IN THE SUPREME COURT OF THE STATE OF NEVADA

CHARLES JESSEPH AND CHARLES CHURCHWELL, Appellants, v. DIGITAL ALLY, INC., Respondent.	Case No.: 78480

APPEAL FROM ORDER GRANTING MOTION TO DISMISS
THE EIGHTH JUDICIAL DISTRICT COURT
STATE OF NEVADA, CLARK COUNTY
HONORABLE ELIZABETH GONZALEZ

APPELLANTS' OPENING BRIEF

John P. Aldrich, Esq.
Nevada Bar No.: 6877
ALDRICH LAW FIRM, LTD.
7866 West Sahara Avenue
Las Vegas, Nevada 89117
702-853-5490

Steven J. Purcell, Esq.
Douglas E. Julie, Esq. (admitted pro hac vice)
Robert H. Lefkowitz, Esq.
PURCELL JULIE & LEFKOWITZ LLP
708 Third Avenue, 6th Floor
New York, New York 10017
212-725-1000

Attorneys for Appellants

NRAP 26.1 Disclosures

The undersigned counsel of record certifies that the following are persons and entities as described in NRAP 26.1(a) and must be disclosed. These representations are made in order that the judges of this court may evaluate possible disqualification or recusal.

Appellants Charles Jesseph and Charles Churchwell are, respectively, former and current individual stockholders of Respondent, represented by Aldrich Law Firm, Ltd. and Purcell Julie & Lefkowitz LLP.

DATED this 9th day of October, 2019.

ALDRICH LAW FIRM, LTD.

John P. Aldrich, Esq.
Nevada Bar No. 6877
7866 West Sahara Avenue
Las Vegas, Nevada 89117
702-853-5490
Attorney for Appellants

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JURISDICTIONAL STATEMENT

This is an appeal from a final order dismissing the action. The Notice of Entry of the Order Granting Respondent's Motion to Dismiss for Failure to State a Claim (the "Order") was filed on February 27, 2019. (Joint Appendix ("JA") 0252-55). The Notice of Appeal was timely filed on March 27, 2019. (JA 0256-58). This Court therefore has jurisdiction over this appeal under NRAP 3A(b)(1).

ROUTING STATEMENT

This case is presumptively retained for the Supreme Court under NRAP 17(a)(11-12) because it raises "as a principal issue a question of first impression involving ... common law," and because it raises "as a principal issue a question of statewide public importance." As the parties and District Court recognized, no Nevada decision expressly controls the precise issue presented here. The case is also presumptively retained under NRAP 17(a)(9) because it originated in business court.

ISSUE PRESENTED

Whether a Nevada court has discretion under the common law to award attorneys' fees and expenses to stockholders and their counsel for substantial benefits conferred on a corporation and its stockholders resulting from a pre-suit litigation demand that prompted the corporation to acknowledge and fix material defects in its capital structure.

STATEMENT OF THE CASE

This is an appeal from the District Court's Order granting Respondent Digital Ally Inc.'s ("Digital Ally" or the "Company") motion to dismiss for failure to state a claim under NRAP 12(b)(5).

Appellants Charles Jesseph and Charles Churchwell (collectively, the "Stockholders") are former and current stockholders, respectively, of Digital Ally who seek an award of attorneys' fees and expenses under the substantial benefit doctrine. The Stockholders and their counsel identified, and caused Digital Ally to fix, critical and destabilizing defects in its capital structure. Prior to commencing litigation, the Stockholders made a pre-suit litigation demand (the "Demand") on the Company's board of directors (the "Board"). Consistent with the underlying purpose of the pre-suit demand requirement, the Stockholders' Demand rendered litigation unnecessary, as the Board responded by correcting the problems the Stockholders had identified in the Demand by (1) withdrawing an unauthorized class of blank check preferred stock which stockholders had never authorized and the Company had improperly deemed approved, and which stockholders subsequently rejected in a re-vote; and (2) obtaining stockholder ratification of a 167% increase in the Company's authorized shares of common stock, a change previously deemed approved in a vote tainted by incorrect voting instructions the Company issued to its stockholders.

The Stockholders sought reimbursement of their attorneys' fees and expenses from Digital Ally for the substantial benefits obtained through the Demand. The Company rejected the request outright, forcing the Stockholders to file a complaint for fees and expenses on September 28, 2018 (the "Complaint"). (JA 0001-16). On November 13, 2018, Digital Ally moved to dismiss, asserting that that neither statute, court rule, nor the substantial benefit doctrine permitted any attorneys' fees to be awarded to the Stockholders. (JA 0018-26). The motion was fully briefed, and oral argument was held on January 14, 2019. The District Court ruled as follows: "In Nevada the substantial benefit doctrine is limited to litigation matters, at least in the currently decided cases. For that reason I'm going to go ahead and grant the motion." (JA 0248). On February 25, 2019, the District Court signed a form of order submitted by Digital Ally granting the Company's motion to dismiss, referring to its reasoning stated following oral argument and finding that "predicate litigation is an essential element for maintaining a claim for attorney's fees under the substantial benefit doctrine found in Nevada common law." (JA 0251).

STATEMENT OF FACTS

A. Parties

Jesseph owned Digital Ally's common stock from January 2015 until November 2015, and Churchwell has owned the Company's common stock

continuously since July 2015. (¶¶ 5-6).[1] Digital Ally is a Nevada corporation and producer of digital video imaging and storage products. (¶ 7).

B. Digital Ally makes unauthorized changes to its capital structure.

The requirements for amending a Nevada company's articles of incorporation are set forth in Section 78.390 of the Nevada Revised Statutes ("NRS"). Among other things, amending the articles of incorporation requires a stockholder vote in which a majority of the company's outstanding stock approve the amendment. (¶¶ 11, 28). When corporate matters are submitted for a stockholder vote, brokerage firms that are New York Stock Exchange ("NYSE") member organizations are subject to rules that govern their ability to vote shares held on behalf of beneficial holders. Beneficial holders are stockholders who hold their shares in accounts at brokerages such as JPMorgan Chase and E*Trade. Under NYSE Rule 452, a beneficial owner is entitled to instruct the broker how shares held in the beneficial owner's account shall be voted. If the beneficial owner does not provide any instructions, brokers are allowed to vote the shares owned by the beneficial owner only for "routine" matters, such as the ratification of the company's auditor. When a beneficial owner does not provide voting instructions, NYSE Rule 452 expressly prohibits a broker from voting the

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[1] All ¶ references are to the Complaint. (JA 0001-16).

beneficial owner's shares on "non-routine" matters, including any matter that "authorizes or creates a preferred stock or increases the authorized amount of an existing preferred stock." (¶ 23).

In 2015 and 2016, Digital Ally proposed two amendments to its Articles of Incorporation (the "Articles of Incorporation") that would change the Company's capital structure. On April 28, 2015, Digital Ally filed its Schedule 14A Definitive Proxy Statement with the U.S. Securities and Exchange Commission (the "SEC") in connection with the Company's 2015 Annual Meeting of Stockholders (the "2015 Proxy"). (¶ 25). The 2015 Proxy sought stockholder approval of four proposals, including an amendment to the Articles of Incorporation increasing the amount of Digital Ally common stock from 9,375,000 to 25,000,000 shares (the "Share Increase Amendment"). And on March 21, 2016, Digital Ally filed its Schedule 14A Definitive Proxy Statement with the SEC in connection with the Company's 2016 Annual Meeting of Stockholders (the "2016 Proxy," and collectively with the 2015 Proxy, the "Proxies"). (¶ 8). The 2016 Proxy sought stockholder approval of five proposals, including an amendment to the Articles of Incorporation creating 10,000,000 shares of a new class of stock known as "blank check preferred stock" (the "Preferred Stock Amendment," and collectively with the Share Increase Amendment, the "Amendments"). (¶ 9). Unlike common stock, which has fixed

rights under the Articles of Incorporation, the creation of blank check preferred stock would give the Board extraordinary discretion to determine, on a "blank check" basis, the voting, dividend, conversion, and other rights to be enjoyed by the holders of this new class of stock.[2]

The Proxies disclosed the majority vote requirement applicable under NRS 78.390, and explained to stockholders how failing to vote would impact the results. (¶¶ 14, 30). Specifically, with respect to the Amendments, beneficial holders of Digital Ally stock were expressly told that if they did not affirmatively submit voting instructions to their brokers (i.e., voting "for", "against", or to "abstain"), the brokers themselves would not have discretionary authority to vote on the Amendments, thus resulting in a so-called "broker non-vote" for those shares. (¶¶ 15, 31). Accordingly, stockholders were told that they could effectively vote their shares against the Amendments by choosing the simplest option available to them: not voting at all. (¶¶ 15, 31).

Following its 2015 Annual Meeting, the Company filed a Form 8-K with the SEC, disclosing the purported voting results on the Share Increase

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[2] "While [preferred stock] can be used to enable a company to meet changing financial needs, its most important use is to implement poison pills or to prevent takeovers by placement of this stock with friendly investors." See https://www.nasdaq.com/investing/glossary/b/blank-check-preferred-stock (last visited October 2, 2019).

Amendment proposal. (¶ 32). According to the 8-K, the Share Increase Amendment received the affirmative vote of a majority of the Company's outstanding stock, and Digital Ally's common stock reserve was increased from 9,375,000 to 25,000,000 shares. (¶ 32). After the 2016 Annual Meeting, the Company filed a Form 8-K with the SEC, disclosing the purported voting results on the Preferred Stock Amendment proposal. (¶ 16). According to that 8-K, the Preferred Stock Amendment received the affirmative vote of a majority of the Company's outstanding stock, and on that basis the Company created 10,000,000 shares of a new class of stock. (¶ 16).

However, read carefully, the voting results announced in the 8-K filings revealed that the Company had improperly permitted brokers to vote in favor of the Amendments even when the beneficial owners had not instructed them to do so. (¶¶ 18, 34). Allowing brokers to vote those shares was in direct contravention of the representations made to Digital Ally's stockholders in the Proxies, and with respect to the Preferred Stock Amendment, was also a violation of the NYSE rules. In both cases, these improperly cast broker votes were outcome-determinative – without them neither Amendment received the necessary votes for approval. (¶¶ 24, 36).

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C. The Stockholders make their Demand and the Board takes corrective action.

On May 18, 2017, the Stockholders served their Demand on the Board. (¶ 38). In their Demand, the Stockholders demonstrated that the Amendments were not validly approved, and advised the Board that the Stockholders would commence litigation unless the Board took corrective action. In response, Digital Ally acknowledged that the Demand had identified a problem "regarding the validity" of the stockholder votes on the Amendments. (¶ 41). To address the improper votes, the Company resubmitted the Share Increase proposal for another vote at a Special Meeting of Stockholders on August 14, 2017, and a majority of stockholders ratified the Share Increase Amendment. (¶ 41). With regard to the Preferred Stock Amendment, the Company did not seek a ratification vote and instead announced that this Amendment needed to be rescinded. (¶ 40). The Board then resubmitted the Preferred Stock Amendment to stockholders at the Company's 2018 Annual Meeting of Stockholders. (¶ 44). This time, after the votes were counted properly, it was revealed that a majority of stockholders had not approved the Board's proposal to create blank check preferred stock through the Preferred Stock Amendment. (¶ 44).

The Stockholders' Demand prevented the Company's capital structure from becoming destabilized. Digital Ally was prevented from issuing shares that

had not been properly approved, and was prevented from creating a new class of stock that its stockholders did not want and had not authorized. But for the corrective actions caused by the Stockholders' Demand, all future stockholder votes would have been contaminated. Digital Ally would not know which stockholders were voting invalid shares and which stockholders were entitled to dividends. With respect to the blank check preferred stock that was never authorized in the first place, the Company's recognition of the purported special rights of those stockholders would be wrongful, and any actions taken on the basis of those purported rights – including with respect to voting, the payment of dividends, and other preferences – would be invalid. The Company would become deeply unstable and exposed to myriad claims, including claims for damages, due to its failed capital structure.

The Stockholders sought to recover their attorneys' fees and expenses from the Company out of court. After Digital Ally refused to negotiate, the Stockholders filed their Complaint, which was dismissed with prejudice by the District Court.

SUMMARY OF ARGUMENT

As the parties and the District Court recognized, no Nevada court has squarely addressed whether the substantial benefit doctrine allows or prohibits an award of attorneys' fees and expenses for the successful prosecution of a

stockholder pre-suit litigation demand. The District Court's conclusion that fees cannot be awarded unless the benefit was obtained through filed litigation is wrong for three main reasons.

First, in *Thomas v. City of North Las Vegas,* 122 Nev. 82, 90-91, 127 P.3d 1057, 1063 (2006), this Court identified three elements that must be met before attorneys' fees and expenses can be awarded under the substantial benefit doctrine, and "litigation" is not one of them. According to *Thomas*, filed litigation is not a prerequisite for an award of attorneys' fees and expenses.

Second, prohibiting stockholders and their counsel from recovering attorneys' fees and expenses as compensation for the creation of a substantial benefit unless the stockholder achieved the benefit through filed litigation is fundamentally unsound policy. Delaware law, which Nevada often finds persuasive on undecided matters of corporate law, permits attorneys' fees and expenses to be recovered for successful pre-suit litigation demands as a matter of public policy. As Delaware has recognized, litigation is a means and not an end: when the assertion of a viable claim creates a substantial benefit for a corporation and its stockholders, stockholders are indifferent to whether the benefit was generated by litigation or a pre-suit litigation demand. Digital Ally identifies no contrary policy reason for prohibiting stockholders and their counsel from recovering fees and expenses in this context.

Third, even if the Court is prepared to find that "litigation" is a prerequisite for an award of attorneys' fees and expenses, it should find the requirement is met here because a stockholder pre-suit litigation demand is inherently an act of litigation required by statute and court rule as a precondition to bringing a lawsuit. That context clearly distinguishes the situation from *ad hoc* pre-suit communications in non-stockholder matters, thus limiting the substantial benefit doctrine to the specific context in which it arose.

STANDARD OF REVIEW

The Order granted a motion to dismiss for failure to state a claim under NRCP 12(b)(5) and is therefore reviewed de novo. *Dezzani v. Kern & Assocs.*, 412 P.3d 56, 59 (Nev. 2018).

ARGUMENT

A. The Complaint adequately pleaded the elements of the substantial benefit doctrine under existing law.

While parties ordinarily are expected to bear their own attorneys' fees under the so-called "American rule," Nevada recognizes a common law exception to this rule which "allows recovery of attorney fees when a successful party confers 'a substantial benefit on the members of an ascertainable class, and where the court's jurisdiction over the subject matter of the suit makes possible an award that will operate to spread the costs proportionately among them.'"

Thomas, 122 Nev. at 90-91, 127 P.3d at 1063 (quoting *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375, 393-94 (1970)). Citing federal precedent, the *Thomas* court established the following three-element test for recovering attorneys' fees and expenses under the substantial benefit doctrine. "To recover fees under the substantial benefit doctrine, a successful party must demonstrate that: (1) the class of beneficiaries is small in number and easily identifiable; (2) the benefit can be traced with some accuracy; and (3) the costs can be shifted with some exactitude to those benefiting." *Id.* at 91 (ultimately quoting *Alyeska Pipeline Co. v. Wilderness Soc'y,* 421 U.S. 240, 265 n.39 (1975)) (internal quotations and alteration indications omitted).

The Complaint sufficiently pleaded all three elements of the substantial benefit doctrine articulated in *Thomas*. The District Court did not find otherwise. The first element is satisfied because Digital Ally's stockholders are a sufficiently small and identifiable group, especially when compared to the taxpaying population of North Las Vegas (a city of more than 200,000 people), the group found to meet this element in *Thomas*. Indeed, *Thomas* specifically identified stockholder matters as the archetype for applying the substantial benefit doctrine. 122 Nev. at 91 ("Typically, the substantial benefit exception is applied in cases involving shareholders or unions."). As *Thomas* also explains, the third element is similarly satisfied when, as here, a stockholder confers a

benefit for all of the company's stockholders, because attorneys' fees "assessed against the corporation . . . are easily and equitably spread among the shareholders . . . who are the beneficiaries of the litigation." 122 Nev. at 91.

This leaves only the second element, i.e., the existence of a traceable benefit, which the Stockholders also satisfied. If not for the Stockholders' efforts, the Company's capital structure would have become highly destabilized by the existence and ultimate issuance of 15,625,000 unauthorized new shares of common stock and 10,000,000 shares of a new, unauthorized class of preferred stock. The issuance of those shares would have portended disaster and threatened to unravel the Company altogether. All future votes and dividend distributions at the Company would be contaminated. And the special, typically pro-management, rights granted to the new preferred shares would have been unenforceable, and any resulting actions taken in recognition of those purported rights would be invalid. Holders of the new stock and the common stock alike would have damages claims against the Company, and creditors could attempt to declare defaults on outstanding loans.[3]

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[3] The repeated lack of support for the Preferred Stock Amendment is not surprising – blank check preferred stock "has been derided by shareholder rights advocates given its potential use as an anti-takeover tactic[.]" *See Greenlight Capital, L.P. v. Apple, Inc.*, 2013 U.S. Dist. LEXIS 24716, at *5 (S.D.N.Y. Feb. 22, 2013); *see*

A recent Delaware Court of Chancery case recognized the substantial benefits associated with having caused a company to avoid these types of consequences, and awarded attorneys' fees to the responsible stockholder. *In re Galena Biopharma, Inc.*, C.A. No. 0423-JTL (Del. Ch. June 14, 2018) (TRANSCRIPT) ("*Galena*") (JA 0046-0113), involved, as here, a company that provided false instructions to its stockholders in connection with a vote to authorize a change in the company's capital structure to increase the authorized common stock. As here, the stockholders in *Galena* were told that brokers could not vote shares held by beneficial owners unless those owners provided voting instructions and brokers then voted those shares anyway. The case was resolved after the parties agreed that the company would have the court validate the company's articles of incorporation, thus eliminating uncertainty about the company's capital structure.[4] In approving the settlement, the court recognized

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also A Voice in the Boardroom, CORNERSTONE CAPITAL GROUP (July 2016) ("Many shareholders oppose [blank check preferred stock] as failing to align with shareholder interests."), available at https://cornerstonecapinc.com/wp-content/uploads/2017/04/A-Voice-in-the-Boardroom_July-2016.pdf (last visited October 2, 2019).

[4] Delaware courts can validate otherwise defective corporate acts and documents under 8 *Del. C.* § 205. Highlighting the sorts of problems that were avoided here because the Stockholders acted promptly, in *Galena* the company had intended to ask stockholders to ratify the articles of incorporation amendments at a special meeting, but was unable to do so because unauthorized shares had already been

that the stockholder had "fixed deep faults in the company's capital structure[.]"(JA 0106). The court held that the benefit obtained "easily supports a fee of $250,000[,]" the maximum allowable under the settlement agreement, and noted it "could support a much larger award" based on precedent. *Id.* The court explained that "giving meaningful awards where plaintiffs raise issues that result in companies taking validative action has important incentive effects" even where "companies can, with a relatively straightforward procedure, take steps to fix things." *Id.*[5]

Because the Stockholders satisfied the elements of the substantial benefit doctrine, Digital Ally's motion to dismiss should have been denied.

B. Filed litigation is not required for an award of attorneys' fees under the substantial benefit doctrine.

Despite the *Thomas* court's articulation of a three-element test, Digital Ally asserted, and the District Court agreed to add, a fourth element to the doctrine. The District Court determined that attorneys' fees and expenses cannot

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issued and contaminated a potential ratification vote. Because of this, the settlement also included a payment to certain stockholders, which was subject to a separately calculated attorneys' fees award.

[5] The court also rejected the company's argument that "this was a problem that the plaintiffs created[,]" a position the court described as reflecting "a profound lack of awareness" given that the problem would have been avoided altogether if the company's disclosures had been accurate in the first place. (JA 0095-96).

be recovered under the substantial benefit doctrine unless the benefit was conferred through filed litigation. The Court should reject this additional element.

Digital Ally's argument that Nevada precedent requires a benefit to have been generated *in litigation* is unsupported by any of the four cases the Company relied on for that proposition. (*See* JA 0022-23, 0228-29). As Digital Ally admitted, the cases are silent on this point. (JA 0241). In *Thomas*, what the court found "determinative" is that the plaintiffs could not meet the substantial benefit doctrine's "third factor required for relief because they ha[d] not demonstrated that the costs will be shifted to those benefiting." 122 Nev. at 92. In *Guild, Hagen & Clark, Ltd. v. First National Bank*, attorneys' fees were denied because the benefit inured to a non-party, and was generated incidentally to counsel's failed efforts to obtain relief for his client. 95 Nev. 621, 624-25 (1979). In *Wagner v. City of North Las Vegas*, the court reversed a denial of attorneys' fees and remanded the case because the district court failed to apply the *Thomas* factors. 2013 Nev. Unpub. LEXIS 1947, at *3 (Nev. Dec. 18, 2013). And in *Schulz Partners, LLC v. Zephyr Cove Prop. Owners Ass'n, Inc.*, the court found that the plaintiff "had failed to prove its substantial benefit argument" because plaintiff

was neither "successful" nor "prevailing." 2011 Nev. Unpub. LEXIS 1047, at *8 (Nev. July 5, 2011).[6]

None of these cases address, consider, or even mention an application for fees outside of filed litigation. Thus, the cases cannot be interpreted to support the contention that fees are categorically unavailable for successful pre-suit litigation demands. While litigation terminology appears in these cases, it is not because litigation is a requirement; it is simply because the substantial benefit doctrine was invoked following filed litigation in those cases. *Argentena Consol. Mining Co. v. Jolley Urga Wirth Woodbury & Standish,* 125 Nev. 527, 536, 216 P.3d 779, 785 (2009) (a statement in precedent that is "unnecessary to a determination of the questions involved" is *dictum* and is not controlling) (internal citation omitted).

Nor do these cases imply that litigation is a prerequisite for a recovery of fees and expenses. As both Digital Ally and the District Court acknowledged, whether the substantial benefit doctrine permits fees and expenses to be awarded for a successful stockholder litigation demand is a matter of first impression in

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[6] The Stockholders are cognizant of the NRAP 36(c)(3) prohibition on relying on unpublished decisions issued before 2016, and cite the above authorities solely to address Digital Ally's reliance on them in the Motion to Dismiss before the District Court.

Nevada. (JA 0241-42). The District Court's ruling that "the substantial benefit doctrine is limited to litigation matters, at least in the currently decided cases" was not an assessment that Nevada law actually limits the reach of the doctrine, or that it should limit the reach of the doctrine, but rather was merely an observation about the existing cases. (JA 0248).

C. Permitting attorneys' fees for successful stockholder litigation demands is appropriate policy for Nevada.

As noted above, in *Thomas* this Court recognized that cases involving stockholders are the paradigm for awarding fees under the substantial benefit doctrine. Permitting stockholders to recover attorneys' fees and expenses for successfully prosecuting a demand without the need for litigation is sound policy, as it fulfills the purpose of the doctrine: incentivizing stockholders to promote the good of their co-investors by spreading the costs of making a successful demand.

This Court routinely looks to Delaware precedent as persuasive authority in shaping Nevada's law on corporate matters.[7] Operating under a rule materially

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[7] *E.g., Parametric Sound Corp. v. Eighth Judicial Dist. Court*, 401 P.3d 1100, 1102 (Nev. 2017) (noting past reliance on Delaware corporate law precedent and adopting Delaware's test for distinguishing between direct and derivative stockholder claims) (citing *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004)); *Kahn v. Dodds* (*In re AMERCO Derivative Litig.*), 127 Nev. 196, 218, 252 P.3d 681, 697 (2011) ("To determine whether demand upon the board is excused, we apply standards articulated by the Delaware Supreme

identical to NRCP 23.1,[8] which imposes the demand pleading requirement, Delaware judges have concluded that the policy underlying the substantial benefit doctrine applies with equal force to litigation and pre-litigation demand resolutions of meritorious claims. *Bird v. Lida*, 681 A.2d 399 (Del. Ch. 1996); *Raul v. Astoria Fin. Corp.,* 2014 Del. Ch. LEXIS 103, at *16-17 (June 20, 2014). In so holding, Delaware courts have explicitly rejected the arguments Digital Ally made to the District Court. Specifically, the Delaware Court of Chancery rejected the argument that attorneys' fees must be unavailable for a litigation demand on the ground that precedent required claims to be meritorious "when filed" – an argument dismissed as "stunted literalism" not "grounded in theory or practice[.]" *Bird*, 681 A.2d at 404-05.

Court"; further citing six Delaware Court of Chancery decisions) (citations omitted); *Shoen v. SAC Holding Corp.,* 122 Nev. 621, 641 (2006) (finding "[t]he Delaware court's approach is a well-reasoned method for analyzing demand futility and is highly applicable in the context of Nevada's corporations law").

[8] Compare NRCP 23.1 ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort.") *to* Del. Ch. R. 23.1(a) ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

The policy underlying Delaware's rule is that public corporations and their stockholders face a collective action problem because, although expenditures on monitoring public companies and enforcing directors' fiduciary duties benefit stockholders collectively, each individual stockholder owns only a fraction of the corporation and therefore has "little incentive to incur those costs himself in pursuit of a collective good[.]" *Bird*, 681 A.2d at 403. The law solves this problem by "awarding to successful shareholder champions and their attorneys risk-adjusted reimbursement payments (i.e., contingency based attorneys' fees)." *Id.* (citation omitted).

However, racing into court is not the only way to remediate corporate wrongdoing. Nor is it the most efficient when, as here, a stockholder can prompt the correction of discrete, actionable wrongdoing by demanding that the company's directors address the issue or face litigation should they refuse. "Substantially the same benefit accrues to the corporation whether it be as a result of the demand or of successful litigation." *Id.* at 404 (citation omitted). Permitting recovery of attorneys' fees for a successful litigation demand serves many positive purposes, not the least of which is discouraging unnecessary litigation and avoiding costs while encouraging stockholder vigilance and careful management by the company's insiders. *See id.* (citation omitted).

The American Law Institute ("ALI") also recommends that stockholders be permitted to recover attorneys' fees for successfully prosecuting litigation demands. Section 7.17 comment e of ALI's Principles of Corporate Governance: Analysis and Recommendations states that "the criterion [for an attorneys' fee award] should be whether the plaintiff's demand or complaint was a significant cause of the relief undertaken by the defendants, not whether plaintiff obtained a judgment or settlement." (emphasis added). By contrast, Digital Ally presented no explanation for why sound public policy would deny attorneys' fees and expenses to stockholders who obtained a substantial benefit through a pre-suit litigation demand. Instead, Digital Ally primarily relied on a Michigan decision, in which the court explained that the stockholder-plaintiff who sought a fee for prosecuting a demand had "advanced many reasonable arguments as to why it may be both sensible and fair to permit a fee award under these circumstances" but rejected the application on the grounds that it was foreclosed by controlling Michigan law, law that is not applicable in Nevada. *See Willner v. Syntel*, 256 F. Supp. 3d 684, 696 (E.D. Mich. 2017); (JA 0024).[9]

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[9] The *Willner* court found that to the extent the substantial benefit doctrine existed "at all" in Michigan, it was not consistent with the federal articulation of the doctrine relied upon in *Thomas*, and that Michigan's statute governing derivative actions expressly required filed litigation to obtain any award. *See* 256 F. Supp. 3d

This case exemplifies why sound policy supports providing compensation for successful pre-suit litigation demands. Attorneys' fees are not awarded to promote litigation, but to provide incentives to encourage appropriate corporate monitoring which ultimately produces positive outcomes for corporations and stockholders. *See In re Activision Blizzard, Inc. S'holder Litig.*, 86 A.3d 531, 548 (Del. Ch. 2014) ("'In [incentivizing counsel with contingent fees], corporations are safeguarded from fiduciary breaches and shareholders thereby benefit.' Understood from this perspective, well-founded stockholder litigation becomes 'a cornerstone of sound corporate governance.'") (citations omitted).

Here, potentially catastrophic defects in Digital Ally's capital structure were detected and remedied as a result of the Stockholders' Demand. Even if a demand was not necessarily required before filing suit, it made sense for stockholders and the Company to attempt to fix the defects efficiently through a pre-suit litigation demand. Contrast that situation to *Galena*, where the same remedy was obtained only after a fire-drill of expensive, expedited litigation. The result obtained here was the same as in *Galena*, and less costly and disruptive to the corporation. As the Delaware Court of Chancery aptly observed in *Bird*:

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at 692-95. The District Court correctly dismissed Digital Ally's reliance on Michigan's "special statutory framework" as uninstructive with respect to "Nevada common law[.]" (JA 0246).

> If we appreciate the collective action problem of shareholders and the neat solution to the collective action problem that paying a bounty to successful shareholders lawyers represents, why should the law care whether Mr. Bird conferred a benefit through a meritorious legal claim or through stimulating the board simply to act in a way he correctly thought was advantageous? In either event the collective action problem of shareholders was overcome and a substantial financial benefit was realized by the corporate collectivity.

681 A.2d at 407.

A world in which counsel in *Galena* are awarded $250,000 while the Stockholders' counsel here receives $0 for producing the same benefits promotes a rule that incentivizes litigation for its own sake, rather than the efficient and successful outcomes that stockholders and courts care about. For stockholders and their counsel who become aware of serious corporate problems, the message would be: either clutter the courts with unnecessary litigation or do not bother trying to fix the problem.

D. Even if "litigation" is required for an award of attorneys' fees and expenses under the substantial benefit doctrine, it should be deemed met in corporate matters where stockholders make a pre-suit litigation demand.

In fashioning a rule reviving this case, this Court could limit its scope to stockholder pre-suit litigation demands. Unlike other communications outside of filed litigation, stockholder litigation demands are a creature of court rule and litigation statute. NRCP 23.1 imposes the demand requirement as a prerequisite for pleading a claim. Chapter 41 of the Nevada Revised Statutes, which generally

addresses rules for litigation, echoes that pleading requirement. Because a litigation demand is a unique creation of procedural rules applicable to stockholder matters, the issuance of such a demand is effectively an act of litigation, albeit one that necessarily occurs before the filing of a complaint.

Nor would instructing the District Court that it has discretion to award attorneys' fees and expenses to the Stockholders in this case open a floodgate to marginal or frivolous claims. Dismissing this concern, the Delaware Court of Chancery noted that: "It is hard [to] imagine frivolous demands as being a practical difficulty in this context" because, among other reasons, a board would first have to accept the demand in its business judgment to create a corporate benefit which could justify a fee. *Bird*, 681 A.2d at 405. Delaware law treats successful pre-suit litigation demands the same as filed cases unilaterally mooted before settlement or judgment, and requires the stockholder to demonstrate that it presented a "meritorious" *legal* claim. *Raul*, 2014 Del. Ch. LEXIS 103, at *15-17 (citing *Bird*, 681 A.2d at 403); *see also In re Primedia, Inc. S'holders Litig.*, 67 A.3d 455, 478 (Del. Ch. 2013) ("[A] claim is meritorious within the meaning of the rule if it can withstand a motion to dismiss on the pleadings if, at the same time, the plaintiff possesses knowledge of provable facts which hold out some reasonable likelihood of ultimate success.") (citation omitted). Under that rule, "where a volunteer stockholder ... notifies directors, not that they are in breach of

their duties, but simply that they have missed a corporate opportunity or should avoid a corporate loss, the consideration of such a notification is a board, not a Court, affair" and no fee is warranted. *Raul*, 2014 Del. Ch. LEXIS 103, at *17. The same limitation easily could be applied here if "substantial benefit" means only a "meritorious legal claim" that directors resolve by taking corrective action in response to a well-taken litigation demand.

CONCLUSION

Appellants respectfully request that this Court reverse the District Court's Order and remand this case for further proceedings with an instruction that benefits conferred by a stockholder pre-suit litigation demand are eligible for an award of attorneys' fees and expenses under the substantial benefit doctrine.

DATED this 9th day of October, 2019.

ALDRICH LAW FIRM, LTD.

John P. Aldrich, Esq.
Nevada Bar No. 6877
7866 West Sahara Avenue
Las Vegas, Nevada 89117
702-853-5490

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Steven J. Purcell, Esq.
Douglas E. Julie, Esq. (admitted pro hac vice)
Robert H. Lefkowitz, Esq.
PURCELL JULIE & LEFKOWITZ LLP
708 Third Avenue, 6th Floor
New York, New York 10017
212-725-1000

Attorney for Appellants

CERTIFICATE OF COMPLIANCE

I hereby certify that this brief complies with the formatting requirements of NRAP 32(a)(4), the typeface requirements of NRAP 32(a)(5) and the type of style requirements of NRAP 32(a)(6) because: This brief has been prepared in a proportionately spaced typeface using Microsoft Word 2010 in 14-point Times New Roman font.

I further certify that this brief complies with the page or type-volume limitations of NRAP 32(a)(7) because excluding the parts of the brief exempted by NRAP 32(a)(7)(C), it is: proportionately spaced, has a typeface of 14 points or more and contains 5,519 words.

Finally, I hereby certify that I have read this appellate brief, and to the best of my knowledge, information, and belief, it is not frivolous or interposed for any

improper purpose. I further certify that this brief complies with all applicable Nevada Rules of Appellate Procedure, in particular NRAP 28(e)(1), which requires every assertion in the brief regarding matters in the record to be supported by a reference to the page and volume number, if any, of the transcript or appendix where the matter relied on is to be found. I understand that I may be subject to sanction in the event that the accompanying brief is not in conformity with the requirements of the Nevada Rules of Appellate Procedure.

DATED this 9th day of October, 2019.

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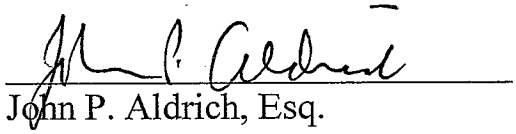
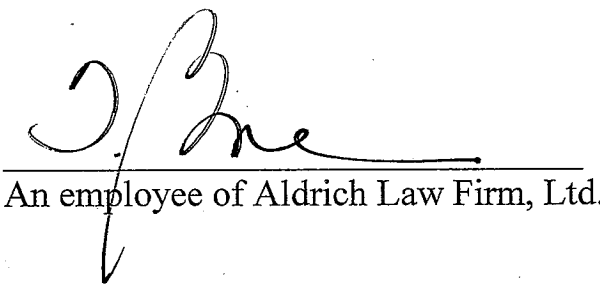


John P. Aldrich, Esq.
Nevada Bar No. 6877
7866 West Sahara Avenue
Las Vegas, Nevada 89117
702-853-5490
Attorney for Appellants

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on the 9th day of October, 2019, I served a copy of **APPELLANT'S OPENING BRIEF** by electronic case filing and service through the Nevada Supreme Court's e-filing service to the following persons:

Jeffrey F. Barr, Esq.
Lee I. Iglody, Esq.
ASHCRAFT & BARR | LLP
2300 West Sahara Ave
Las Vegas, Nevada 89102
barrj@ashcraftbarr.com
iglodyi@ashcraftbarr.com



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