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IN THE SUPREME COURT OF THE STATE OF DELAWARE

CITY OF BIRMINGHAM RETIREMENT AND RELIEF SYSTEM, ROBERT L. REESE, POLICE RETIREMENT SYSTEM OF ST. LOUIS, EDWARD TANSEY, AND ESTATE OF LEATRICE SEINFELD, Plaintiffs Below-Appellants, v. LYNN J. GOOD, ANN M. GRAY, G. ALEX BERNHARDT, SR., MICHAEL G. BROWNING, HARRIS E. DELOACH, JR., DANIEL R. DIMICCO, JOHN H. FORSGREN, JAMES H. HANCE, JR., JOHN T. HERRON, JAMES B. HYLER, JR., WILLIAM E. KENNARD, E. MARIE MCKEE, E. JAMES REINSCH, JAMES T. RHODES, CARLOS A. SALADRIGAS, B. KEITH TRENT, LLOYD M. YATES, JAMES E. ROGERS, WILLIAM BARNET III, PHILIP R. SHARP, Individual Defendants Below-Appellees, and DUKE ENERGY CORPORATION, Nominal Defendant Below-Appellee.	No. 16, 2017 On Appeal from The Court of Chancery, C.A. 9682-VCG PUBLIC VERSION - Filed: March 28, 2017

[CORRECTED] APPELLANTS' OPENING BRIEF

Martin S. Lessner (No. 3109)
Kathaleen St. J. McCormick (No. 4579)
Nicholas J. Rohrer (No. 5381)
Meryem Y. Dede (No. 6148)
YOUNG CONAWAY STARGATT & TAYLOR LLP
Rodney Square
1000 North King Street
Wilmington, DE 19801
(302) 571-6600

Delaware Counsel for Plaintiffs Below-Appellant

BARRACK, RODOS & BACINE
Robert A. Hoffman
Jeffrey W. Golan
Julie B. Palley
3300 Two Commerce Square
2001 Market Street
Philadelphia, PA 19103
(215) 963-0600

ROBBINS ARROYO LLP
Felipe J. Arroyo
Shane P. Sanders
Gina Stassi
600 B Street, Suite 1900
San Diego, CA 92101
(619) 525-3900

SCOTT+SCOTT,
ATTORNEYS AT LAW, LLP
Judith S. Scolnick
Donald A. Broggi
Thomas L. Laughlin
The Helmsley Building
230 Park Avenue, 17th Floor
New York, NY 10169
(212) 223-6444

Co-Lead Counsel for Plaintiffs Below-Appellants

ANDREWS & SPRINGER, LLC
Peter B. Andrews
Craig J. Springer
3801 Kennett Pike
Building C, Suite 305
Wilmington, DE 19807
(302) 504-4957

Counsel for Individual Plaintiff Below-Appellant, Robert L. Reese and City of Birmingham Retirement and Relief System

LAW OFFICES OF ALFRED G. YATES, JR., P.C.
Alfred G. Yates, Jr.
519 Allegheny Building
429 Forbes Ave.
Pittsburgh, PA 15219

Counsel for Individual Plaintiff Below-Appellant, Robert L. Reese

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NATURE OF PROCEEDING

Plaintiffs Appellants ("Plaintiffs"), stockholders of nominal Defendant Duke Energy Corporation ("Duke" or the "Company") brought this action derivatively in order to seek redress for the substantial harm caused to Duke by Defendants' complicity in the Company's unlawful mismanagement of its coal ash ponds in the State of North Carolina. In May 2015, Duke pled guilty to nine *criminal* violations of the federal Clean Water Act ("CWA"), 33 U.S.C. §§1251 *et seq.*, and agreed to pay a $102 million fine, the largest criminal fine ever imposed by a federal court in North Carolina. By at least 2013, the Defendants were aware that each of Duke's 33 unlined coal ash ponds located at 14 Company facilities in North Carolina were violating the CWA by discharging toxic and carcinogenic pollutants into the State's waterways. (A151-52).[1] Many of their ponds seeped contaminated water into adjacent rivers, in violation of their permit. Some of these illegal seeps were engineered, meaning the discharge was deliberately conveyed into the rivers through man-made structures. Yet rather than seeking to bring these sites into compliance with the law, Defendants acted to avoid any remediation of the ash ponds, thereby exposing the Company to tremendous environmental liabilities.

Duke's Board of Directors ("Board") was advised about the environmental problems at the coal ash ponds that Duke maintained. In particular, the Board was

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[1] Citations to the Appendix to Appellants' Opening Brief filed contemporaneously herewith are designated herein as "A###."

kept very closely informed about the situation at two of Duke's sites – Asheville and Riverbend – where environmental groups had served Duke and the North Carolina Department of Environmental Quality ("DEQ")[2] with notices of intent to sue ("NOI") under the CWA for the illegal seeps and exceedances of groundwater standards. In response, Duke, with the Board's knowledge, enlisted DEQ to bring its own enforcement action against Duke, thereby stripping environmental groups of the right to sue on their own. Defendants contend this strategy was a good-faith effort by the Company to work with a regulator to avoid litigation by environmentalists while nevertheless crafting a solution that would bring the Company into compliance with the law in a cost-effective manner. But at least as reasonable an inference from the particularized facts pled by Plaintiffs is that Duke's strategic plan was to avoid ***any*** environmental clean-up of its ash ponds by colluding with DEQ, a captive regulator, to agree to a proposed consent decree that did not impose any remediation requirements on the Company. Since the directors' endorsement of a strategy designed to ***evade compliance*** with positive law is a breach of the fiduciary duty of loyalty, demand is futile.

Duke's Board, which includes Defendants, was fully apprised of and endorsed this unlawful strategy. [redacted]

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[2] DEQ had earlier been the Department of Environmental and Natural Resources ("DENR"). The agency will be referred to throughout as DEQ.

[redacted] Indeed, by July 2013, Duke had negotiated a sweetheart deal with DEQ that was to be embodied in a consent decree requiring the Company to pay a trivial $99,000 fine and which did not require any remediation at all.

The proposed collusive agreement between Duke and DEQ never came to fruition because, on February 2, 2014, a massive coal ash spill occurred at Duke's Dan River Steam Station in Eden, North Carolina. The spill was caused by the rupture of a 1950s-era, corrugated metal stormwater pipe that lay beneath a coal ash containment pond adjacent to the river. Twelve days later, a smaller stormwater pipe was also found to be releasing coal ash into the Dan River. By the time the spills were contained, approximately 27 million gallons of contaminated water had entered the Dan River, amounting to the third largest coal ash spill in the

[3] Unless stated otherwise, all emphasis is added and internal citations are omitted.

nation's history. Coal ash coated the river bottom for 70 miles in North Carolina and Virginia.

In the aftermath of the spill, a harsh spotlight was thrown on Duke's cozy relationship with DEQ, which had favored shielding regulated entities (whom it considered "customers") from the expenses of abating unlawful pollution. As a result, DEQ withdrew from the proposed consent decree and initiated enforcement litigation at Duke's other coal ash sites. Even then, as a North Carolina federal district court would find in 2015, it failed to diligently prosecute that litigation.

Defendants' unwillingness to engage in any remediation of Duke's ash ponds before the Dan River spill, even while knowing that the ponds were discharging contaminated water in violation of the law, was an unambiguous breach of the directors' duty of loyalty that requires at a minimum an honest, good-faith attempt to comply with positive law. The directors' breach resulted in significant financial harm to the Company. The Dan River spill sparked a criminal investigation by the U.S. Department of Justice ("DOJ"), which ultimately resulted in payment of the $102 million fine described above, as well as other sanctions for Duke's CWA violations. Additionally, Duke was required to expend tens of millions of dollars in clean-up costs, and fines that were ultimately imposed by DEQ, other governmental entities and through citizen suits.

Plaintiffs, on the basis of Board minutes and presentations obtained through their books and records inspection pursuant to 8 *Del. C.* §220, brought this action seeking a recovery for Duke for these and other harms that resulted from Defendants' breach of their duty of loyalty to the Company. A fair reading of those documents, and other particularized allegations in the Complaint, and reasonable inferences therefrom, compel the conclusion that demand on the Board was futile and the Complaint should have been upheld.

STATEMENT OF FACTS

A. Duke's Coal Ash Disposal Practices Violated Environmental Laws

1. Duke's Coal Ash Ponds

Duke is the largest provider of electrical power in the U.S. and relies on coal-fired power plants to supply much of that capacity. (A066). The process of burning coal for electrical power results in waste byproducts known as Coal Combustion Residuals ("CCRs"). (A038, A066-67). The largest component of CCRs is coal ash, which contains many toxic and carcinogenic substances, such as arsenic, cadmium, chromium, cobalt, lead, mercury, and selenium. *Id.* For decades, Duke disposed of coal ash by mixing it with water and storing the resulting coal ash slurry in unlined ash ponds. Because disposal in this manner required a water source, the ash ponds were located next to adjacent waterways. *Id.* Duke has 33 unlined coal ash ponds located at 14 active or retired power plants in North Carolina. (A040). The disposal of coal ash in unlined ash ponds – sometimes called "wet ash management" or "unlined coal ash storage" – is the cheapest disposal method and the riskiest to the environment and public health. (A073-75).

In general, Duke's unlined ash ponds relied on a process of decantation to reduce the contamination of the coal ash: particulates and chemicals settled to the bottom, leaving relatively less contaminated water at the top. (A155-56). The toxic

CCR materials settled at the "toe" or bottom of the pond, while the cleaner waters, near the surface, were discharged to the adjacent rivers in an amount and manner tightly set by an EPA permit. *Id.* The retaining walls for the unlined ponds typically consist of earthen berms that separate the ponds from the waterways, making the ponds prone to seeps, whereby contaminated water leaches through porous earthen dams to reach nearby groundwater. (A189-90). In addition to these seeps, several of Duke's ponds, including those at Asheville, Riverbend, and H.F. Lee, also featured deliberately engineered seeps. (A118, A151-52, A196, A198). Engineered seeps are created by channeling natural seeps into man-made drains or pipes placed at the toe of ponds (where the concentration of toxins is highest) and discharging the effluent into the adjacent waterways, thereby creating a risk of contaminating adjacent waterways. (A189-91, A198).

2. Governing Environmental Laws

Duke was obligated to maintain its ash ponds in a manner that complied with both federal and state environmental statutes and regulations. Of relevance in this case, the CWA prohibited Duke from making "pollutant discharges," such as toxic coal ash water, directly into waterways unless such discharges were allowed under a National Pollutant Discharge Elimination System ("NPDES") wastewater permit. (A070). NPDES permits are issued by the EPA directly or by a state, if

the EPA had granted authorization to the state.[4] (A158). NPDES permits set out in great detail how, where and when discharges may be made from point sources, and require that all equipment facilitating the discharge be maintained in good order. (A159-60).

In 2010, the EPA issued guidance making clear that seeps discharged directly into the waters of the United States, such as those at issue in this case, were covered by the CWA and thereby illegal unless expressly allowed under an NPDES permit. (A190-91). Each unauthorized discharge, such as the seepage of water from coal ash ponds that reaches a navigable waterway (*i.e.*, the rivers adjacent to Duke's 33 coal ash ponds), constitutes a violation of the CWA. (*Id.*; A070). None of the permits granted to Duke at any of the coal ash sites allowed for seeps into navigable waters. (A267) ("Seeps are unpermitted discharges."). Further, since 2010, the NPDES permitting process required Duke to "monitor groundwater" quality "to assure [that] natural resources [we]re protected in accordance with federal and state water quality standards." (A191).

The CWA calls for injunctive relief or remediation, and both civil and criminal penalties for violations. It is a CWA violation to discharge any pollutant (such as coal ash wastewater) into a waterway that is not expressly permitted under

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[4] Forty-nine states were authorized to grant permits, including North Carolina since 1979. (A157).

a NPDES permit. 33 U.S.C. §1319(c), (d). The primary enforcer of violations is the EPA or the authorized state regulators. 33 U.S.C. §1319(a). However, interested citizens may also commence citizen suits to seek enforcement of a permit, and abatement of any discharges in violation of the permit, in the event that the regulators decline to bring or diligently prosecute an enforcement action. 33 U.S.C. §1365.[5] Third-party litigators, such as environmental groups, are required, as a condition precedent to suit, to issue a 60-day NOI to the violator and the regulator stating their intention to sue and the specific laws and/or permit provisions that are alleged to be violated. Citizens are permitted to go forward with suits only if the regulator fails to initiate an enforcement action within the 60-day notice period, or if the regulator initiates an enforcement action but then fails to "diligently prosecute" it. 33 U.S.C. §1365(b)(1). If the regulator does sue and diligently prosecutes, then the third party loses standing to pursue. 33 U.S.C. §1365(b)(1).

The NPDES permit also requires that the permittee ensure that groundwater surrounding coal ash basins are protected in accordance with federal and state water quality standards. (A191). North Carolina sets safety limits for various

[5] "The primary function of the provision for citizen suits is to enable private parties to assist in enforcement efforts where Federal and State authorities appear unwilling to act." *Water Quality Protection Coalition v. Mun. of Arecibo*, 858 F. Supp. 2d 203, 211 (D.P.R. 2012) (quoting *North and South Rivers Watershed Assoc., Inc. v. Town of Scituate*, 949 F.2d 552, 555 (1st Cir. 1991).

toxic and carcinogenic materials found in coal ash. If groundwater discharges exceed any of the various standards, that constitutes an "exceedance," which is unlawful under both federal and state law. (A103-04).

For years, but at least for 2010-2014, Duke violated the CWA, as a standard operating procedure, by allowing seeps to illegally pour hundreds of millions of gallons of contaminated wastewater into North Carolina's waterways. There is no question that these seeps – particularly those that Duke channeled directly into rivers – violated the CWA because they were not allowed for under Duke's NPDES permits. As the U.S. Government stated during Duke's sentencing:

> ***[T]here is clearly no dispute that you are not supposed to channel seeps directly into a river without a permit.*** . . . The fact that the defendants were aware that their earthen coal ash basins would inevitably have seeps and did not take precautions to ensure that those seeps were not being channeled through ditches and other conveyances constructed by its employees to nearby rivers, which was in fact allowed to occur for a period of years at each of those facilities, is again indicative of a need for change in the culture of the defendants and their management of the coal ash basins. (A119).

3. Defendants Knew that Duke Was Violating Environmental Laws

Duke executives were well aware that illegal seeps, including deliberately engineered seeps, were occurring at many of its ash ponds, and that there were exceedances of groundwater standards for toxic substances at each of the 33 ponds. (A103-04). An August 28, 2014 letter from DEQ to EPA Administrator Regina McCarthy and Lynn Good, Duke's CEO, makes clear that these problems

were well known and well documented for many years. (A041-42, A072-73). The letter stated that Duke's coal ash ponds have been associated with "long ignored environmental problems." The letter further noted that: "These problems, ranging from unauthorized discharges to groundwater contamination, ***have been well known and well documented for decades***, yet virtually no initiative was undertaken . . . to address these problems until quite recently." (A041-42). In its concluding section, the letter stated, among other things:

> It is clear that prior to January 2013 when this Administration took office, ***Duke Energy was allowed to operate coal ash impoundments resulting in groundwater contamination that potentially threatens North Carolina's environment and public health...***
>
> ***As early as 2007, then it was known that there were exceedances of environmental standards at many of these coal ash sites.*** However, until very recently, no serious action was taken ***by anyone***, including citizens groups, to assess the situation or require remediation.

(*Id.*; *see also* A296). The letter leaves no doubt that the serious environmental problems with Duke's coal ash ponds were well known for many years by many parties, including Duke.[6]

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[6] In the proceedings below, Defendants attempted to minimize the import of DEQ's letter by arguing that it mostly concerns the past failure to address coal ash problems by the agency responsible for enforcing environmental laws. (A801). However, while the DEQ letter – which was written about seven months ***after*** the Dan River spill – reflects the agency's criticism of previous administrations, ***this in no way detracts from the fact that Duke was aware it was violating environmental laws***. Defendants also pointed out that the DEQ letter noted that unlined ash ponds "are designed with engineered seeps to maintain structural integrity." *Id.* Regardless of their purpose, once the seeps entered the navigable

The Joint Factual Statement that Duke agreed to as part of its May 2015 plea agreement with the DOJ also makes clear the Company was well aware that its coal ash management practices violated environmental laws. The Statement admits, for example, that since 2010, groundwater monitoring required as part of the NPDES permitting process "has shown exceedances of groundwater water quality standards for pollutants under and near the basins including arsenic, boron, cadmium, chromium, iron, manganese, nickel, nitrate, selenium, sulfate, thallium, and total dissolved solids." (A191-92). Moreover, "[a]t various times between 2010 and 2014 the Defendants included general references to seeps in correspondence and permit applications with [DEQ] and disclosed more detailed information concerning certain seeps, including engineered seeps (i.e., man-made channels)." *Id.*; (A192). However, "[***t]he Defendants did not begin gathering and providing detailed, specific, and comprehensive data concerning seeps, and particularly seeps discharging to waters of the United States, at each of the North Carolina coal ash basins to [DEQ] until after the DAN RIVER spill in 2014.***" *Id.* Thus, the Company has acknowledged that it was aware of the seeps and that there were exceedances of groundwater quality standards, but took no

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waterways, the Company was in violation of the CWA and was obligated to take remedial action to comply.

action to even gather and compile comprehensive data about them, let alone take steps to abate them, until after the Dan River spill.

4. Duke's Board Was Told About Duke's Widespread Violations and Approved a Strategy to Collude with DEQ to Avoid Taking Remedial Action

One of Duke's Board committees, the Regulatory Policy and Operations Committee ("RPOC"), was formed in 2012 and oversaw the Company's regulatory, strategic and public policy positions. (A126-27). Eight of the fourteen Demand Directors regularly attended committee meetings during the relevant period.[7] The RPOC met 10 times between its July 2012 formation and the end of 2013, and it was the regular business practice of the Company to have the RPOC report to the full Board after each meeting. (A072). [redacted]

[7] Defendants Bernhardt, Herron, Hyler, Meserve, Rhodes, Saladrigas sat at various points on the RPOC, and Defendants Good and Gray regularly attended meetings.

[redacted] In response to these notices, Duke developed a strategy to seek DEQ's intervention in the contemplated litigation, thereby preempting the citizen suits. This strategy was not undertaken in good faith for the purpose of crafting a regulatory solution to address known violations of the law. Rather, it was intended to allow Duke to continue doing business as usual and avoid remediation of its ash ponds. Duke management looked to its captive regulator, DEQ, to facilitate that strategy, which Trent described to the Board.

DEQ, which had not been a particularly vigorous enforcer of environmental laws for multiple administrations (A044), became particularly friendly to industry and to Duke with the 2012 election of North Carolina Governor Pat McCrory

("McCrory"), who had previously been a Duke employee for 28 years and who had received $1.1 million in campaign contributions from Duke and its employees. (A094). McCrory's appointee to head DEQ, John Skvarla ("Skvarla"), described DEQ's regulated entities as "customers" and proclaimed that "instead of crushing their dreams, they now have a state government that treats them as partners." (A095-96). DEQ insiders noted that, under McCrory's administration, "North Carolina has changed the definition of who its customer is from the public and natural resources it is supposed to protect to the industries it regulates." (A096). DEQ staffers became "hesitant to crack down on polluters who might complain to Mr. Skvarla or a lawmaker, at the risk of their jobs." (A306). As a result, DEQ effectively abandoned its role of pursuing enforcement against polluters.

According to emails obtained by the *New York Times*, Duke's lawyers had contacted DEQ after receiving the NOI letters to seek an agreement concerning the subject of the planned citizen suits. (A097). This occurred shortly before Trent's presentation to the Board in May 2013. DEQ and Duke's lawyers subsequently discussed how the SELC, which filed the NOIs, could be excluded from any discussions concerning an agreement. *Id.* In late March 2013, and late May 2013, DEQ filed its own enforcement actions against Duke arising from CWA violations at Asheville and Riverbend respectively, the two sites which the citizen suits were

targeting for violations. DEQ's intervention effectively preempted the citizen suits. *Id.*

The Board was well aware of this strategy and condoned its implementation.

[redacted] The full Board also reviewed the RPOC meeting minutes. (A100-01).

The minimal nature of the proposed settlement with DEQ emerged over the next several months. In July 2013, DEQ submitted a proposed settlement for resolving the environmental claims for the Asheville and Riverbend facilities. The proposed consent order assessed civil penalties against Duke for approximately $99,000 – a meaningless amount for a Company that was earning over $2.5 billion per year. Even more significantly, ***the proposed consent decree did not include any mandate that Duke ensure that the engineered seeps flowing from the Company's ash ponds were not flowing into adjacent waterways.*** (A100). While the consent order did allow for the possibility of some monitoring studies – not abatement – there was no timetable by which the studies were required to be undertaken. In August 2013, DEQ, [redacted] filed complaints with respect to Duke's twelve other North Carolina facilities that store coal ash. (A100). The tactic was an effort to extend the reach of the proposed consent decree to all fourteen Company facilities with coal ash sites and ensure that no remediation would be required at any of them.

[redacted]

[redacted]

[redacted] Indeed, there is nothing in the record from which the Board could have reasonably concluded that Duke had any plans for remediating the seeps that were in clear violation of state and federal environmental laws.

5. The Board's Sanctioning of an Unlawful Strategy to Evade the Law Was a Proximate Cause of the Guilty Plea and Ensuing Harm

DEQ and Duke proceeded with their collusive enforcement action. DEQ established a thirty-day period for public comments on the proposed consent order, which period ended on August 14, 2013. (A105). According to a September 13,

2013 DEQ report, the agency received nearly 5,000 comments. Nearly 93% of the comments stated that DEQ should conduct a public hearing on the proposed consent order, and 54% stated that the studies that the proposed consent order would require did not go far enough in addressing environmental concerns. *Id.* On September 27, 2013, the EPA weighed in and criticized the proposed consent order. *Id.* On October 4, 2013, DEQ submitted an amended consent order to the court. Despite the comments received from the public and the EPA, the proposed consent order maintained the civil penalties at $99,000 and still failed to require Duke to undertake remediation of any of its ash ponds. (A105-06).

By knowingly condoning a strategy that allowed Duke to continue to violate the law, Defendants breached their duty of loyalty and exposed the Company to significant harm. That risk became a reality when the Dan River spill occurred, prompting DEQ to withdraw from the consent decree. The DOJ initiated a criminal investigation that ultimately led to guilty pleas for, among other misconduct, the illegal discharge of coal ash and coal ash wastewater at the Riverbend, Asheville and H.F. Lee sites through "engineered" channels and drainage ditches.

B. The Dan River Spill Was Emblematic of the Board's Failure to Require Duke to Comply with Environmental Laws

On February 2, 2014, a 48-inch corrugated metal stormwater pipe, installed sometime in the mid-1950s, ruptured underneath a coal ash containment pond at

Duke's retired Dan River Steam Station. The rupture caused a massive release of coal ash pollutants and contaminated water directly into the adjacent Dan River. On February 14, 2014, government investigators determined that a smaller stormwater pipe at the Dan River station was also releasing coal ash into the Dan River. As a result of the spills, approximately 39,000 tons of coal ash and 27 million gallons of contaminated water entered the Dan River before the spill was contained, making it the third worst coal ash spill in the nation's history. (A040, A086-87).

Duke ultimately pled guilty to three counts of criminal misconduct associated with the Dan River spill. In connection with its plea agreement, Duke acknowledged that in 2011 and 2012, several requests had been made by Duke engineers to conduct a camera inspection of the stormwater pipes running underneath the Dan River ash basin. (A172-75). The inspection would only have cost $20,000, but the requests were denied by Duke's Vice President of Budgeting. Commenting on these facts at Duke's sentencing hearing, the U.S. Government stated:

> It is the defendants' failure to listen to their employees and to rely on those employees' expertise, ***it is the historic systemic problems within the company that brought them here***, but it is also, Your Honor, the breach of the public's trust. (A115-16).

Plaintiffs do not contend that Defendants were specifically aware that the stormwater pipes underneath the Dan River ash pond were corroded and in danger of rupturing. However, there is reason to believe that the failure to properly inspect the stormwater pipes was the product of a high-level decision within the Company. After the Dan River spill, DEQ issued a notice of violation to Duke for failing to obtain a stormwater permit for the facility. Duke was ultimately cited for failing to obtain stormwater permits for five other facilities as well. (A043). Stormwater permits would not allow the discharge of wastewater from coal ash basins. (A163). The lack of permits for Dan River and five other facilities was the product of Duke's resistance to conducting stepped-up monitoring of its stormwater systems, as the permits would have required, and pressure exerted by Duke on its captive regulator, DEQ, to avoid the issuance of permits for individual facilities.

As reported in a March 3, 2014 *New York Times* article, George Everett, Duke's director of environmental and legislative affairs, met with DEQ officials in 2011 and 2012 to discuss the issue of stormwater permits. Duke reportedly sought a general landfill permit for its ash ponds around the State, a less stringent permit than the stormwater permits for individual facilities that DEQ was seeking to require. (A089-90). According to a *Charlotte Observer* article, also dated March 3, 2014, stormwater regulators at DEQ said a general permit would not be

sufficient because it would not address the specific risks of pollution from an ash basin. But Duke reportedly resisted the issuance of individual stormwater permits because it did not want to be subject an extended public comment period, which would have been required before such permits could be issued. (*Id.*; *see also* A163). Further, personnel in DEQ with direct responsibility for stormwater permits reportedly sought the issuance of individual permits, but were told to wait until a supervisor could discuss it with the Company. *Id.* As a result, the issue was allowed to languish, and Duke was well aware that it was operating without the required permits. The Company's failure to comply with the law allowed it to avoid a more stringent inspection regime that would have been required under a stormwater permit, which would likely have resulted in discovery of the corroded pipes that gave rise to the Dan River spill.

SUMMARY OF ARGUMENT

The Court of Chancery erred in holding that the Complaint does not adequately plead facts from which it may reasonably be inferred under *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), that Duke's directors face a substantial likelihood of personal liability for allowing the Company to violate environmental laws by the unlawful operation of its coal ash ponds. In rejecting Plaintiffs' particularized allegations that the directors, in bad faith, were exploiting Duke's relationship with a captive state regulator to evade compliance with environmental laws, the Court of Chancery: (i) failed to consider highly relevant federal court precedent that the *same* regulator, during the *same* time period, failed to enforce in good faith the *same* environmental laws governing coal ash pond maintenance against Duke; and (ii) improperly discredited Plaintiffs' reasonable interpretation of Board minutes and presentations. Giving Plaintiffs the benefit of all reasonable inferences, these minutes reveal the Board knew Duke's proposed consent decree with DEQ was an evasion of, not compliance with, environmental laws. By declining to assess the demand futility allegations as a whole, or to make reasonable inferences in Plaintiffs' favor, as is required under Delaware law on a motion to dismiss, the Court below erred by holding Plaintiffs not merely to a strict burden of proof, but to an impossible burden of proof on Plaintiffs' breach of loyalty claim. The Company's criminal guilty plea in 2015 concerns the same

environmental violations at the same sites that the Board learned of in great detail two years earlier, yet failed to take any meaningful action to abate. This fact alone makes the Court's dismissal of the Complaint improper.

ARGUMENT

I. THE COURT BELOW ERRED IN DETERMINING THAT THE COMPLAINT FAILED TO PLEAD DEMAND FUTILITY

A. QUESTION PRESENTED

Does the Complaint sufficiently allege that the Board's knowing or reckless disregard allowed the Company to violate federal and state environmental laws, thereby subjecting the directors to liability under *In re Massey Energy Co.*, 2011 WL 2176479, at *20 (Del. Ch. May 31, 2011), which mandates that Delaware directors strive to comply with positive law? (A127-35; A435-36; A442-43; A446-47; A485; *see also* Plaintiffs' Notice of Appeal, filed January 9, 2017 and Amended Notice of Appeal, filed January 24, 2017).

B. SCOPE OF REVIEW

The Court's review of the decision on a motion to dismiss under Del. Ch. Ct. R. 23.1 is *de novo* and plenary. *Del. Cty. Emp. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1021 (Del. 2015); *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008). The Court must accept all well-pleaded allegations as true and draw all reasonable inferences in Plaintiffs' favor. *Sandys v. Pincus*, 2016 WL 7094027, at *3 (Del. Dec. 5, 2016); *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

C. MERITS OF THE ARGUMENT

1. Standard for Demand Futility

A key tenet of Delaware corporate law is that a director may not knowingly countenance corporate law-breaking.

> Under Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity.

Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121, 131 (Del. Ch. 2004).

> Delaware law does not charter law breakers, and a fiduciary of the Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.

In re Massey Energy Co., 2011 WL 2176479, at *20. *See also* Strine, Leo, et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, Georgetown Law Journal, Vol. 98:629, 650 (hereafter, "*Loyalty's Core Demand*") ("When directors knowingly cause the corporation to do what it may not – engage in unlawful acts or unlawful businesses – they are disloyal to the corporation's essential nature.").

A Delaware director is granted a wide berth in making business judgments on behalf of the corporation he or she stewards and those decisions may be good, bad, negligent, or down-right foolish without exposing the director to personal liability. 8 *Del C.* §145 (excluding director from liability for ordinary negligence).

But the "line in the sand" limit on the director's authority, for which a transgression does expose the director to personal liability, is where the director fails to at least aim to comply with positive law. *See Loyalty's Core Demand*, *supra* at 649 (conduct by directors knowingly allowing a corporation to break the law is "disloyal in the most fundamental sense"). Since a shareholder derivative action is one of the most effective tools to ensure directors remain mindful of their duty to the company on whose board they serve to obey positive law, it is important the proper balance be set in applying the demand futility standard. While one goal is to shield boards of public companies from strike suits, it is equally important to protect shareholder rights by allowing suits with a reasonable basis to proceed. *Ryan v. Gifford*, 918 A.2d 341, 352 (Del. Ch. 2007).

The interpretive rule that "affords plaintiffs all reasonable inferences that logically flow from the particularized facts alleged in the complaint" in a Rule 23.1 complaint must be applied (rather than simply acknowledged) so that "the grist" can properly be separated from "the chaff," and cases that reasonably appear to be valid are permitted to go forward past the motion to dismiss stage. *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000) (plaintiff is entitled to "all reasonable factual inferences" flowing from the allegations of its complaint, and must establish only a "reasonable doubt" regarding the ability of a company's board to consider a demand). Indeed, this Court has recently underscored the importance of

granting a plaintiff every reasonable inference and forgoing making inferences on behalf of the defendant at the pleading stage. "[A]lthough the plaintiff is bound to plead particularized facts in pleading a derivative complaint, so too is the court bound to draw ***all inferences*** from those particularized facts in favor of the plaintiff, not the defendant, when dismissal of a derivative complaint is sought." *Sanchez*, 124 A.3d at 1022 (quoted in *Sandys v. Pincus*, 2016 WL 7094027, at *3); s*ee also In re China Agritech, Inc. S'holder Deriv. Litig.*, 2013 WL 2181514, at *14 (Del. Ch. May 21, 2013) ("The requirement of factual particularity does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations.").

Delaware law does not require a plaintiff to plead facts or evidence supporting a "judicial finding" of director impartiality because that would be "an excessive criterion" in applying Rule 23.1. *Grobow v. Perot*, 539 A.2d 180, 183 (Del. 1988); *Brehm*, 746 A.2d at 254 (a plaintiff is "***not*** required to plead evidence"). Moreover, "substantial likelihood" of liability under *Rales* does not "require[] that a plaintiff . . . demonstrate a reasonable probability of success on the merits." *Rales*, 634 A.2d at 934. Rather, a plaintiff need only "make a threshold showing, through the allegation of particularized facts, that [the] claims have ***some*** merit." *Id.* (citing *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984)).

Here, Plaintiffs' particularized allegations *and reasonable inferences* therefrom show there are overwhelming reasons to doubt the directors could have

responded with the requisite disinterest to a demand. To the contrary, the directors: (1) knew and received information that Duke was maintaining its coal ash ponds in a manner that violated environmental laws; and (2) knowingly worked with DEQ, a captive regulator, to maintain the status quo of their coal ash ponds, rather than remediate the violations. Further, such failures proximately resulted in injury to Duke.

2. Duke's Directors Knew of and Received Detailed Information Concerning the Company's Violations of Environmental Laws

The Defendants disputed below that Duke's Board members knew there were environmental violations at Duke's coal ash ponds. This contention is not tenable, however, in the face of Defendants' admission that the Board was given "extensive presentation[s]" on their maintenance of coal ash ponds, where they "talk[ed] about these issues . . . discuss[ed] them . . . underst[ood] them, . . . and [were] told . . . [what] is actually happening on the ground." (A366). [redacted]

[redacted]

Another salient piece of evidence of the Board's knowledge of Duke's unlawful conduct, which cannot be reconciled with Defendants' contention that the directors had a good-faith belief that the Company was complying with the law, is that [redacted] Although the underlying goal of the DEQ actions was to deprive the citizens' groups from maintaining standing to sue the Company, [redacted] Duke and its Board knew that the environmental violations would continue.

Defendants argued below that *Melbourne Municipal Firefighters' Pension Trust Fund on Behalf of Qualcomm, Inc. v. Jacobs*, 2016 WL 4076369 (Del. Ch. Aug. 1, 2016), *on appeal,* Case No. 444, 2016 (Del.), "closely resembles" this case. (A320). In *Melbourne*, the Court of Chancery determined that the Qualcomm directors were not acting in bad faith because they sincerely believed the company's business practices were aligned with relevant antitrust law, despite several substantial international regulatory fines and adverse verdicts. Here,

however, Duke's Board clearly recognized their maintenance of seeping coal ash ponds was illegal, [redacted] In addition, Duke's 2015 guilty plea, which admits that Duke bore full responsibility for all violations, including at the Riverbend and Asheville sites, renders *Melbourne* utterly inapposite.

Defendants also asserted below that, since the Board was facing "an area of changing regulations and emerging legal theories as to whether seeps are discharges" (A374), Plaintiffs' allegations of the Board's bad faith should not be credited. However, the EPA's 2010 directive that seeps that are not specifically allowed under an NPDES permit would constitute a CWA violation was very clear. As the U.S. Government noted during Duke's sentencing hearing, "there is clearly no dispute that you are not supposed to channel seeps directly into a river without a permit." (A605). Accordingly, there is no basis for finding that the Board acted in good faith by allowing this illegal activity to continue.

In any event, Delaware law does not require that a law be nuance-free for a Delaware director to have a duty to obey it. To the contrary, in *Louisiana Municipal Police Employees' Retirement System v. Pyott ("Pyott I")*, 46 A.3d 313 (Del. Ch. 2012), *rev'd sub nom on other grounds, Pyott v. Louisiana Mun. Police Employees' Retirement System*, 74 A. 3d 612 (Del. 2013), the Court of Chancery found demand to be futile where the directors of pharmaceutical company Allergan

were briefed on, but did not quash, a business plan that could reasonably be interpreted as driving an increase in sales by illegally promoting off-label use of an FDA-approved product, BOTOX. *Id.* at 352-53. The Court made this determination notwithstanding that what constitutes off-label selling of pharmaceutical products was not a bright line. *See Schouest v. Medtronic, Inc.*, 13 F. Supp. 3d 692, 701 (S.D. Tex. 2014) ("Federal law does not expressly define . . . off-label promotion."). Indeed, the Court of Chancery recognized that the directors may well have "approved a business plan and management initiatives in the good faith belief that Allergan was remaining within the bounds of the law, although perhaps close to the edge." *Id.* at 356. Yet, the Court of Chancery upheld the *Caremark* claim in *Pyott* because there existed a reasonable doubt that the Allergan board could disinterestedly consider a demand.

Here, the factual allegations of the Complaint are even stronger than those in *Pyott.* As alleged, based in part on internal books and records, Duke's Board knew

[redacted] Plaintiffs

are thus entitled to the reasonable inference that the directors knew Duke's coal ash ponds were being maintained unlawfully, and to a finding that demand was futile.

3. The Board Was Aware that Duke Was Colluding with DEQ to Avoid Compliance with Environmental Laws

The Opinion correctly summarizes the differing scenarios posed by the parties in this Action. The Defendants posit that the Board made a good-faith decision to work with DEQ and block citizen suits filed by environmentalists (who may have a more aggressive agenda) to fashion a consent order that would achieve compliance at Duke's coal ash sites in a cost-effective manner. Plaintiffs posit a different scenario based upon inferences that are at least, if not more, reasonable.

> [P]laintiff's view [is that] "in exploiting its relationship with this tainted regulator, [Duke] was increasing the risk of harm to third parties, as well as potential company liability, and the board was aware of this and yet did nothing to stop it, in a conscious disregard of its duty to act."

(A503). Plaintiffs' view was more than amply supported by the facts alleged and the reasonable inferences drawn from them. *See Pyott I*, 46 A.3d at 356 ("At this stage of the case, I must credit this inference [in favor of plaintiff], even if I believe it more likely that the directors acted in good faith.").

a. DEQ Was a Captive Regulator

In 2015, a federal district court rendered a decision in *Yadkin Riverkeeper, Inc. v. Duke Energy Carolinas, LLC*, 141 F. Supp. 3d 428, 454 (M.D.N.C. 2015), that confirms Plaintiffs' allegations that DEQ was a captive regulator of Duke. In

Yadkin, which is in the record (A420), Duke sought dismissal of a citizen suit seeking to abate environmental violations at its Buck Steam coal ash site, based on its contention that DEQ was already prosecuting in good faith its own action concerning the same facility. The court denied Duke's motion after finding that DEQ was not "diligently prosecuting" its action to seek compliance. The court described the standard of "diligent prosecution" as follows:

> [A] CWA enforcement prosecution will ordinarily be considered 'diligent' if the judicial action "is capable of requiring compliance with the Act and ***is in good faith calculated to do so."***

141 F. Supp. 3d at 441. "It requires that the agency 'try, diligently' to achieve compliance." *Id.*

The court traced the history of DEQ's eleventh-hour blitz of enforcement actions filed in state court in 2013 encompassing each of Duke's thirty-three coal ash ponds at its fourteen North Carolina facilities, including the Buck Steam site, "in an alleged effort to preempt citizen groups from initiating their own suits in federal court." *Id.* at 442 n.7. Following the flurry of enforcement actions, ***the court noted that nothing meaningful was done to prosecute them.*** *Id.* Indeed, even after the February 2014 Dan River coal ash spill prompted the DOJ to investigate the relationship between Duke and DEQ, the court found that DEQ had done little, if anything, to move the case forward. Based upon this record of non-prosecution, the court stated that it was "unable to find that DENR was trying

diligently or that its state enforcement action was calculated, ***in good faith,*** to require compliance with the Act." *Id.*[8]

The Court of Chancery's failure to consider *Yadkin*'s express finding regarding DEQ's bad-faith prosecution of Duke's unpermitted seeps from its toxic coal ash ponds cannot be reconciled with the requirement that the Court must make all inferences in plaintiff's favor in determining demand futility. *Sandys v. Pincus*, 2016 WL 7094027, at *3. A key part of Plaintiffs' claims in this case is that DEQ filed enforcement actions in 2013, not to bring Duke into compliance with environmental laws but to prevent the citizen suits from effectuating compliance. That finding is at the heart of the *Yadkin* decision. Moreover, the fact that DEQ could not be prodded into effective prosecution of the CWA even ***after*** the February 2014 Dan River disaster is further evidence that DEQ was, exactly as Plaintiffs pled, a captive regulator that was not interested in achieving compliance.

Yadkin provides persuasive evidence that DEQ was a captive regulator and did not bring its actions "in good faith, to require compliance with the Act." Other evidence, as pleaded in the Complaint, includes: (i) Duke's campaign contributions to Governor McCrory, a former Duke executive; (ii) quotes from agency employees telling of threatened job loss if environmental laws were enforced under

[8] The alleged violations at the Buck Steam Station included engineered seeps, similar to those at Asheville and Riverbend on which the Board was briefed in 2013.

a "customer-friendly" regime; (iii) meetings between Duke and DEQ shortly after the threatened citizen suit at Asheville, where Duke sought help from the regulator; and (iv) [redacted] In addition, the paltry sum of the proposed consent decree ($99,000 for a company with annual earnings in excess of $2.5 billion), and its lack of required remediation, are evidence that DEQ was not interested in obtaining compliance with the law. None of these allegations was credited in the Opinion.

By alleging that DEQ was essentially a captive of the industries it was supposed to regulate, especially Duke, Plaintiffs are not asserting that DEQ or other state officials were "corrupt" in the sense that they were taking bribes from the Company. Plaintiffs recognize that political leaders and those serving under them have latitude to make policy choices in determining how aggressively they will enforce the law. Further, Plaintiffs have no issue with a company that seeks to work lawfully with regulators for a cost-effective remedy for violations instead of facing litigation by environmental groups who may be more zealous prosecutors. Plaintiffs contend, however, that Duke, with the knowledge and approval of its directors, crossed the line by exploiting its relationship with DEQ so as to allow Duke to continue to violate the law in exchange for a sweetheart "slap on the wrist" penalty. In fact, although the Court of Chancery made no reference to

Duke's 2015 guilty plea, the Company's acknowledgement of violations at Asheville and Riverbend (on which the Board had been briefed two years earlier) reflects that Duke essentially agreed with Plaintiffs' contentions in this lawsuit: they crossed the line.

b. The Board Knew the Proposed Consent Decree Would Not Bring Duke Into Compliance

The Court of Chancery also erred in not crediting Plaintiffs' reasonable inferences from the 220 documents showing Board knowledge that the consent Decree was a sham. For example, the Court discounted the significance of the quotation marks around the phrase [redacted] Instead the Court opined – without any support in the record – that the quotation marks only meant that the phrase was a "term of art." (A506-07).[9] In addition, it was error to deny Plaintiffs' request that the statement in the [redacted]

[9] Indeed, several terms of art were not in quotes, for example, [redacted]

Defendants argued below that they did not act in bad faith because the Board "was taking responsible action to address the issues that had been identified." (A374). In support of this contention they pointed out that the Board was told, among other things, [redacted]

In order to sustain the claims in the Complaint, however, Plaintiffs need not assert that Duke was taking absolutely no steps to protect the safety of its 2,497 acres of toxic coal ash ponds. In *Massey*, where some concrete steps were taken toward improving miner safety, the Court credited plaintiffs' plausible inferences that the outside directors went "through the motions – rather than make good faith efforts to ensure that Massey cleaned up its act." *See Massey Energy*, 2011 WL 2176479, at *19.

Similarly, the Duke directors' claimed belief – that their executives could pick and choose which environmental laws should be obeyed and which could be violated – does not insulate them from liability. [redacted]

[redacted] It simply is not Duke's or the Board's province to decide that seeps that were illegal under the Company's permits could be ignored. *See, e.g.*, *Westmoreland Cty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719, 726-27 (7th Cir. 2013) (Baxter directors' decision to reduce expending funds to fix a defective pump – as required by FDA officials – because the effort had become too costly was deemed "bad faith" at the motion to dismiss stage). Defendants' contention below that Duke's limited attempts at remediation should insulate them from liability is also belied by the Company's own admission in connection with its guilty plea, that it did not "***begin gathering and providing detailed, specific, and comprehensive data concerning seeps***" until ***after*** the Dan River coal ash spill. (A192).

Moreover, all of the activities cited by Defendants, whatever their merit, begs the question of what the Board was actually told about the proposed consent decree and whether the Board was aware that the consent decree would, in effect, allow the Company to continue to violate the law. On this question, the record amply demonstrates that there was no basis for the Board to conclude that the proposed consent decree would remedy the Company's violations. [redacted]

[redacted]

[redacted] Thus, there is nothing in the record to suggest that the Board could have reasonably concluded that the proposed consent decree required Duke to undertake any actual remediation of its environmental violations. Certainly the particularized allegations and reasonable inferences therefrom entitle this Complaint to proceed at the Rule 23.1 stage.

II. THE DIRECTORS' UNFAITHFUL CONDUCT PROXIMATELY CAUSED DUKE'S CRIMINAL CONVICTION AND ENSUING CIVIL FINES

Plaintiffs are seeking a recovery on behalf of Duke for the harm caused by Defendants' breach of their duty of loyalty to the Company. The corporate harm to Duke includes, among others: (i) the payment of a $102 million fine as part of the Company's guilty plea to the federal criminal indictment; (ii) the expenditure of more than $24 million in repairs and remediation associated with the catastrophic Dan River coal ash spill; (iii) the assessment of nearly $12 million in fines and penalties to state and municipal entities in North Carolina and Virginia arising from the Dan River spill; (iv) a $7 million fine imposed by DEQ related to groundwater contamination at the Company's L.V. Sutton Facility; and (v) protracted enforcement litigation with DEQ and related citizens' environmental lawsuits.

The Complaint more than sufficiently alleges that these corporate harms were proximately caused by Defendants' disloyalty to the Company. As described above, the reasonable inferences drawn from the Complaint show that Defendants breached their duty of loyalty by allowing Duke to enter into a consent decree that allowed Duke to continue to engage in known violations of the law. The tragic Dan River spill focused attention on Duke's relationship with DEQ and forced DEQ to withdraw from the proposed consent decree. It also prompted DOJ to

investigate the Company, leading to the criminal information and $102 million fine.

Three counts of the criminal indictment related to the engineered seeps at Asheville, Riverbend and H.F. Lee. As described above, Defendants were aware from at least 2013 that these engineered seeps existed, yet took action through the sham consent decree to evade compliance with the law. There is thus a direct link between the Board's disloyalty in allowing and condoning the Company's violations of environmental laws and at least three of the nine criminal counts relating to engineered seeps at the Asheville, Riverbend and H.F. Lee facilities to which Duke pled guilty. This, by itself, provides a sufficient nexus between the Board's breach of its duty of loyalty and the harm the Company has sustained through fines, expedited compliance schedules, and other costs that Duke has been forced to pay.

Moreover, had a consent decree that placed Duke on a path to remediating its ash pond sites been agreed to by the time of the Dan River spill, it is possible the DOJ would not have pursued criminal action against the Company (or at least not for the illegal seeps). And had the Dan River site been inspected as lower-level employees repeatedly sought (for the nominal cost of $20,000) or had the site received a proper stormwater permit that would have required a more stringent inspection regime, the Dan River spill may have been averted altogether. As

described by the U.S. Government at Duke's sentencing hearing, the issues with engineered seeps and the failure to authorize camera inspections were "systemic" failures caused by a corporate culture that failed to value environmental compliance. (A115-16, A119). By allowing such a corporate culture to flourish, the Defendants' breach of their fiduciary duty led directly to the harms sustained by the Company. *See South v. Baker*, 62 A.3d 1, 15 (Del. Ch. 2012) ("If a corporation suffers losses proximately caused by illegal conduct ... then there is a sufficient connection between the occurrence of the illegal conduct and board level action of conscious inaction to support liability.")

CONCLUSION

For all the foregoing reasons, Appellants respectfully request reversal of the decision of the Court of Chancery.

Dated: March 13, 2017

YOUNG CONAWAY STARGATT & TAYLOR LLP

/s/ Nicholas J. Rohrer

Martin S. Lessner (No. 3109)
Kathaleen St. J. McCormick (No. 4579)
Nicholas J. Rohrer (No. 5381)
Meryem Y. Dede (No. 6148)
YOUNG CONAWAY STARGATT & TAYLOR LLP
Rodney Square
1000 North King Street
Wilmington, DE 19801
(302) 571-6600

Delaware Counsel for Plaintiffs Below-Appellant

BARRACK, RODOS & BACINE
Robert A. Hoffman
Jeffrey W. Golan
Julie B. Palley
3300 Two Commerce Square
2001 Market Street
Philadelphia, PA 19103
(215) 963-0600

ROBBINS ARROYO LLP
Felipe J. Arroyo
Shane P. Sanders
Gina Stassi
600 B Street, Suite 1900
San Diego, CA 92101
(619) 525-3900

SCOTT+SCOTT, ATTORNEYS AT LAW, LLP
Judith S. Scolnick
Donald A. Broggi
Thomas L. Laughlin
The Helmsley Building
230 Park Avenue, 17th Floor
New York, NY 10169
(212) 223-6444

Co-Lead Counsel for Plaintiffs Below-Appellants

ANDREWS & SPRINGER, LLC
Peter B. Andrews
Craig J. Springer
3801 Kennett Pike
Building C, Suite 305
Wilmington, DE 19807
(302) 504-4957

Counsel for Individual Plaintiff Below-Appellant, Robert L. Reese and City of Birmingham Retirement and Relief System

LAW OFFICES OF ALFRED G. YATES, JR., P.C.
Alfred G. Yates, Jr.
519 Allegheny Building
429 Forbes Ave.
Pittsburgh, PA 15219

Counsel for Individual Plaintiff Below-Appellant, Robert L. Reese

CERTIFICATE OF SERVICE

I, Nicholas J. Rohrer, Esquire, hereby certify that on March 28, 2017, I caused to be served a true and correct copy of the foregoing document upon the following counsel of record in the manner indicated below:

By File & ServeXpress

Kenneth J. Nachbar, Esquire
Susan Wood Waesco, Esquire
Alexandra M. Cumings, Esquire
MORRIS NICHOLS ARSHT & TUNNEL LLP
1201 North Market Street
16th Floor
Wilmington, DE 19801

Peter B. Andrews, Esquire
Craig J. Springer, Esquire
ANDREWS & SPRINGER, LLC
3801 Kennett Pike
Building C, Suite305
Wilmington, DE 19807

Seth D. Rigrodsky, Esquire
RIGRODSKY & LONG PA
2 Righter Parkway, Suite 120
Wilmington, DE 19803

/s/ Nicholas J. Rohrer
Nicholas J. Rohrer (No. 5381)