

IN THE SUPREME COURT OF THE STATE OF DELAWARE

HAROLD GRILL 2 IRA, Derivatively on Behalf	)	
of Nominal Defendant UNITED	)	No. 390,2013
TECHNOLOGIES CORPORATION,	)	
	)	On appeal From the
Plaintiff Below-Appellant,	)	Court of Chancery of the
	)	State of Delaware
v.	)	
	)	The Honorable
LOUIS R. CHÊNEVERT, JOHN V. FARACI,	)	Leo E. Strine, Jr.
JEAN-PIERRE GARNIER, JAMIE S.	)	C.A. No. 7999-CS
GORELICK, EDWARD A. KANGAS, ELLEN J.	)	
KULLMAN, MARSHALL O. LARSEN,	)	
RICHARD D. MCCORMICK, HAROLD	)	
MCGRAW III, RICHARD B. MYERS, H.	)	PUBLIC VERSION
PATRICK SWYGERT, ANDRE	)	FILED: SEPTEMBER 20, 2013
VILLENEUVE, CHRISTINE TODD	)	
WHITMAN, and GEORGE DAVID,	)	
	)	
Defendants Below-Appellees,	)	
	)	
and	)	
	)	
UNITED TECHNOLOGIES CORPORATION,	)	
	)	
Nominal Defendant Below-Appellee.	)	

CORRECTED OPENING BRIEF OF PLAINTIFF-BELOW APPELLANT

RIGRODSKY & LONG, P.A.

Seth D. Rigrodsky (#3147)

Brian D. Long (#4347)

Gina M. Serra (#5387)

2 Righter Parkway, Suite 120

Wilmington, DE 19803

(302) 295-5310

Attorneys for Plaintiff Below-Appellant

Harold Grill 2 IRA

OF COUNSEL:

HARWOOD FEFER LLP

488 Madison Avenue
New York, NY 10022
(212) 935-7400

Date Filed: September 17, 2013

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NATURE AND STAGE OF THE PROCEEDINGS

The conduct giving rise to this derivative action was egregious and protracted. It concerns multi-year improprieties by the Board of Directors (the “Board”) of United Technologies Corporation (“UTC” or the “Company”), which, when repeatedly presented with and then discussing at numerous Board meetings, evidence of export violations by UTC subsidiaries Pratt & Whitney Canada (“PWC”) and Hamilton Sundstrand Corporation (“HSC”), for at least four years, misstated and exaggerated to federal agencies the corrective actions taken. (PWC and HSC are collectively referred to as the “Subsidiaries.” The Subsidiaries and UTC are collectively referred to as the “UTC Entities.”) As a result of the sustained misconduct by the entire Board, the Company was required to pay \$55 million in fines and penalties. The Board’s misconduct involved their complicity in misrepresentations to federal agencies by failing to correct prior false disclosures to the government about illegal conduct by the Subsidiaries in connection with their export of certain military helicopter components to China in violation of the U.S. Arms Export Control Act, 22 U.S.C §§ 2778-80 (“AECA”) and International Traffic in Arms Regulation, 22 C.F.R. 120-30 (“ITAR”). The suit names as defendants fourteen UTC Board members (the “Director Defendants”).¹ ¶¶15-18. A 21-23.²

¹The Director Defendants are Louis R. Chênevert, John V. Faraci, Jean-Pierre Garnier, Jamie S. Gorelick, Edward A. Kangas, Ellen J. Kullman, Marshall O. Larsen, Richard D. McCormick,

On July 10, 2012, Plaintiff served a demand to inspect UTC's books and records pursuant to Delaware General Corporation Law Section 220 (the "220 Demand"). A 69-75. In the 220 Demand, Plaintiff sought, *inter alia*, minutes of UTC Board and its committee meetings at which export violations by the Subsidiaries were discussed. On September 4, 2012, UTC responded to that request (the "220 Response") with redacted minutes of Board and its audit committee meetings together with certain Board presentation materials. A 76-161.

The Verified Derivative Complaint (the "Complaint") was filed in the Court of Chancery on November 1, 2012. On February 8, 2013, Defendants moved to dismiss the Complaint, arguing that Plaintiff's failure to make a pre-suit demand on the Board warranted dismissal. In opposing the Director Defendants' motion, Plaintiff argued demand was excused because the Complaint set forth particularized allegations showing a substantial likelihood of directorial liability for fiduciary duty breaches. Their substantial likelihood of liability had become apparent when Plaintiff learned, in part from the response to its 220 Demand, that the Board and its Executive Committee had discussed the export violations over a two-year period, and for those two years

Harold McGraw III, Richard B. Myers, H. Patrick Swygert, Andre Villeneuve, Christine Todd Whitman, and George David.

² Paragraphs in the Complaint shall be referred to as "¶ ____." References to the pages of the Appendix shall be "A ____."

and an additional two years, failed to correct the statements made to the government about those violations.

Plaintiff argued that the Director Defendants' breach of their fiduciary duties by failing, over that four-year period, to correct the Subsidiaries' false disclosures about their export violations to the government, led to the U.S. Government's charging UTC in an Information (the "Information") with having "knowingly and willfully mak[ing] and caus[ing] to be made materially false and fraudulent statements in certain disclosures." *U.S.A. v. United Tech. Corp., et al.*, Crim. No. 3:12 cr146/WWE (D.C. Conn. June 28, 2012). ¶ 113. A 50. A 220-32. In response to the Information, the UTC Entities, including UTC, entered into a Deferred Prosecution Agreement ("DPA") with the government. ¶ 113. A 50. A 173-219.

Plaintiff further argued that the Information resulted from UTC's admitted misrepresentations and/or failures to correct, beginning in 2006, prior misrepresentations in various communications to the State Department's Office of Defense Trade Controls Compliance ("DTCC"). The DTCC advised UTC that it considered those 2006 and post-2006 disclosures to be deficient. It is because of those 2006 misstatements that the Information was filed against UTC, not the Subsidiaries' pre-2006 conduct. And it was those 2006 misstatements and UTC's failure to take corrective actions post-2006 for which UTC was assessed penalties of

\$55 million. UTC was charged with violation of Title 18 U.S.C. § 1001,³ because failure to correct prior misrepresentations itself violates that Title. Minutes produced in response to the 220 Demand make clear that Board members discussed the prior ITAR and AECA violations at Board and committee meetings, yet failed to correct the previous disclosures made about those export violations. The Board's failure to correct are made clear in Appendix A to the DPA (A 212) under the heading "The Corrective Actions," in which UTC admitted:

The UTC Entities' disclosures also stated: "P&W/UTC . . . will continue to maintain and implement [certain] corrective actions . . . to avoid any future occurrences of this type of violation." During the course of the investigation, the UTC Entities were asked to report on the status of the corrective actions they had identified in the Z10 [the relevant Chinese helicopter] disclosure letters. ***In a July 2010 response, UTC acknowledged that they had neglected to follow through on, and had overstated several of the corrective actions – corrective actions that were presented to DDTC as mitigating factors to consider in their review of the conduct.***

Emphasis added (ellipsis in original).

³ (a) Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully—

- (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact;
- (2) makes any materially false, fictitious, or fraudulent statement or representation; or
- (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry:

shall be fined under this title, imprisoned not more than 5 years, . . . or both.

Plaintiff further argued that it held UTC stock at all times during the alleged Board misconduct, having acquired those shares in July 2006, the month in which UTC sent its first misleading letter to the State Department. Conduct by the UTC Entities and their employees prior to July 2006, concerning Chinese helicopter-related equipment, is included in the Complaint only to describe the misconduct, and misrepresentations about such misconduct, that was subsequently covered-up by the Director Defendants. Because they were made aware of the prior export violations, the Board should have been scrupulous in its dealings with the government in seeking to resolve the Chinese helicopter dealings. The fact that beginning in July 2006, UTC prevaricated and misled the government by, at the very least, failing to correct prior misrepresentations, must be laid at the feet of the Director Defendants because of the numerous presentations and discussions at Board and committee meetings. Accordingly, Plaintiff amply clears the bar excusing demand under Rule 23.1.

By Letter Opinion dated June 18, 2013, as revised by Letter Opinion dated June 24, 2013,⁴ the Court of Chancery, without oral argument, granted the Director Defendants' motion to dismiss and dismissed the action, with prejudice as to the named Plaintiff. In so ruling, the Court of Chancery held, as a matter of law, that "The plaintiff's brief claims that the directors were informed about the false disclosures in board meetings between 2006 and 2008, but the complaint only alleges

⁴References to pages of the June 24th Letter Opinion shall be "Op. at ____."

that the board discussed the export violations in those meetings, *not* that the board was made aware that the company had made false disclosures and knowingly failed to cause UTC to correct them.” Op. at 8-9 (emphasis in original; footnote omitted).A 12-13. In so ruling, the Court of Chancery committed error because (a) the Complaint adequately alleges the Director Defendants knew the Company had made false disclosures, and (b) even if the Complaint does not specifically so allege, a reasonable inference from the Complaint’s particularized factual allegations is that each Director Defendant did know of the false disclosures.

Plaintiff appeals from the June 24, 2013 Letter Opinion.

SUMMARY OF ARGUMENT

1. The Complaint alleges in detail, including material obtained in the response to Plaintiff's 220 Demand, that the Board was advised at numerous meetings (both those of the full Board as well as its Executive Committee), about export violations by the Subsidiaries and false disclosures, by UTC itself, to the government about such violations. Notwithstanding the Board discussions, for four years the Board failed to correct any of the false disclosures. Finally, in its Form 10-K, filed with the Securities and Exchange Commission ("SEC") on February 9, 2013, UTC admitted that, in connection with the illegal export to China of certain helicopter components: "in November 2011, DTCC [the State Department's Office of Defense Trade Controls Compliance] informed us that it considers certain of our voluntary disclosures filed since 2005 to reflect deficiencies warranting penalties and sanctions."

¶ 112. A 49. The referenced penalties and sanctions were exacted, even though, as admitted by UTC: "[m]ost of our voluntary disclosures are resolved without the imposition of penalties or other sanctions." *Id.* This time, however, it was different. It was different because, according to the DPA Statement of Facts, it was only in "a July 2010 response, UTC acknowledged that HSC had neglected to follow through on, and had overstated several of the corrective actions – corrective actions that were presented to DDTC as mitigating factors to consider in their review of the conduct." A212. As a consequence of the Board's overstatement of UTC's corrective action over

a four-year period, during which the illegal Chinese helicopter exports were discussed at no fewer than six Board and Board committee meetings, there is a substantial likelihood that each Director Defendant may be held liable for UTC's misrepresentations to the government, thereby excusing pre-suit demand. The Court of Chancery erred in holding otherwise.

2. The Court of Chancery erred by making findings of fact and failing to draw reasonable inferences in Plaintiff's favor. The Court of Chancery erected an insurmountable pleading barrier for Plaintiff to overcome. The Court of Chancery erroneously failed to draw the factual inference from Plaintiff's particularized allegations that the Director Defendants, having discussed export violations over a four-year period must, at some point, have been made aware that the UTC Entities had made false disclosures and then knowingly failed to cause the Company to correct them. As a result, the Court erroneously required Plaintiff to plead evidence solely within Defendants' knowledge, obtainable by Plaintiff only through discovery. The Court of Chancery further required Plaintiff to demonstrate a reasonable probability of success on the merits rather than make only the requisite threshold showing, through the allegation of particularized facts, that its claims have some merit.

STATEMENT OF FACTS

A. Summary Of Facts

The Complaint alleges misrepresentations by the Director Defendants themselves, by their failure to correct misrepresentations to the Federal Government for a four-year period, during which time they were aware of prior export violations. By virtue of Board and Board committee minutes made available by UTC pursuant to the 220 Demand, Plaintiff learned that the Board or one of its committees discussed the alleged misconduct at least in December 2006; in February and December 2007; and once again in September 2008. ¶¶ 99, 101 – 03, 105, 106. A 46, 47. The fact of such discussions during Board meetings renders reasonable the factual inference that the Board was made aware that the Company had made false disclosures and knowingly failed to cause UTC to correct them.

The inference is reasonable because of the Board discussions and the admissions in the DPA. Although in its 2006 disclosures, UTC had represented it was already in the process of implementing, and would continue to implement corrective measures to improve its controls over export compliance, as of July 2010 UTC, by its own admission in the DPA, had failed to actually implement the corrective measures and had exaggerated certain measures taken. ¶ 108. A48. As a result of four years of misrepresentations and/or failures to correct misrepresentations to the government, the Information was filed against UTC and certain subsidiaries. ¶ 113. A 50. UTC then

entered into the DPA (§ 114; A 50-51) and a Consent Agreement with the DTCC. § 115. A 51.

The Complaint does not plead failure of oversight by the Board but alleges particularized facts about Board misconduct creating a reasonable doubt that Defendants' actions "w[ere] otherwise the product of a valid business judgment." *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). The Complaint specifies dates of meetings at which Board members were advised of the prior export violations and materials presented to the Board. The Director Defendants have thereby been rendered incapable of exercising their business judgment because they knew about the corporate misconduct and chose not to correct it. Plaintiff is therefore entitled to displace the Board's authority to control this litigation. Each Board member attending meetings at which the corporate misconduct was discussed is incapable of exercising his or her judgment in evaluating the allegations of the Complaint because each faces a substantial likelihood of liability. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993). In short, even if the Board had in place a complete export control compliance system, an Audit Committee, a Public Issues Review committee, specialized compliance officers and personnel, and a method for dealing with compliance issues, it is irrelevant. This is not a *Caremark* case,⁵ based on lack of board supervision. By virtue of their four-year long effort to mislead the government about this illegal

⁵*In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

conduct, each Board member “caused [UTC] to violate the positive laws it is obliged to obey.” *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).

The Complaint describes, by way of background, conduct engaged in by the Subsidiaries, by which they made misleading disclosures to DTCC. Between 2000 and 2006, the Subsidiaries secretly participated in the development of a Chinese military attack helicopter in violation of a United States arms embargo and federal arms traffic control statutes. This conduct of the Subsidiaries, besides violating federal law, undermined America’s safety by providing American military technology to China, which in turn was supplying arms to such countries as Iran and North Korea. When UTC finally decided it was necessary to disclose these illegalities, such disclosures for four years, beginning in 2006, were false and misleading, causing the imposition of penalties of as much as \$55 million and reputational harm to UTC in its dealings with the government. ¶ 3. A 17.

The gravamen of the Complaint is that the conduct of the Director Defendants in their dealings with the Department of State, after they learned of the illegal dealings with China, gives rise to a substantial likelihood of their liability. The Board conduct post-2006 shows beyond cavil that the first red flag was waved in February 2006 when put on notice of the Subsidiaries’ misconduct. ¶¶ 8 and 89. A 19 and A 43-44. Thereafter, in July 2006, UTC submitted a misleading description of the export violations to the Department of State (¶¶ 9, 92, and 93; A 19-20, 44, 45) and for four

years thereafter, they continued to mislead the government (¶¶ 108, 111-15; A 48, 49-51) until in July 2010 UTC acknowledged the misrepresentations. As a result, the government filed a criminal information against the UTC Entities, in which a guilty plea was entered (by PWC) and prosecution deferred (against UTC and HSC), and UTC agreed to pay a civil penalty of \$55 million. ¶¶ 113-15. A 50-51.

B. Background Facts

1. The Subsidiaries' Misconduct

The background facts leading to the allegations against the Board upon which the Complaint is based are laid out in detail in the Complaint at ¶¶ 38–91, A29-44 and ¶¶ 116-17, A 51-53. A brief review of those facts serves as prologue to the allegations of subsequent misconduct by the Director Defendants giving rise to their substantial likelihood of liability.

The Subsidiaries manufacture military aircraft and components. UTC derives substantial income from its military contracting both with the U.S. government and foreign governments. Through its military aerospace business, UTC is subject to AECA and ITAR. AECA restricts U.S. defense contractors' sales of certain sensitive technologies to certain foreign countries. ITAR implements the provisions of AECA and is interpreted and enforced by the DTCC. The relevant portions of ITAR provide that information and material related to U.S. military technologies may not be shared with any foreign person or state unless authorized by the Department of State.

Significantly, ITAR-restricted material includes civilian technologies modified with ITAR-controlled military technologies. Thus, a civilian helicopter engine modified with an ITAR-controlled component is itself ITAR-controlled. ¶ 4. A 18.

When a company breaches the export controls, it is required immediately and truthfully to disclose the violation to the DTCC. Failure to obtain authorization for military exports or truthfully disclose breaches of the export controls is a crime punishable by fines, remedial penalties, loss of export privileges, and debarment from bidding on U.S. government contracts. Due to the breadth and seriousness of the penalties, the adequacy of UTC's controls over ITAR-compliance is vital to its ongoing success as a military contractor. ¶ 5. A 18-19.

Beginning in 2000, the Chinese government approached PWC about supplying PT6C – 67C engines to power a new twin-engine, 5.5 ton helicopter called the Chinese Medium Helicopter (“CMH”). ¶ 38. A 29.⁶ The project was purportedly for development of a dual-use helicopter platform with the military version to be developed first and followed by a civil version. UTC believed that if it helped the Chinese develop the military version, it would become the exclusive supplier of the later-developed civil version. This would provide UTC with a long-sought entrance into the large and untapped Chinese civil helicopter market. ¶ 6. A 19. The Chinese

⁶Due to a scrivener's error, paragraph numbers 38-43 were repeated in the Complaint. This is one of two instances in this brief where any of those paragraphs is quoted.

government said it intended to use the 67C engines in development models of the military version and production models of the civil version, but that it planned to use Chinese-made engines in production models of the military version. ¶ 38. A 29.⁷

In early November 2000, the Chinese provided PWC with a briefing paper on the civil version of the CMH. “the Z10C.” The Z10C was a 6-ton helicopter intended for passenger and freight transportation, tourism, oil-rig servicing, and search and rescue. The schedule for development of the Z10C was essentially the same as the schedule for the military version. ¶ 44. A 31.

Immediately thereafter, PWC realized that the real Chinese interest was in the military helicopter. On November 13, 2000, an intra-office PWC email observed that the “sudden appearance” of the civil program:

[I]ndicate[s] that it *may have been put together to aid approval for [the] export license...* [b]y putting forward the civil helicopter program now... *real or imagined...* an opening is created for P&WC to insist on exclusivity in [the] civil version of this helicopter[.]

¶ 45. A 31 (emphasis added).

PWC agreed to supply engines and certain engine components to the Chinese. The engines were certified for civil use by the U.S. government and did not require export authorization. PWC shipped ten 67C engines to China between November 2001 and October 2002. ¶ 50. A 33. However, for the engines to function properly

⁷See footnote 6 above.

on the attack helicopters (the Z10), modified software for electronic engine control (“EEC”) had to be loaded onto the engines. This software, unlike the engines themselves, was controlled by export restrictions. ¶¶ 4 and 7.A 18, 19. According to the Information, “From the inception of the Project, PWC knew that the PRC was developing a military attack helicopter, for which U.S.-sourced components would be prohibited.” On numerous occasions between 2002 and 2005, the Subsidiaries illegally delivered the restricted engine software to China that they knew, because Chinese representatives had so advised them, that the first application would be military and a civil version would follow later. Thus, the Subsidiaries’ employees were aware that the first application would be military and that this implicated U.S. arms sanctions and U.S. and Canadian export restrictions. ¶¶ 7 and 10. A 19, 20.

Any potentially lingering questions about whether the initial CMH was to be military and not civilian was answered when PWC engineers travelled to Jingdezhen, China for its ground testing. There they saw tested not a twelve-seat transport helicopter that would be either civil or dual use, but saw what was clearly a prototype of an attack helicopter. ¶ 59. A 35-36. Upon their return, the engineers and others continued work on this project for an additional two to three years. ¶ 60. A 36.

By the middle of 2005, UTC had been supplied with briefing materials discussing the military version of the CMH, and UTC personnel were inquiring into

the legality of the program. A formal investigation had not yet begun and no disclosures had been made to the Department of State. ¶ 80. A 41.

As of September 2005, it became clear that the Z10C civil version would never be produced when the Chinese identified a separate “Z15” as the civil version in an end use statement. In November 2005, PWC contracted with the Chinese for 60 67C production engines at \$475,000 each (a total of \$28,500,000) for use on the military version CMH to be delivered beginning in mid-2006. ¶¶ 81, 82. A 42. Ultimately, PWC did not ship any production engines to China for the Z10 or civil variant. ¶ 88. A 43.

Lawyers from UTC and PWC, among others, met to discuss the briefing materials and PWC’s Chinese programs and to determine whether UTC had to disclose the export of HSC EEC software to China. ¶ 90. A 44. On May 8, 2006, UTC decided an export control violation had occurred and had to be reported to the State Department. ¶ 91. A 44. The reports were not truthful and a four-year deception began, at least part of which was approved, at least at some points, by each member of the Board.

2. UTC Provides Misleading Disclosures to The Government

On February 15, 2006, when UTC was preparing briefing materials in advance of its April 2006 shareholder meeting, an investment advisory service advised its Investor Relations Department that it was researching the nature and degree of UTC’s

involvement in the manufacture of a Chinese combat helicopter. As a result of its research, the service was considering advising its clients to divest themselves of UTC stock, and requested any information UTC could provide. ¶ 89. A 43-44. Those briefing materials apparently included UTC's Board Chairman and other directors who were preparing for the annual meeting. *Id.*

In its first communication to the State Department, UTC made clear that deception was to be the UTC Entities' watchword in describing the CMH to the government. Even though (a) PWC engineers had been advised by Chinese representatives that the first application of the EEC would be military, (b) PWC engineers had seen the prototype was in a military configuration, and (c) in November 2005, PWC had contracted with the Chinese for 60 production engines, on July 17, 2006, UTC filed its initial disclosure letter with the DTCC, which stated:

Several years into the CMH program P&WC became aware that a CMH military variant was to be the lead version

¶ 92. A 44. Follow-up submissions in August and September 2006 similarly conveyed false information of the actions taken by the UTC Entities in connection with the purported remedial action taken. ¶ 93. A 45.

C. The Director Defendants' Breaches Of Fiduciary Duty

Board and committee minutes produced pursuant to the 220 Demand show discussions of the helicopter component violations took place at the following meetings:

- December 12, 2006 – internal Board presentation titled “Business Practices” references CMH project. ¶ 99. A 46.
- December 2007 – internal Board presentation titled “Litigation” with headings “Z-10 Investigation Update.” ¶ 101. A 47.
- December 11, 2007 – Audit Committee minutes referencing disclosure to State Department of export disclosure violations. ¶ 102. A 47.
- December 12, 2007 – Board minutes discussing export control violations. ¶ 103. A 47.
- September 20, 2008 – Audit Committee minutes referencing “Z-10 export matter.” ¶ 105. A 47.
- September 10, 2008 – Board minutes showing Board given updated on “Z-10 Investigation.” ¶ 106. A 47.

Misrepresentations to the State Department given their knowledge of the CMH issues because of discussions at Board meetings was a particularly egregious act by the Director Defendants, given the fact that its misrepresentations could have led to debarment of UTC from engaging in defense exports, is evident from UTC’s Form 10-K filings.⁸

⁸ UTC’s Form 10-K filings with the SEC disclose its percentages of annual sales to the government: 2002 – 16% ¶ 57, A 19; 2003 – 17% ¶ 70, A 38; 2004 – 15% ¶ 77, A 41; 2005 – 14% ¶ 83, A 42; 2006 – 14% ¶ 100, A 46; 2007 – 14% ¶ 104, A 47; 2008 – 13% ¶ 107, A 47; 2009 – 18% ¶ 109, A 48; 2010 – 18% ¶ 110, A 48-49; and 2011 – 17% ¶ 112, A 49.

Given the briefings and reports received by the Board about the Subsidiaries' export control violations, together with the criticality of UTC's business relations with the U.S. government, if the Board were exercising its fiduciary obligations, one would have expected prompt and accurate disclosure about its subsidiaries' CMH-related conduct. Unfortunately for UTC, due to the Directors' cover-up, such was not the case. As UTC finally disclosed in its February 9, 2012 Form 10-K for its 2011 fiscal year under the heading "Legal Proceedings":

A significant portion of our activities are subject to export control regulation by the U.S. Department of State (State Department) under the U.S. Arms Export Control Act and International Traffic in Arms Regulations (ITAR). From time to time, we identify, investigate, remediate and voluntarily disclose to the State Department's Office of Defense Trade Controls Compliance (DTCC) potential violations of ITAR. DTCC administers the State Department's authority under the ITAR to impose civil penalties and other administrative sanctions for violations, including debarment from engaging in the export of defense articles or defense services. *Most of our voluntary disclosures are resolved without the imposition of penalties or other sanctions. However, in November 2011, DTCC informed us that it considers certain of our voluntary disclosures filed since 2005 to reflect deficiencies warranting penalties and sanctions. We are currently in discussions with DTCC to reach a consent agreement, which we anticipate will provide for a payment by the Company and commitments regarding additional remedial compliance efforts.*

The voluntary disclosures that we anticipate will be addressed in the consent agreement currently under

discussion *include 2006 and 2007 disclosures regarding the export by Hamilton Sundstrand to P&WC of certain modifications to dual-use electronic engine control software*, and the re-export of P&WC of those software modifications and subsequent P&WC-developed patches to China during the period 2002-2004 for use in the development of the Z-10 Chinese military helicopter. *The DOJ has also separately conducted a criminal investigation of the matters addressed in these disclosures, as well as the accuracy and adequacy of the disclosures.* We have been cooperating with the DOJ's investigation. Since November 2011, we have been in discussions with the DOJ to resolve this matter.

¶ 112 (emphasis added). A 49-50.

The deficient voluntary disclosures “warranting penalties and sanctions” occurred despite Board knowledge of the prior ITAR and AECA export violations. ¶¶ 92-98, 108. A 44-46, 48. The minutes demonstrate they were advised of the violations over a lengthy period of time. Yet, the Board still caused the Company to submit disclosures to the Department of State so deficient as to remove them from UTC's prior typical resolutions that were “without the imposition of penalties or other sanctions.” A suggestion as to why the Board may have continued the cover-up and misrepresentations is discussed below at 21, but in any event, the cover-up after the Board learned of ITAR violations raises a reasonable doubt that the conduct was a valid exercise of business judgment and that the Director Defendants cannot exercise disinterest and independent judgment because they face a substantial likelihood of liability.

The Board itself caused UTC to make, as the Company ultimately admitted, deficient disclosures leading to the imposition of fines and penalties totaling \$55 million and certain required revisions to corporate oversight. Such conduct subjects the entire UTC Board to a substantial likelihood of liability because, as admitted in the DPA Statement of Facts:

On July 17, 2006, the UTC Entities submitted to DDTC their initial disclosure letter regarding the export of the EEC software. The UTC Entities also made follow-up submissions to DDTC on August 11, 2006 and September 6, 2006.

The thrust of the disclosure letters was that none of the UTC Entities had any idea that the Chinese were developing a military attack helicopter until 2003 or 2004, and that after learning about it, and subsequently realizing the corresponding export violations, the UTC Entities had taken swift remedial action to address the issue.

The False Statements in the Disclosures

In the disclosure, the UTC Entities falsely claimed that the Z10 program, from its outset, was intended to be a dual-use helicopter program where civil and military applications would be developed in parallel, using the same or similar architectural structure, referred to as a “common platform.” The disclosures falsely suggested that the UTC Entities were unaware that the Chinese initially intended to build a military helicopter.

* * *

In fact, the Chinese initially told PWC that the first application was military and that the civil version would follow at some undetermined future date. Contemporaneous PWC documents confirmed that certain PWC employees believed that the first application would be military and that the PWC GM for Asia Marketing had specifically advised the PWC International Marketing VP and the PWC Export Manager [for Government Relations and Export Controls] that “[d]iscussions on

PT6C-67C for Chinese Z-10 *attack helicopter* [we]re progressing smoothly.” (Emphasis added.)

* * *

The UTC Entities also falsely stated in the disclosures that they did not learn until several years into the project, when PWC engineers first saw the Z10 attack helicopter prototype in a hangar in China in March 2003, that: (1) the Chinese were developing an attack helicopter; and (2) this military version of the helicopter was to be the lead version. The disclosures further misstated that, even then, PWC continued to believe China’s assurances that the civil program was underway – until PWC engineers saw that the second prototype was also an attack helicopter.

A 210-11.

Subsequently, after four years of reviewing the facts relating to the CMH sales and the misrepresentations to the government about such sales, the Board finally acknowledged the misrepresentations. Again, as admitted in the DPA Statement of Facts:

The UTC Entities’ disclosures also stated: “P&W/UTC . . . will continue to maintain and implement [certain] corrective actions . . . to avoid any future occurrences of this type of violation.” During the course of the investigation, the UTC Entities were asked to report on the status of the corrective actions they had identified in the Z10 disclosure letters. In a July 2010 response, UTC acknowledged that HSC had neglected to follow through on, and had overstated several of the corrective actions – corrective actions that were presented to DDTC as mitigating factors to consider in their review of the conduct.

A 212.

For four years, the Board studied the CMH export violations, and during those four years, the UTC Entities (including UTC itself), “neglected to follow through on,

and had overstated several of the corrective actions.” After four years of misrepresentations, UTC finally disclosed in its 2011 Form 10-K, described at pp. 14-15 above, the deficiencies of the prior disclosures that would cause penalties to flow.

Notwithstanding the allegations of a four-year review of the CMH-related export violations, the admitted misrepresentations, and the imposition of fines and penalties because of the atypical nature and inadequacies of the purported disclosures, the Court of Chancery held, as a matter of law, that the Complaint does not allege the Board “was made aware that the Company had made false disclosures and knowingly failed to cause UTC to correct them.” Op. at 9 (footnote omitted). In so holding, the Court of Chancery erred by not making the reasonable inference that in the numerous meetings at which the Director Defendants discussed the CMH export violations, at least once they were made aware “that the company had made false disclosures and knowingly failed to cause UTC to correct them.” That does not seem an implausible inference.

ARGUMENT

A. Question Presented

Did the Court of Chancery erroneously fail to draw the factual inference from Plaintiff's particularized allegations that the Director Defendants, having discussed export violations over a four-year period must, at some point during that period, have been made aware that the UTC Entities had made false disclosures and then knowingly failed to cause UTC to correct them? Op. at 8-9. A 12-13.

B. Scope And Standard Of Review

This Court's review of the decision of the Court of Chancery applying Rule 23.1 is *denovo* and plenary. *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000)(hereinafter "*Disney*").

C. Merits

1. Applicable Standards for Evaluating Demand Futility

Court of Chancery Rule 23.1(a) requires that the complaint in a shareholder's derivative action "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." In evaluating a motion to dismiss pursuant to Rule 23.1, the Court must apply the following standards: The particularized factual allegations of the complaint are "taken as true" (*Aronson*, 473 A.2d at 815) and "[p]laintiffs are entitled to all reasonable

factual inferences that logically flow from the particularized facts alleged, but conclusory allegations are not considered as expressly pleaded facts or factual inferences.”*Disney*, 746 A.2d at 255.

The court must determine whether or not the particularized factual allegations of the derivative complaint create a reasonable doubt that, as of the time the complaint is filed, the board could have properly exercised its independent and disinterested business judgment in responding to a demand. If the shareholder plaintiff satisfies this burden, then demand will be excused as futile. *Rales*, 634 A.2d at 934.

Reasonable doubt is a flexible concept, implicating a “highly factual . . . inquiry” to be decided on a “case-by-case basis,” and is not susceptible to the formulation of “a criterion of general application.”*Grobow v. Perot*, 539 A.2d 180, 186 (Del. 1988), *vacated on other grounds*, 1988 Del. Ch. LEXIS 152 (Del. Ch. Nov. 25, 1988). The reasonable doubt standard is particularly appropriate in derivative suits, because the plaintiff typically has not had the benefit of discovery. *See Rales*, 634 A.2d at 934 (requiring a reasonable probability of success on the merits would be “an extremely onerous burden to meet at the pleading stage without the benefit of discovery”). Hence, there is no requirement that Plaintiff “demonstrate a reasonable probability of success [on the merits.]” Rather, Plaintiff need only make a “threshold showing, through the allegation of particularized facts, that their claims have some merit.”*Id.* The reasonable doubt standard “is sufficiently flexible and workable to

provide the stockholder with ‘the keys to the courthouse’ in an appropriate case where the claim is not based on mere suspicions or stated solely in conclusory terms.” *Grimes v. Donald*, 673 A.2d 1207, 1217 (Del. 1996) (footnote omitted). Furthermore, Plaintiff is required “only [to] allege specific facts . . . not plead evidence” of demand futility. *Aronson*, 473 A.2d at 816.

Yet, pleading evidence is what the Court of Chancery required in holding:

Of course, it is a breach of the duty of loyalty for the directors of a corporation to knowingly cause that corporation to break the law. But the complaint does not allege that the directors caused any legal breach, in the first instance, or even that they were aware before the end of 2011 that UTC had broken the law. Not only that, but the complaint does not even plead any facts in an attempt to support a pleading stage inference that any particular director should have known that the disclosures were false, much less plead facts supporting a pleading stage inference of actual knowledge. The complaint is largely devoid of any attempt to plead facts connecting the directors to the disclosures made to the State Department about the export of the software, either before or after those disclosures were made. Rather, the complaint alleges only that an unnamed UTC executive was aware that the disclosures were deficient at the time that they were made. The plaintiff’s brief claims that the directors were informed about the false disclosures in board meetings between 2006 and 2008, but the complaint only alleges that the board discussed the export violations in those meetings, *not* that the board was made aware that the company had made false disclosures and knowingly failed to cause UTC to correct them.

Op. at 8-9 (emphasis in original; footnotes omitted). A 12-13.

In so holding, the Court of Chancery required Plaintiff to plead exactly what was said at the Board meetings about the export violations. The minutes show discussions and presentations about such violations. What exactly was said, and by whom, is not required at the pleading stage because Plaintiff has not yet had discovery of individual Director Defendants. Plaintiff has made the threshold showing on particularized facts that the case has merits because, as the Court of Chancery recognized, each Board member was made aware that the Subsidiaries had violated export laws. As noted in *La. Mun. Police Emps.' Ret. Sys. v. Pyott*, 46 A.3d 313, 357 (Del. Ch. 2012), *rev'd on other grounds*, 2013 Del. LEXIS 179 (Del. Apr. 4, 2013): “a plaintiff does not have to point to actual confessions of illegality by defendant directors to survive a Rule 23.1 motion in a *Caremark* case.” The reasoning should apply to this non-*Caremark* case as well, yet the decision of the Court of Chancery appears to require Plaintiff to plead a confession of illegality by the Director Defendants.

In short, the inferences to which Plaintiff is entitled demonstrate the requisite threshold showing, through allegations of particularized facts, that Plaintiff's claims have some merit. To contend that the Director Defendants discussed the export violations for four years and never discussed the falsity of related disclosures seems an unreasonable conclusion and was error by the Court of Chancery.

The inference is reasonable because of admissions by the UTC Entities in the DPA. According to the DPA Statement of Facts:

PWC believed that the CMH program provided a substantial financial opportunity for the company because the civil helicopter market in China, which was just beginning to develop, was expected to become very large after air space restrictions were lifted.

* * *

In February 2006 – after HSC was no longer involved in the program – PWC sought approval from the Canadian government to export 120 engines to China, 110 of which were to be used as production engines for the military version of the helicopter, and 10 of which were to be used as developmental engines in support of the development of the civil version. In a cover letter PwC stated: “The Chinese aircraft market is distinguished by its enormous potential We have been working towards this opportunity for some time. We have cultivated close business ties with China with the belief that our investment would one day bring us favorable returns. The moment is at hand. Our engine has been selected, and we have been awarded significant production orders.”

A 200.

In the event, “PWC never shipped any production engines to China for the Z10 or the civil variant. The only PWC engines shipped to China were the 10 developmental engines.” *Id.* at 17. It appears, however, that the UTC Entities might have continued to hold out hope for obtaining CMH contracts. It was not until July 2010 that UTC made a real ITAR correction by acknowledging HSC’s

misrepresentations to the DTCC. That date is close to the date referenced at ¶ 26 of the Information (A 227), which states:

Although UTC, PWC and HSC are no longer involved in the program, the Z10 military attack helicopter is now in production, with initial batches delivered to the People's Liberation Army of China ("PLA") in 2009 and 2010.

With the Z10 program in production, the Director Defendants knew the UTC Entities could no longer hope to obtain CMH contracts and UTC could now come clean with the State Department.

2. Defendants Breached Their Fiduciary Duty of Loyalty to UTC

The Subsidiaries violated the law and, in further violation of the law, the Board covered up their illegal conduct. The Board and one of its committees were advised on at least six occasions of ITAR violations by UTC subsidiaries in connection with the EEC for the CMH, and either authorized or permitted misleading "disclosures" of the conduct to be submitted to the government for over four years.⁹ Accordingly, it is the Director Defendants' own conduct, not the failure to supervise, monitor, or otherwise control or learn about the misconduct of employees that gives rise to their liability. Red flags were abundant. The Director Defendants discussed at meetings the Z10 helicopter situation at least six times over a two-year period and never

⁹ The Board cannot claim lack of opportunity to correct any misrepresentations. According to the DPA Statement of Facts, UTC made the following number of disclosures to the State Department: nine in 2006, 17 in 2007; 21 in 2008, 35 in 2009; 45 in 2010; 35 in 2011; and five by March 31, 2012. A 177, fn. 4.

corrected the fraudulent disclosures in the prior July, August, and September 2006 disclosures to the government.

The Director Defendants breached their fiduciary duty of loyalty “by causing the corporation to violate the positive laws it is obliged to obey.” *Guttman*, 823 A.2d at 506 (citation omitted). *See also In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006) (failure “to act in good faith may be shown . . . where the fiduciary acts with the intent to violate applicable positive laws”). The positive law violated was the requirement to tell the truth to federal agents under Title 18 U.S.C. § 1001. The Company was charged in Count Two of the Information with knowingly making and causing to be made “materially false, fictitious and fraudulent statements in certain disclosures . . . knowing the same to contain such materially false, fictitious and fraudulent statements, namely, by submitting disclosures, on July 17, 2006 and September 6, 2006” to the Department of State, while “UTC, PWC and HSC knew and were in possession of materials demonstrating that PWC personnel knew, at the project’s inception in 2000, that the Z10 program involved a military attack helicopter,”[a]ll in violation of Title 18, United States Code, Section 1001.” A 229-30. As noted above, prosecution for Count Two against UTC was deferred pursuant to the DPA.

In *McCall v. Scott*, 239 F.3d 808, 823 (6th Cir.), *amended on denial of reh’g*, 250 F.3d 997 (6th Cir. 2001) (decided under Delaware law), the Sixth Circuit found

that the directors breached their fiduciary duties through their sustained failure to act against the corporation's systemic health care fraud occurring over the course of approximately two years. The court cast aside defendants' protestations of lack of knowledge of the fraud – echoed by Defendants here – by pointing to certain red flags, including, among others, a federal investigation, audit information, and ongoing practices by the corporation from which their conscious disregard of their duties could be inferred. *Id.* at 819-20. Here, the Board's own knowledge and conduct gave rise to potential criminal liability.

Accordingly, Plaintiff meets the standard of alleging “facts with particularity which, taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.” *Aronson*, 473 A.2d at 815. Stated otherwise, “the directors were conscious of the fact that they were not doing their jobs.” *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 123 n.46 (Del. Ch. 2009) (citing *Guttman*, 823 A.2d at 506). Even if the Director Defendants choose to argue that they did not actually authorize misrepresentations and refusals to correct them for four years (even though they did), they run afoul of the requirements of *Rales*, *supra*, which teaches that directors face liability when incapable of exercising disinterested and independent judgment because they face a substantial likelihood of liability, even if there were “no conscious decision by directors to act or refrain from acting” *Id.* at 933-34 n.9.

Whether it is the second prong of *Aronson* or the *Rales* test that is in play, demand is excused. As this Court found in *Guttman*:

When, however, there are allegations that a majority of the board that must consider a demand acted wrongfully, the *Rales* test sensibly addresses concerns similar to the second prong of *Aronson*. To wit, if the directors face a “substantial likelihood” of personal liability, their ability to consider a demand impartially is compromised under *Rales*, excusing demand.

Id. at 501 (footnote omitted).

Defendants’ citation to *Stone v. Ritter*, 911 A.2d 362, 364 (Del. 2006), in the Court of Chancery, demonstrates the weakness of their demand argument because, in *Stone*, the Court stated that “the plaintiffs acknowledge that the directors neither ‘knew [n]or should have known that violations of law were occurring,’ *i.e.*, that there were no ‘red flags’ before the directors.” The facts differ greatly from those here. Plaintiff here alleges actual knowledge of criminal violations and the Board’s refusal, for over a four-year period, to correct those violations.

Wood v. Baum, 953 A.2d 136 (Del. 2008), also cited, is similarly unavailing to the Director Defendants. In *Wood*, unlike here, “the Court of Chancery correctly concluded that there were no cognizable ‘red flags’ from which it could be inferred that the defendants knew that FAS 115 was being improperly applied, or that the defendants otherwise consciously and in bad faith ignored the improprieties alleged in the complaint.” *Id.* at 143. The *Wood* Court so found because “[u]nder Delaware

law, red flags ‘are only useful when they are either waved in one’s face or displayed so that they are visible to the careful observer.’” *Id.* (footnote omitted). In *Wood*, plaintiffs failed to provide the Court with any “red flags” even though directed by the Court to do so before oral argument. *Id.* Here, as noted above, “red flags” were waved in the Board’s face, visible to even the most careless observers, during two years of Board presentations and discussions resulting in four years of cover-up.

The duty breached is that of loyalty because the Board’s conduct at issue caused the Company to violate the law, namely, 18 U.S.C. § 1001. “[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey. *See* 8 Del. C. § 102(b)(7)(ii).” *Guttman*, 823 A.2d at 506. For such conduct, demand is excused because “[A] fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.” *In re Goldman Sachs Group, Inc. S’holder Litig.*, 2011 Del. Ch. LEXIS 151, at *65 (Del. Ch. Oct. 12, 2011), *aff’d sub nom.*, *SEPTA v. Blankefein*, 44 A.3d 922 (Del. 2012), citing *In re Massey Energy Co. Deriv. & Class Action Litig.*, 2011 Del. Ch. LEXIS 83 (Del. Ch. May 31, 2011). In *Massey Energy*, the plaintiffs sought a preliminary injunction based on whether that corporation’s directors “breached their fiduciary duty by knowingly failing to discharge their duty to try to make sure that Massey complied with its legal obligations” *Id.* at *71. While

denying the preliminary injunction, the court noted that arguments concerning defendant directors' states of mind would require careful consideration at trial:

At a pleading stage, however, they are of little moment in light of the particularized facts pled by the plaintiffs. Despite the straw man arguments of certain academics, ***Delaware law does not charter law breakers.*** Delaware law allows corporation to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue 'lawful business' by 'lawful acts.' As a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.

Id. at *73-74 (emphasis added; footnote omitted).

Whatever reason the Director Defendants here may have had to mislead the Department of State, their conduct in knowingly causing the Company to overstate and negligently fail to follow through on corrective actions renders them liable for the \$55 million harm suffered by UTC. Stated otherwise, in Leo E. Strine, Jr. *et al.*, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L. J. 629, 652 (2010), where "a corporation faces major injury as a result of illegal conduct, we see no reason why corporate fiduciaries should not face responsibility if they ***knowingly caused or tolerated the illegal conduct.***" (Emphasis added.) The Director Defendants here knowingly caused or tolerated UTC's illegal conduct.

CONCLUSION

The Complaint sets forth particularized allegations, and with the reasonable inferences derived therefrom, shows that each Director Defendant faces a substantial risk of personal liability. Hence, pre-suit demand on the Board was excused. Accordingly, the June 24, 2013 decision of the Court of Chancery should be reversed.

RIGRODSKY & LONG, P.A.

By: */s/ Brian D. Long*

Seth D. Rigrotsky (#3147)
Brian D. Long (#4347)
Gina M. Serra (#5387)
2 Righter Parkway, Suite 120
Wilmington, DE 19803
(302) 295-5310

OF COUNSEL:

HARWOOD FEFER LLP
488 Madison Avenue
New York, NY 10022
(212) 935-7400

*Attorneys for Plaintiff Below-Appellant
Harold Grill 2 IRA*

Date Filed: September 17, 2013

CERTIFICATE OF SERVICE

I hereby certify that on this 20th day of September, 2013, the foregoing PUBLIC VERSION OF CORRECTED OPENING BRIEF OF PLAINTIFF-BELOW APPELLANT was served, by File & ServeXpress, on the following attorneys of record:

Seth D. Rigrodsky
Brian D. Long
Gina M. Serra
RIGRODSKY & LONG, P.A.
2 Righter Parkway, Suite 120
Wilmington, DE 19803

/s/ D. McKinley Measley
D. McKinley Measley (#5108)