direct in a direct harm jurisdiction. Courts find that such transactions support a direct claim for relief under a variety of dilution-related fact patterns and for a multitude of reasons. First, as Defendants concede in their brief, multiple decisions permit shareholders to bring "expropriation" claims directly where "(1) a stockholder having majority or effective control causes the corporation to issue excessive shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders" (the "Transactional Paradigm"). *Vardanyan v. Moroyan*, No. 5:12-cv-05645, 2014 U.S. Dist. LEXIS 104236, at *13-*14 (N.D. Cal. July 29, 2014) (California law); *Gentile v. Rossette*, 906 A.2d 91, 100 (Del. 2006) (Delaware law); *Torian v. Craig*, 2012 UT 63, ¶26, 289 P.3d 479, 485 (Utah law); *May v. Coffey*, 2007 Conn. Super. LEXIS 877, at *16-*17 (Conn. Super. Ct. Mar. 30, 2007) (Connecticut law). The Complaint does not currently plead facts to fit within this scenario, but could be amended to do so.

Second, Delaware courts hold that direct stockholder "[s]tanding [on a dilutive stock issuance] will also exist if the board that effectuated the transaction lacked a disinterested and independent majority." *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 658 (Del. Ch. 2013). After relying on *Carsanaro* as an accurate statement of Delaware law in both their trial court briefing and their opening appellate brief,[12] Defendants now reverse course and claim that *Carsanaro* is "highly uncertain," "overbroad," and "conflicts" with Delaware law. Supplemental Brief at 27-28. Yet in *In re Nine Sys. Corp. S'holders Litig.*, No. 3940-VCN, 2014 Del. Ch. LEXIS 171 (Del. Ch. Sept. 4, 2014), another Vice Chancellor in the Court of Chancery reached the same conclusion. In *Nine Sys.*, the plaintiff stockholders challenged a recapitalization plan that diluted all of the company's non-insider stockholders on a pro rata, equally shared fashion. *Id.* at *68. After a detailed analysis of the law, the Delaware Chancery Court concluded that, "the Plaintiffs may also establish standing by proving that a majority of the Board was conflicted – here, meaning interested or

[12] *See* PA050-79; Petitioners' Reply Brief in Support of Petition for Writ of Mandamus, or, in the Alternative, Writ of Prohibition at 24.

not independent – when it approved and implemented the Recapitalization." *Id*. at *85-*86. Despite defendants' protests, two separate Vice Chancellors did not get it wrong – that is indeed the state of the law under the direct harm test. Plaintiffs' Complaint pleads facts that fit within this scenario. ¶¶23-34.[13]

Third, courts consistently permit stockholders to bring equity dilution claims directly where those stockholders lose collective control of the corporation or otherwise suffer a diminution in voting rights. *See Barber v. Modavox, Inc.*, No. CV-08-1896, 2008 U.S. Dist. LEXIS 106923, at *9-*10 (D. Ariz. Dec. 18, 2008) ("Plaintiffs' claim that the breach of fiduciary duty resulted in decreased voting power is a direct claim and will not be dismissed."); *Gentile*, 906 A.2d at 98 ("The defendants concede that a 'stock dilution' claim may be brought as a direct claim if voting rights are harmed."); *Baldwin Cty. Elec. Mbrshp. Corp. v. Catrett*, 942 So. 2d 337, 346 (Ala. 2006) ("[A]n action to protect shareholder or member voting rights can be maintained as a direct or individual action."); *Albers v. Edelson Tech. Partners, L.P.*, 201 Ariz. 47, 52, 31 P.3d 821, 826 (Ariz. Ct. App. 2001) ("Appellants' allegation that Defendants' wrongful actions decreased [Appellants'] voting power and control of the corporation states a cognizable claim for relief that may properly be maintained as a direct action.") (quotations omitted). Plaintiffs' Complaint pleads facts that fit within this scenario. ¶7.

Fourth, shareholders may bring an equity dilution claim directly where (1) the equity dilution stripped the shareholder of its ability to meaningfully participate in corporate affairs, and (2) a derivative action would primarily benefit a non-injured party. *See Kollman v. Cell Tech Int'l, Inc.*, 250 Or. App. 163, 279 P.3d 324 (2012). In *Kollman*, defendant-officer sold 90% of the corporation's shares to a third party at a price below fair market value. *Id.* at 176-77. The transaction diluted all shareholders,

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[13] All "¶" and "¶¶" references are to the Complaint, which is contained at PA001-49.

and did so equally. *Id.* at 174. The transaction also allowed defendant-officer to terminate plaintiff as an officer of the corporation, and increase defendant-officer's salary. *Id.* at 176. The court, applying the direct harm test, held that the shareholder could bring its claim directly because the equity dilution stripped the shareholder of its ability to meaningfully participate in corporate affairs and a derivative claim would primarily benefit the third party, who already benefitted by receiving 90% of the corporation's shares at an artificially low price. *Id.* at 184. Specifically, the court stated:

> As for the benefit of the recovery, were [defendant] correct that this action should be treated as derivative rather than direct, ***the lion's share of any recovery would go to [the corporation], ultimately to the benefit of [the third party], who already has benefitted from the breach of fiduciary duty***. Because our focus is on the nature of the harm, and because we decline to elevate form over substance in applying that test, we conclude that the trial court properly denied [defendant]'s motion for a directed verdict on [plaintiff]'s direct claim for breach of fiduciary duty.

Id. Plaintiffs' Complaint pleads facts that fit within this scenario. Complaint, *passim.*

Fifth, shareholders may bring equity dilution claims directly where the issuance of shares by corporate directors, officers, and majority shareholders involved fraud. *See Lochhead v. Alacano*, 697 F. Supp. 406 (D. Utah 1988). In *Lochhead*, the corporation's directors, officers, and majority shareholders issued shares to themselves at a price below fair market value while misleading stockholders in the process. *Id.* at 408. The transaction diluted the minority shareholders' equity interest. *Id.* at 411. When determining that minority shareholders could bring their equity dilution claims directly, the court held that (1) the corporation did not suffer a loss in value due to the issuance of additional shares because the issuance of additional shares only decreased the price of each share rather than the value of the corporation itself, and (2) a shareholder has an individual property right in maintaining the proportion between his stock and the entire capital stock, and a suit to protect this right is direct. *Id.* at 411-12. The court concluded: "Mr. Lochhead had the right to maintain his relative status as a stockholder and to protect his proportionate ownership interest against fraudulent dilution." *Id.* at 413. Plaintiffs' Complaint pleads facts that fit within this scenario. ¶¶8, 43-47, 57, 114-115.

IV. RESPONSE TO DEFENDANTS' SUPPLEMENTAL BRIEF

While Defendants use the Court's invitation for supplemental briefing as an opportunity to re-argue the merits of their appeal, the Court did not request another round of argument regarding the facts in this case. On those points, Plaintiffs rest on our earlier briefing, oral argument, and the application of direct/derivative tests contained therein, including our application of the direct harm test as articulated in both *Cohen* (Answer of Real Parties in Interest to the Petition for Writ of Mandamus or, in the Alternative, Writ of Prohibition ("Answering Brief") at 23-27) and *Tooley* (Answering Brief at 31-33), as well as our discussion of the Complaint under a dilution-based analysis (Answering Brief at 35-36). A few of Defendants' new (yet unresponsive) arguments are worth addressing, however, and Plaintiffs respond to those points as follows:

A. Defendants Misconstrue the Complaint's Allegations

Defendants' "summary of the transaction" contains averments found nowhere in the Complaint or the litigation record in general. Parametric was not a "nearly bankrupt company" at the end of 2013, Supplemental Brief at 2, it was a technology company with sound financials and "incredible potential, including the value of the Company's HyperSound (HSS(r)) technology." ¶103. On the other hand, "Turtle Beach's financial performance had rapidly deteriorated, having tripped its debt covenants with third-party lenders. It also appears that Turtle Beach's lenders forced the Merger in order for Turtle Beach to manipulate Parametric and access the public markets without incurring the expense of its own Initial Public Offering." ¶6.

Defendants do not confront the facts as alleged, which support a direct claim under the test as articulated in *Cohen*, *Tooley*, and by the ALI. Despite the unattractiveness of the transaction to Parametric public stockholders, the Parametric Board agreed that Turtle Beach could acquire Parametric through a stock issuance that specifically diluted Plaintiffs and the rest of Parametric's then-current stockholder base. ¶¶2-7. The Board received unique benefits not shared by stockholders at large. Its Chairman and Chief Executive, Kenneth Potashner, attempted to use the transaction to obtain personal control over a separate subsidiary "worth a billion" in his view, while multiple other directors demanded personal side payments in exchange for voting on the Merger. ¶¶22-34. Turtle Beach executives knowingly induced the Parametric Board to breach its fiduciary duties and, as a result, Turtle Beach insiders benefitted by obtaining 80% control of the combined entity. ¶¶3, 7, 36-47, 84-90. This special treatment contrasts with Parametric's then-current public stockholders, who were reduced from a collective controlling interest to approximately 20% ownership. ¶20. The Merger was effectuated through a fraud on Parametric's shareholders by a proxy issued by Parametric and approved by Turtle Beach. ¶¶8, 57, 114.

B. Defendants' Misconstrue the Direct Harm Test

As described above, the District Court faithfully applied *Cohen* in holding that this challenge to a merger is direct and *Cohen* is in line with precedent from direct harm jurisdictions. Kleinberger, 58 Baylor L. Rev. at 90-91 ("[Under the direct harm test], "[c]laims that management has sold out too cheaply in a merger are also examples of direct claims."). Critically, the plaintiffs in *Cohen*, *Parnes*, and *info*GROUP were all stockholders of the target/acquired company and lost collective control or were cashed out as a result of the mergers. *Cohen*, 119 Nev. at 19; *Parnes*, 722 A.2d at 1246; *infoGROUP, Inc.*, 2011 Del. Ch. LEXIS 147, at *41 ("the alleged wrong here was suffered by the shareholders, whose company was sold in an allegedly tainted transaction"). So too were the Plaintiff stockholders of Parametric. They were not stockholders of the acquiring Company; they were stockholders in an acquired company. They lost collective control and suffered unfair dilution of their shares, while Defendants received disproportionate benefits in the form of additional stock (Turtle Beach) and side payments (the Board). ¶¶22-114.

Defendants' only authority to support their contention that the District Court misapplied the direct harm tests consists of Delaware's *J.P. Morgan* decisions, however, *J.P. Morgan* does not undermine *Cohen* nor the District Court's application of *Cohen*. In *J.P. Morgan*, the plaintiffs were stockholders in the acquiring entity to a merger. *See In re J.P. Morgan Chase & Co. S'holder Litig. v. Harrison*, 906 A.2d 766, 768 (Del. 2006). The plaintiffs alleged that the acquiring company paid too much for a target entity and that this overpayment reduced the value of the acquiring company at large. *Id.* at 769. Thus, the plaintiff stockholders in *J.P. Morgan* were majority shareholders before and after the merger, they did not suffer a loss of control, they did not suffer a material diminution in voting power, their voting rights were not impaired or coerced, and they were not misled. *See generally id.* Unlike this case, in *J.P. Morgan*, no stockholder or director in the acquiring company received any unique or disproportionate benefit and, also unlike here, no stockholder group received uniquely unfair treatment in the merger. *Id.* The derivative nature of the claims in *J.P. Morgan* makes sense – if there was a harm of overpayment, it was suffered by the entire corporation, not by any subset group of stockholders. In that scenario, the recovery would benefit the corporation at large, as it should. In contrast here, the lion's share of the recovery would go back to wrongdoers who brought about the harm in the first place. As described above, such a result is unfair, illogical, and undermines traditional Nevada standing jurisprudence.

As explained in the Answering Brief, Plaintiffs' claims seek redress for their injuries as a result of the unfair 80%/20% valuation on their individual shares pursuant to the Merger. Plaintiffs could still prevail even if Parametric, as an entity, received an overall benefit by obtaining a larger company, Turtle Beach, as a subsidiary through the Merger. It would not matter to Parametric, the entity, if the ratio on the Merger were 80/20, or 50/50, or 99/1, or vice versa – the dilution ratio valuation of stock is an issue that pertains exclusively to shareholders, not the Company. Thus, the undervaluation of their individual shares, the misrepresentations in connection with the Merger, and the public shareholder class's loss of collective control of Parametric are all injuries to the shareholders – those are not injuries to Parametric, or Turtle Beach, the entity. *See*, *e.g.*, *infoGROUP*, 2011 Del. Ch. LEXIS 147, at *41-*42 ("If the Plaintiff's loyalty claim succeeds, it is the shareholders who would be entitled to compensatory damages for the value they lost when the Company was improperly sold.").

C. Defendants Misconstrue Dilution Cases

Defendants' answer to the Court's second question is based on a misinterpretation of the law when they state that "the ***only*** recognized exception to this general rule [that dilution cases are 'unequivocally' derivative under all three tests] applies in cases involving allegations of misappropriation of corporate assets by controlling shareholders." Supplemental Brief at 1 (emphasis in original). Defendants primarily cite to Delaware cases for this point, but then discard the rest of Delaware jurisprudence when advocating for their "controlling shareholder" requirement of direct standing. Indeed, Defendants' very premise has twice been rejected by the Delaware Court of Chancery: "that a controlling stockholder's conduct may be challenged through an expropriation claim that is both direct and derivative under *Gentile II* does not mean that an expropriation claim that is both direct and derivative may only be asserted against a controlling stockholder." *Nine Sys. Corp.*, 2014 Del. Ch. LEXIS 171, at *78-*80. That court further explained:

> [I]t makes little sense to hold a controlling stockholder to account to the minority for improper expropriation after a merger but to deny standing for stockholders to challenge a similar expropriation by a board of directors after a merger. After all, Delaware law endows the board – not a controller – with the exclusive authority to manage and direct the corporation's business affairs, the foremost example of which is the

> power to issue stock. Why, then, should Delaware law hold a controlling stockholder to a higher standard than the board of directors? After careful reflection, the Court has struggled to articulate a satisfactory answer. . . . Thus, as an alternative ground, the Plaintiffs may also establish standing by proving that a majority of the Board was conflicted – here, meaning interested or not independent – when it approved and implemented the Recapitalization.

Id. at *82-*86.[14]

Defendants also argue that *Carsanaro* creates "an exception that would swallow the rule," Supplemental Brief at 31, which is also an argument the Court of Chancery rejected: "Importantly, *Carsanaro* is consistent with, and does not swallow the whole of, the settled *Tooley* test because the circumstances that would support a dual expropriation claim, as recognized in *Gentile II*, remain narrow: '[t]he expropriation principle operates only when defendant fiduciaries (i) had the ability to use the levers of corporate control to benefit themselves and (ii) took advantage of the opportunity.'" *Nine Sys. Corp.*, 2014 Del. Ch. LEXIS 171, at *85. That is just what the Complaint alleges here.

V. CONCLUSION

Of the three tests for determining whether a shareholder's claim is direct or derivative, the direct harm test is the most widely used, offers the most clear and

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[14] Defendants' other cases do not support their position. *Sweeney v. Harbin Elec., Inc.*, No. 3:10-cv-00685-RCJ-VPC, 2011 U.S. Dist. LEXIS 82872 (D. Nev. July 26, 2011), which has never been cited or approved by any recorded decision, is addressed in the Answering Brief at 34-35. The rest of Defendants' citations do not involve claims by plaintiff stockholders who owned shares in an acquired company or otherwise suffered a material diminution in voting rights. *See, e.g.*, *Feldman v. Cutaia*, 951 A.2d 727 (Del. 2008) (challenging issuance of stock options to directors); *Schuster v. Gardner*, 127 Cal. App. 4th 305 (Cal. App. 2005) (issuing shares to defendants allowing them to go on an "acquisition spree," but no allegations of lost control or material diminution in voting rights); *May v. Coffey*, 291 Conn. 106, 967 A.2d 495 (Conn. 2009) (close corporation, no merger, no loss of control; plaintiff challenged a stock offering where all stockholders were allowed to participate); *Danielewicz v. Arnold*, 137 Md. App. 601, 769 A.2d 274 (Md. App. 2001) (no merger, no loss of control; plaintiff challenged his lack of a possessory interest to shares bequeathed in multiple wills); *Sw. Health & Wellness, LLC v. Work*, 282 Ga. App. 619, 639 S.E.2d 570 (Ga. App. 2006) (close corporation, no merger, no loss of control; plaintiffs challenged shares sold in order to obtain corporate financing).

simple standard, and was implicitly adopted by this Court in *Cohen*. The direct harm analysis, also adopted by the ALI Principles of Corporate Governance, correctly seeks to match the injury to the claimant, thus ensuring that injured parties are compensated for the harm and uninjured parties are not. The direct injury definition of the direct/derivative distinction squarely fits with basic principles of standing and fairness under Nevada law.

Nevada should, therefore, continue to apply the direct harm test. The District Court properly applied the direct harm test as articulated in *Cohen* and correctly determined that the Complaint alleges direct harm to the plaintiff stockholders. Under the direct harm test, allegations that a merger is "invalid due to the fact that a majority of the Board was interested or lacked independence . . . is a clear case of a direct claim . . . the alleged wrong here was suffered by the shareholders, whose company was sold in an allegedly tainted transaction." *infoGROUP, Inc.*, 2011 Del. Ch. LEXIS 147, at *41.

Last, claims involving stockholder dilution do not warrant a separate category of treatment, rather, if the Plaintiff stockholders are disproportionately and directly harmed as a result of the dilutive transaction, the claims are direct. This transaction unfairly diluted Parametric's then-current public stockholders, while Defendants received a disproportionate benefit. The direct harm test works to ensure that the injured parties, here the Plaintiff stockholders, receive the benefit of a recovery. For this reason, "although some discrepancies exist in the case law, most courts have properly considered . . . actions to prevent the improper dilution of voting rights" as direct claims. RPI004-05.

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I hereby certify under penalties of perjury that on this date I served a true and correct copy of the foregoing document by sending the document via email to the addresses listed below.

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