

IN THE SUPREME COURT OF THE STATE OF DELAWARE

IN RE PINPOINT BEARINGS, INC. : No. 17, 2011  
SHAREHOLDERS LITIGATION :

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EDWARD MILLER, :  
 :  
 Plaintiff Below- :  
 Appellant, :  
 :  
 v. :  
 : Court Below:  
 : Court of Chancery  
 MICHAEL SANCHEZ, CLARE MITCHELL, : of the State of Delaware  
 BRENDAN ELLSWORTH, TIMOTHY : in and for New Castle County  
 FLETCHER, MARSHA FRANKLIN, : Civil Action No. 4958-VCM  
 DAPHNE KEYES AND ERIC LAM, : Consol. Civil Action No.  
 : 4952-VCM  
 Defendants Below- :  
 Appellees, :  
 :  
 and :  
 :  
 PINPOINT BEARINGS, INC., :  
 :  
 Nominal Defendant Below- :  
 Appellee. :

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Appellant's Opening Brief

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Team "A"  
Counsel for  
Plaintiff Below-Appellant  
EDWARD MILLER

Dated: February 11, 2011

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## NATURE OF PROCEEDINGS

It is undisputed that from early 2009 to October 2010, Pinpoint Bearings, Inc. ("Pinpoint"), a Delaware corporation, committed five separate violations of the federal False Claims Act. These violations were directly linked to three mid-level managers who engaged in a cost-cutting scheme in relation to government contracts. In light of Pinpoint's board of directors' ("Director Defendants") duty of oversight, which the Director Defendants utterly failed to perform, four individual shareholders filed four separate lawsuits against the Director Defendants for breach of their duty of oversight.

Edward Miller ("Miller") filed suit first in the federal district court of Texas. The other three actions were filed a day later in the Court of Chancery of Delaware. Miller also filed in the Court of Chancery, along with two motions: One to consolidate the four actions and another to stay the Delaware actions in light of the pending first filed Texas case. The Director Defendants opposed the motion to stay and also sought to enjoin Miller from proceeding with the Texas case.

The outcome of these motions hinged on the validity and fairness of an exclusive forum selection bylaw ("Forum Bylaw") unilaterally adopted by the Director Defendants, which requires all fiduciary duty claims to be litigated in Delaware. On January 12, 2011, the Court of Chancery found the Forum Bylaw was both valid and fair. Miller's motion to stay was denied and the motion to enjoin Miller was granted. Miller appeals this interlocutory order challenging both the validity and fairness of the bylaw. This Court having accepted Miller's interlocutory appeal scheduled oral arguments for March 17, 2011.

## SUMMARY OF ARGUMENT

1. The Forum Bylaw is invalid under Delaware law and the Court of Chancery erred in upholding the Forum Bylaw as valid. First, while Delaware law generally permits the Director Defendants to adopt and amend Pinpoint's bylaws, this power is limited. Particularly, the Director Defendants do not have the power to interfere with the right of the shareholders to sue derivatively. Thus, the Forum Bylaw must be struck down because it precisely obstructs the shareholders' right to sue on behalf of Pinpoint wherever appropriate. Additionally, the Forum Bylaw unilaterally adopted by the Director Defendants is not the product of an express agreement; not even as a contract of adhesion. As such, the Forum Bylaw does not constitute an enforceable contractual forum selection clause. Therefore, the Forum Bylaw is invalid as a matter of law.

2. The Forum Bylaw is unenforceable against Miller's Texas claim in equity. The Director Defendants' decisions to adopt and enforce the Forum Bylaw are tainted with their own self interest. Their interest is in limiting the number of shareholders able and capable of representing Pinpoint's best interests. Because enforcing the Forum Bylaw raises questions of whether enforcement is for Pinpoint's benefit, or for the Director Defendants' litigation interests, the Unocal standard of heightened scrutiny is appropriate. Under the Unocal standard curtailing Miller's claim is no more efficient or convenient for Pinpoint but does improve the likelihood the Director Defendants will face less zealous advocates. Thus, enforcement is not reasonable rendering the Forum Bylaw unenforceable in equity.

## STATEMENT OF FACTS

In early September 2010, the Office of the Inspector General of the United States ("Inspector General") was informed that Pinpoint was engaged in an illegal cost-cutting scheme. In re Pinpoint Bearings, Inc. S'holders Litig., Del. Ch. No. 4958-VCM, 5, McCloskey, J. (January 12, 2011). Acting upon this report the Inspector General immediately informed Pinpoint that a formal investigation into the reported allegations would be conducted. Id. at 6. In response, the Director Defendants immediately convened an emergency meeting on September 10, 2010. Id. The Director Defendants then appointed a special committee and hired independent counsel to conduct an internal investigation. Id. Pinpoint's investigation revealed it had committed several violations of the federal False Claims Act with regards to various government contracts it held with the U.S. Military.<sup>1</sup> Id.

The report specifically found that beginning in early 2009 three of Pinpoint's mid-level managers employed a cost-cutting scheme. Id. at 5. As part of the scheme, the three mid-level managers omitted critical testing of the specialty bearings but continued to certify and bill as though all required testing was performed. Id. Throughout the time the mid-level managers carried out the cost-cutting scheme, the Director Defendants did not have in place a legal compliance and reporting system to prevent such illegal conduct. Id. at 8-9. As a result, the Director Defendants did not discover the cost-cutting scheme until October 2010, after the federal investigation launched. Id. at 6. Together the cost-cutting scheme and the Director

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<sup>1</sup>The U.S. Military accounts for 60% of Pinpoint's revenue. Id. at 5.

Defendants' utter failure of oversight cost Pinpoint \$500 million in fines and penalties. Id.

Pinpoint's shareholders did not take well the public announcement of the violations and settlement terms. Id. at 7. First, Pinpoint's stock price fell ten percent (10%) the day after the announcement. Id. Second, Miller filed a lawsuit stating two claims against the Director Defendants in the federal district court of Texas where Pinpoint is headquartered. Id. One claim is a derivative action for breach of the duty of oversight and the second claim is a direct federal securities fraud section 10(b) class action. Id. Thereafter, Webb, Patrick, and Kohn, three other Pinpoint shareholders each filed separate lawsuits in the Court of Chancery each asserting a claim for breach of the duty of oversight against the Director Defendants, identical to Miller's Texas claim. Id.

To avoid competing and conflicting judgments, Miller also filed the breach of fiduciary duty claim in the Court of Chancery and sought a stay of the Delaware actions in light of the first filed Texas case. Id. at 8. Not surprisingly, the Director Defendants opposed Miller's motion and sought to enjoin Miller from prosecuting the fiduciary duty claim outside of Delaware. Id. at 10. The Director Defendants assert that the Forum Bylaw requires all derivative fiduciary duty claims to be litigated exclusively in the Court of Chancery. Id. However, since the Director Defendants unilaterally adopted the Forum Bylaw on June 10, 2010, amidst their breach of their duty of oversight coupled with their self-interest in the outcome of this action, the validity and fairness of the bylaw are now at issue before this Court.

## ARGUMENT

### **A. THE COURT OF CHANCERY ERRONEOUSLY HELD THE DIRECTOR DEFENDANTS' UNILATERALLY ADOPTED FORUM BYLAW IS AN ENFORCEABLE CONTRACTUAL FORUM SELECTION CLAUSE.**

#### **1. Question Presented**

Whether the Forum Bylaw is invalid under Delaware law?

#### **2. Scope of Review**

This interlocutory appeal from the decision of the Court of Chancery on the validity of the Forum Bylaw involves a mixed question of law and fact. Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985). To the extent the conclusions by the Court of Chancery involve mixed questions of law and fact the Supreme Court's scope of review is *de novo*. Zirn v. VLI Corp., 681 A.2d 1050, 1055 (Del. 1996).

#### **3. Merits of the Argument**

##### **I. The Forum Bylaw was not lawfully adopted because its subject matter falls outside of the permissible scope of the Director Defendants' power to adopt, amend, or repeal Pinpoint's bylaws.**

The Delaware General Corporation Law ("DGCL") grants Pinpoint's shareholders exclusively the right to adopt, amend or repeal bylaws. Del. Code Ann. tit. 8 § 109(a) (2010). However, as an enabling statute, the DGCL permits Pinpoint to confer, through its charter, to the Director Defendants the independent power to adopt, amend or repeal bylaws. Id. Once such power is conferred to the board, as it was so conferred to the Director Defendants, it is undisputed that both the shareholders and the board possess this power independently and concurrently. CA, Inc. v. AFSCME, 953 A.2d 227, 231 (Del. 2008).

But as this Court has made clear, the DGCL does not allocate "to the board and the shareholders the identical, coextensive power to

adopt, amend and repeal the bylaws." CA, Inc., 953 A.2d at 231.

Instead, this broad enabling power conferred to the board and the shareholders is limited by mandatory sections of the DGCL or where it would "achieve a result forbidden by settled rules of public policy."<sup>2</sup> From this, a simple and yet illusive rule is distilled: A bylaw is not valid whether adopted by the board or the shareholders if the subject of the bylaw is not within the scope and reach of their respective powers. See CA, Inc., 953 A.2d at 231-32.

The rule is illusive because no bright line rules exist to determine the scope of the Director Defendants' unilateral power to adopt bylaws. However, this Court in CA, Inc. enunciated a two step approach for making such determination. First, the Court turns to relevant Delaware law to determine the scope of the board's power on the subject of the bylaw. 953 A.2d at 231-32. Second, the bylaw is examined to determine whether it falls within the permissible scope. Id. Under the CA, Inc. approach, the Forum Bylaw is invalid if (1) the Director Defendants' power to adopt a bylaw pertaining to forum choice is limited at law and (2) the bylaw as drafted exceeds the limitation imposed at law.

- i. Pinpoint's shareholders' exclusive right to institute derivative actions limits the scope of the Director Defendants' power to adopt, amend or repeal bylaws.

That Pinpoint's shareholders possess exclusively the right to initiate this derivative action on behalf of Pinpoint is not a novel

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<sup>2</sup>Edward P. Welch & Robert S. Saunders, What We Can Learn From Other Statutory Schemes: Freedom and Its Limits in the Delaware General Corporation Law, 33 Del. J. Corp. L. 845, 850 (2008) (quoting Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952)).

idea. In Delaware it has long been recognized that shareholders possess "an independent" and "individual" "right to initiate [a derivative] lawsuit." Zapata Corp. v. Maldonado, 430 A.2d 779, 782-83 (Del. 1981) (citing the 1927 Supreme Court's decision in Sohland v. Baker, 141 A. 277 (Del. 1927) as "sound law"). This right is reposed in the shareholders as a device intended to be used to enforce the rights of the corporation. The goal sought to be attained through the threat or use of the derivative action is to encourage directors to act in compliance with their duties or stand to be held liable. See Anne Tucker Nees, Who's the Boss? Unmasking Oversight Liability within the Corporate Power Puzzle, 35 Del. J. Corp. L. 199, 213 (2010).

Recognizing that, under the flexible and dynamic corporate laws of Delaware, seldom will any party be granted unbridle power, the question remains: What role, if any, can the Director Defendants play in this subject? To answer this question, this Court must turn to the provisions of the DGCL and the judicial decisions of the Delaware courts. CA, Inc., 953 A.2d at 233.

Sections 327 and 141(a) of the DGCL are relevant to this inquiry. First, section 327 requires a plaintiff who files a derivative suit to be a shareholder of the corporation. Del. Code Ann. tit. 8 § 327 (2010). But a shareholder's right to sue derivatively does not arise from section 327. Schoon v. Smith, 953 A.2d 196, 204 (Del. 2008). Rather the right is derived from the shareholders' equitable standing to sue derivatively. Id. Section 327 safeguards the shareholders' right to sue derivatively by excluding all others. See Id. And in Schoon, this Court upheld this safeguard by refusing to extend the

right to sue derivatively to directors. Id. With this, the Director Defendants' permissible scope to act in the subject of derivative suits begins to take shape. Section 327 and Schoon, at the very least, make clear that the Director Defendants do not have the right to sue derivatively and do not have the power to abrogate the shareholders' right.

On the other hand, section 141(a) grants the Director Defendants broad managerial power. Del. Code Ann. tit. 8 § 141(a) (2010). One such power is the decision making authority to cause a corporation to initiate, or refrain from initiating, litigation. Zapata, 430 A.2d at 782. But once the directors refuse to cause the corporation to sue or where demand to the directors would be futile, as in this case, the shareholders have the right to sue derivatively. At this juncture, the Director Defendants are not without power but their managerial powers on this subject are limited to deciding in the interest of the corporation solely whether the suit should continue or not. See Id. at 784-85. As such, the Director Defendants could have prevented this derivative action all together, but only by causing Pinpoint to sue or by filing a motion to dismiss upon a showing that this action is detrimental to Pinpoint. Id. at 787. Beyond these powers, the Director Defendants may not unilaterally meddle with the shareholders' right to sue derivatively.

The above relevant parameters establish the Director Defendants' power to act on the subject of derivative suits is largely limited. Now, the Forum Bylaw must be scrutinized and tested against these limitations Delaware law imposes on the Director Defendants.

- ii. The Forum Bylaw exceeds the limitations Delaware law imposes upon the Director Defendants' power to adopt, amend or repeal bylaws.

Contrary to the findings of the Court of Chancery, the Forum Bylaw impermissibly intrudes upon the shareholders' substantive rights and powers. This Court has time and time again cautioned that it is not a proper function of bylaws to "intrude" upon the rights of either constituency. Datapoint Corp. v. Plaza Sec. Co., 496 A.2d 1031, 1036 (Del. 1985); CA, Inc., 953 A.2d at 233 (invalidating a shareholder bylaw because it would unduly intrude upon board authority). Specifically, in Datapoint, this Court invalidated a board adopted bylaw on the basis that it was "so pervasive as to intrude upon fundamental stockholder rights." 496 A.2d at 1036.

In Datapoint, as in this case, this Court was asked to determine the validity of a bylaw unilaterally adopted by the board. 496 A.2d at 1032. The right at issue in Datapoint was the shareholders' right to act by written consent under section 228. Id. While the right involved in Datapoint is different from the right involved in this case, it is of no consequence. Both the Datapoint shareholders and here the Pinpoint shareholders were conferred by Delaware law a fundamental right to act on behalf of the corporation. The Datapoint shareholders could take action by written consent under section 228 and here Pinpoint's shareholders, empowered by section 327 and the doctrine of equitable standing, can initiate a derivative action. Both of these rights are fundamental because they help strike an appropriate balance between the board's authority, on one hand, and the board's accountability, on the other. Recognizing that few are

the tools that help strike this balance, the Director Defendants are not permitted to tip the scales. And just as in Datapoint, this Court must assure this balance by finding the Forum Bylaw impermissibly intrudes upon a fundamental right of the shareholders.

Also significant, is that the bylaw challenged in Datapoint did not abrogate the shareholders' right to act under section 228. 496 A.2d at 1036. The bylaw simply limited the shareholders' ability to exercise their exclusive right under section 228. A limitation on such right, this Court held, was sufficient to render the bylaw invalid. Id. Thus, any argument in this case that the Forum Bylaw is valid because it does not abrogate the shareholders' right to sue derivatively must fall on deaf ears. Further, given the importance of the shareholders' right to sue derivatively, the Court of Chancery was mistaken when it opined that the Forum Bylaw did not limit substantively the shareholders' litigation rights and powers. The practical effect of the Forum Bylaw is to close the door to the courthouse on many of the 28,000 Pinpoint shareholders scattered throughout the fifty States - this is a limitation. Simply, the Forum Bylaw intrudes upon the shareholders' fundamental right to sue derivatively and thus is invalid as a matter of law.

**II. Even if the Director Defendants could unilaterally adopt the Forum Bylaw, it does not constitute a valid contractual forum selection clause.**

Albeit corporate bylaws are presumed to be valid, a "bylaw that is inconsistent with any statute or rule of common law ... is void." Frantz, 501 A.2d at 407. The question here, different from the former, is "whether there is any law 'inconsistent' or 'contrary' to

the inclusion of a forum-selection clause in the bylaws.” Sara Lewis, Transforming the “Anywhere But Chancery” Problem into the “Nowhere But Chancery” Solution, 14 Stan. J.L. Bus. & Fin. 199, 206 (2008).

- i. The proper forum for shareholder derivative actions is determined at law, except where the parties contractually designate an appropriate forum.

In keeping with Delaware’s well established judicial doctrines for resolving traditional forum disputes, this Court should find the Forum Bylaw impermissibly curtails Miller’s freedom to choose where to initiate the derivative action. Subject to Federal and State laws,<sup>3</sup> shareholder-plaintiffs, like Miller, have the freedom to initiate derivative claims wherever appropriate, even if that means somewhere other than Delaware. Faith Stevelman, Regulatory Competition, Choice of Forum, and Delaware’s Stake in Corporate Law, 34 Del. J. Corp. L. 57, 61 (2009). Delaware has long recognized and valued this principle upholding “a plaintiff’s choice of forum except in rare cases.” Berger v. Intelident Solutions, Inc., 906 A.2d 134, 135 (Del. 2006). In fact, the *McWane* presumption favoring a stay of Delaware actions where there is an ongoing, earlier-filed, substantially similar action in another court rests upon this principle, along with the rubric of comity. Stevelman, supra, at 107. Precisely these principles and rules of law afford Miller, and other shareholders alike, the right to file suit wherever proper, including the district court of Texas.

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<sup>3</sup>Federal courts are available by means of diversity and supplemental jurisdiction, with venue rules establishing which federal court is appropriate. State courts are also available whenever “long arm statutes” apply. See Stevelman, supra, at 61.

Of course, since the United States Supreme Court's landmark case of Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972), parties may contract to designate the forum for all litigation between them. On this point, Miller does not dispute that, hypothetically speaking, an agreement between the directors and shareholders designating Delaware as the exclusive forum would be binding and enforceable. But this is not such a case. In this case, the Director Defendants unilaterally adopted the Forum Bylaw. The shareholders did not consent or even acquiesce to the adoption of the Forum Bylaw. In short, no agreement was ever reached to designate the Court of Chancery as the exclusive forum for all intra-entity disputes.

To overcome the clear absence of an agreement, the Court of Chancery erroneously relies on Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991). The Court of Chancery mistakenly asserts that Carnival approves the unilateral imposition, unbeknownst to the other contracting party, of a forum selection clause. However, in Carnival, the U.S. Supreme Court simply held that a non-negotiated forum-selection clause contained in a form contract was enforceable. 499 U.S. at 593. In reaching its decision the court specifically noted the purchasers "conceded that they had notice of the forum-selection provision." Id. The court thus reasoned that at the very least the purchasers, having notice of the clause, "retained the option of rejecting the contract with impunity." Id. at 595.

Quite the opposite is true in this case. Pinpoint's shareholders neither had notice nor did they retain the option of rejecting the bylaw, much less with impunity. The Forum Bylaw was forced upon the

unsuspecting shareholders under the guise of the Director Defendants' power to adopt and amend Pinpoint's bylaws. However, the Director Defendants' power does not encompass a midstream unilateral amendment where the validity of the bylaw rests squarely on traditional elements of contract law - here the requirement of mutual assent. Without the shareholders' assent, even on a take it or leave it basis, the Forum Bylaw is invalid. Miller's freedom to select another appropriate forum must be upheld under the *McWane presumption*.

- ii. The Forum Bylaw also fails to constitute a permissible contractual forum clause under Delaware law.

In Delaware, as a general rule, "only the formal parties to a contract are bound by its terms." Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P., 963 A.2d 746, 760 (Del. Ch. 2009). In this regard, admittedly Pinpoint's shareholders are formal parties to the contract, i.e., the bylaws, in a strict sense of the phrase "formal parties." However, Delaware courts only regard those who "execute" the contract as formal parties. Weygandt v. Weco, LLC, 2009 Del. Ch. LEXIS 87, \*9-10 (Del. Ch. May 14, 2009). In fact, it is Delaware's policy to not extend contractual rights and obligations to parties that did not execute the contract. Id. at \*10. Miller acknowledges that under the well settled principles of Delaware law he is a party to the bylaws, a contract, as they existed at the time he acquired his stock. What Miller disputes is that he, or any other shareholder of Pinpoint, can be bound to the Forum Bylaw, a term they did not agree to and did not execute by majority vote or otherwise.

Unfortunately, the Court of Chancery also erred in this point. The Court of Chancery reasoned, quoting Kidsco Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995), that because Pinpoint's bylaws provide that they may be amended by the board, the contract is "subject to the board's power to amend the by-laws unilaterally." However, this rule of law pertains only as to those rights afforded "under the terms of the by-law as it then existed." Id. The rule is inapplicable whereas here, Pinpoint's bylaws, prior to the amendment, were silent as to forum selection and did not afford any particular rights on this subject. Instead, Pinpoint's shareholders' right to select a proper forum is solely afforded by law, not by the corporate bylaws.

Moreover, this Court's recent holding in Ingres Corp. v. CA, Inc., 8 A.3d 1143 (Del. 2010), foreclosed this issue. This Court specifically stated:

[W]e hold that where contracting parties have *expressly agreed upon a legally enforceable forum selection clause*, a court should honor the parties contract and enforce the clause, even if, absent any forum selection clause, the McWane principle might otherwise require a different result.

Ingres Corp., 8 A.3d at 1145 (emphasis added). Thus, in Delaware a forum selection clause is enforceable only to the extent it is the product of the parties express agreement. Since the shareholders and the Director Defendants did not expressly agree to the Forum Bylaw, it is invalid.

Finally, Chancellor Laster's comment that "corporations are free to [adopt] charter provisions selecting an exclusive forum for intra-entity disputes" must be analyzed in light of these authorities. In re Revlon, Inc. S'holders Litig., 990 A.2d 940, 960 (Del. Ch. 2010).

First, the suggestion was limited to charter provisions. Before his opinion is extended to bylaws, the implications of his express statement and any extension thereof should be carefully considered. Amendments to the charter require the board's approval and shareholder vote, with a majority vote binding all the shareholders. Stevelman, supra, at 132-33. Shareholder vote alleviates the lack of express agreement problem a unilateral bylaw simply cannot overcome. Second, in the absence of unanimous shareholder approval, policy based on the efficient market hypothesis dispels any concern that dissenting shareholders would prevail on the basis that they individually did not agree to the amendment. As a matter of policy, courts "enforce provisions approved by a majority of shareholders" because such decisions are value-maximizing for all shareholders. See Lewis, supra, at 213. Lastly, while bylaws are viewed as the internal governance contract, the charter is deemed "the basic contract of the entity" that gives rise to the fiduciary relationship. Douzinus v. Am. Bureau of Shipping, Inc., 888 A.2d 1146, 1149 (Del. Ch. 2006). Thus, a forum selection provision "limiting and regulating the powers of the ... shareholders" and touching upon the fiduciary relationship is proper only in the charter, not the bylaws.<sup>4</sup>

Therefore, Chancellor Laster was absolutely accurate in carefully limiting his suggestion to "charter provisions." Unfortunately, the Director Defendants and the Court of Chancery read this comment too broadly and attempted to fit a square peg in a round hole, it simply does not fit. Hence, the Forum Bylaw is invalid as a matter of law.

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<sup>4</sup>See Del. Code Ann. tit. 8 § 102(b)(1) (2010).

**B. THE COURT OF CHANCERY ERRONEOUSLY HELD THAT THE ADOPTION AND ENFORCEMENT OF THE FORUM BYLAW RAISED NO ISSUE OF SELF INTEREST AND DID NOT REQUIRE HEIGHTENED SCRUTINY.**

**1. Question Presented**

Whether the Forum Bylaw is unenforceable as a matter of equity?

**2. Scope of Review**

This interlocutory appeal from the Court of Chancery on the fairness of the Forum Bylaw involves a mixed question of law and fact. Frantz, 501 A.2d at 407. To the extent the conclusions by the Court of Chancery involve mixed questions of law and fact the Supreme Court's scope of review is *de novo*. Zirn, 681 A.2d at 1055.

**3. Merits of the Argument**

**I. The Director Defendants' decisions to adopt and enforce the Forum Bylaw are subject to heightened scrutiny when reasonable doubt exists regarding their loyalty to Pinpoint and its shareholders.**

Delaware law requires directors to be able to make business decisions impartially. Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984). If the Director Defendants' discretion is paralyzed by self interest, heightened scrutiny is necessary. Id. at 813. While the Court of Chancery summarily determined the Director Defendants' *only* interests in the Forum Bylaw was convenience, efficiency, and predictability, Delaware law requires a challenged decision to "be evaluated in light of relevant circumstances" which may require heightened scrutiny. Cede & Co. v. Technicolor., Inc., 634 A.2d 345, 368 n.36 (Del. 1993); See Schnell v. Chris-Craft, 285 A.2d 437, 438 (Del. 1971) (board decision to change the date of shareholder meeting considered in light of prior board decisions to not provide list of stockholders and reject demands for change in management).

The circumstances demonstrate there was much for the Director Defendants to be self interested. The investigation for violation of the False Claims Act began just 90 days after the Forum Bylaw's adoption. Admitted violations resulted in \$500 million in fines and penalties to Pinpoint, precipitating four separate oversight liability claims against the Director Defendants. Staring personal liability in the face the Director Defendants elected to enforce the Forum Bylaw. The "cognizable" self interest arising from these circumstances rebuts the business judgment rule. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). Whether the Forum Bylaw was adopted, enforced, or both with knowledge of the potential oversight liability, the Director Defendants have personal interest in limiting the number of claims that can be brought against them. Through the Forum Bylaw they attempt to impose such limitation.

While the above circumstances are a glimpse of the Director Defendants' self interest, "reasonable doubt" exists when there is a substantial likelihood of liability. Aronson, 473 A.2d at 815. And where a substantial likelihood exists that the Director Defendants are liable, their decisions to adopt and enforce the Forum Bylaw are not entitled to deference. Heightened scrutiny applies.

- i. Sufficient uncontroverted facts establish reasonable doubt that the Director Defendants were self interested in adopting the Forum Bylaw requiring heightened scrutiny.

The broad managerial power vested in the Director Defendants is harnessed by their fiduciary duties defined at common law. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). Inclusive of those duties, loyalty requires the Director Defendants to discharge their duty of

care in good faith. Stone, 911 A.2d at 369. Their failure to act in the face of a known duty to act is a breach of the duty of good faith. In re Walt Disney Co. Derv. Litig., 906 A.2d 27, 67 (Del. 2006).

The Director Defendants' self interest in adopting the Forum Bylaw stems from their knowing failure to assure the government testing and certification requirements were met. This is consistent with oversight liability which is established if directors knew or should have known the corporation was violating the law due to an inadequate or nonexistent legal compliance system and failed to take good faith corrective action. In re Caremark Int'l, Inc., 698 A.2d 959, 971 (Del. Ch. 1996). Pinpoint's own report found that between early 2009 and October 2010, mid-level managers implemented a cost-cutting scheme. The scheme centered on mid-level managers omitting requisite testing, and then certifying and billing as if the testing had been performed; in short, defrauding the government. Since the government accounted for 60% of Pinpoint's revenue, the cost-cutting scheme left greater profits to Pinpoint. However, the apparent increase in profits is no excuse for the Director Defendants' failure to monitor Pinpoint's operations. In fact, the Director Defendants had a duty to assure the success was bona fide and could not have merely rubber stamped "management-prepared documents" in blind reliance. Hillary A. Sale, Monitoring Caremark's Good Faith, 32 Del. J. Corp. L. 719, 728 (2007).

Any argument, that the Director Defendants did not know of the absence of a legal compliance system fails. It is precisely they who are charged with this duty. The Director Defendants should have known

of their duty to implement a legal compliance system. Even Federal Statutes charge the Director Defendants with this duty. Specifically section 8B2.1 of the United States Code which defines "an effective" legal compliance program, requires that only "[h]igh-level personnel" such as "directors" or "officers" be charged with oversight of the program. 18 U.S.C.S. §§ 8B2.1, 8A1.2 (LexisNexis 2011). Given that mid-level managers could not be responsible for legal compliance the Director Defendants cannot shield themselves behind employee misconduct. These uncontroverted facts establish reasonable doubt that the Director Defendants acted under the influence of self interest in adopting the Forum Bylaw.

- ii. Because the Director Defendants are self interested as named parties to the action, their decision to enforce the Forum Bylaw must be reviewed under heightened scrutiny.

No deference is afforded to a self interested board's decision affecting fiduciary duty claims brought against it. Carol F. Wilder, The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits, 5 Pace L. Rev. 633, 642 (1985). While naming a director as a party to litigation is insufficient to taint an entire board, when the entire board is named as defendants all subsequent decisions pertaining to the claim are tainted. Id. Here, as named defendants, the Director Defendants are tainted by the substantial likelihood of oversight liability. They could not impartially make the decision to curtail Miller's federal fiduciary duty claim.

Zapata illustrates, that even when tainted directors delegate their decision to an independent and disinterested committee,

heightened scrutiny applies. 430 A.2d at 787. In Zapata, a self interested board delegated to new and independent directors authority to decide whether to proceed with the derivative action against the board. Id. at 781. This Court recognized the possibility that curtailing the action may be in the best interest of the corporation. Id. at 788. However, since the self interested board had great motivation to appoint directors that would exonerate them, heightened scrutiny was required. Id. at 788-89.

The need for heightened scrutiny is stronger in this case than in Zapata. In Zapata, at least the tainted board refrained from making the decision themselves, but even then this Court applied heightened scrutiny. Here, like in Zapata, all Director Defendants are tainted, however no effort was made to distance their self interest from the decision to curtail Miller's Texas claim. Thus the Court of Chancery erred when summarily extending deference to the Director Defendants' decision to enforce the Forum Bylaw. The operative effect of the Forum Bylaw curtails both Miller's and the vast majority of Pinpoint's shareholders' right to sue derivatively.

**II. The Forum Bylaw fails under the appropriate standard of review, the Unocal standard.**

Delaware law applies heightened scrutiny as an equitable check to protect against misuse of a "board's statutory power" and thus ensures fairness and reasonableness. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1377 (Del. 1985). Here, by its very nature, enforcement of the Forum Bylaw could not be entirely fair to Pinpoint, the shareholders, and the board.

Miller does not contend that in equity, a bright line rule is drawn. Indeed, as Justice Moore stated in Unocal, the DGCL grows and develops and though "silent as to a specific matter" this "does not mean that it is prohibited." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985). Law is counterbalanced with equity. Schnell, 285 A.2d 437, 439 (Del. 1971) (because action is legally valid, does not mean that it is equitably permissible). Instead, Miller proposes the Unocal standard as appropriate because it is designed to resolve inherently unfair actions like enforcement of the Forum Bylaw. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 930 (Del. 2003).

Specifically the Forum Bylaw sweeps with a broad brush. Through it, the Director Defendants renounce all discretion and managerial authority preventing them from delegating their litigation decisions to independent disinterested directors. Because the Forum Bylaw is mandatory, it does not contain a fiduciary-out clause to allow the Director Defendants to discharge their duties. Thus, the Forum Bylaw mirrors the "lock up" agreement found unenforceable in Omnicare under Unocal.

- i. The Forum Bylaw is a defensive mechanism triggering the Unocal Standard.

The Unocal standard applies when directors take defensive action in response to threats to corporate policy and effectiveness. Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990). The two prongs of Unocal are: (1) a reasonable ground for believing a danger to corporate policy and effectiveness must exist; and (2) the defensive

response must be proportionate to the threat posed. Unocal, 493 A.2d at 957.

Derivative actions divert a board's attention from wealth maximization to litigation. This rings true here where multiple claims in two States were brought against the Director Defendants. The Forum Bylaw, which mitigates this threat, is a defensive measure. Just like directors implementing a poison pill, directors enforcing a forum selection bylaw defend themselves or the corporation constituting a defensive measure intricately bound up in self interest. While, to date, this Court has not had the opportunity to apply the Unocal standard to a forum selection bylaw, this does not mean that it cannot be done.

ii. The Unocal Standard can be applied to the Forum Bylaw.

To be sure, this case does not present an acquisitory context. However heightened scrutiny has been modified before to address non-acquisitory cases. See Zapata, 430 A.2d at 787. In Zapata, this Court modified the intrinsic fairness test shaping the inquiry to ensure the independent committee's determination was made in the best interest of the corporation and reasonably reached. Id. Similarly, this Court has expanded the Unocal standard's application to threats to corporate policy. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995). And thereafter this Court expanded its application to a no "change in control" scenario. Omnicare, 818 A.2d at 933.

Thus, the Unocal standard can be applied in a manner appropriate to the circumstances at hand. In fact, this Court stated that the Unocal standard is not intended to be "structured" or mechanistically

applied, instead it is "abstract theory" or a "flexible paradigm applicable to a myriad of 'fact scenarios' confronting corporate boards." Unitrin, 651 A.2d at 1373-74. As such, Unocal is proper in the instant case because the Forum Bylaw inherently precludes entire fairness. It is defensive by nature and its enforcement shares the same "omnipresent specter" of self interest found in takeover countermeasures. Unocal, 493 A.2d at 954. Therefore, Unocal is appropriate to determine the fairness of the Forum Bylaw.

iii. The Forum Bylaw fails the Unocal Standard.

Although of first impression, it has been recognized that the enforcement of a forum selection clause may create a risk of "sweetheart settlement" analogous to "entrenchment" in a traditional Unocal scenario.<sup>5</sup> The Unocal standard applies when, as here, litigation is filed by a plaintiff in the headquarters State and by other plaintiffs in the charter State, thus creating the opportunity for the challenged board to choose the weakest advocate. Id. In applying the Unocal standard to the Forum Bylaw, the Director Defendants' motivation is determined in the context of the two prongs; reasonable identification of a threat and proportionate response. Under each prong the primary consideration is whether the Director Defendants acted to maximize Pinpoint's wealth or for their own personal incentives in litigation, such as their pursuit of a "sweetheart settlement." See Id.

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<sup>5</sup> Joseph A. Grundfest, Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches, Rock Center for Corporate Governance at Stanford University Working Paper No. 91 (October 8, 2010) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1690561##](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690561##) (The 2010 Pileggi Lecture).

Applying the first prong, the inquiry is whether Miller's Texas federal claim was reasonably identified as a threat. First in the interest of wealth maximization, enforcement of the Forum Bylaw does not eliminate litigation but increases it. Pinpoint will have to litigate the fiduciary duty claims in Delaware, but still must litigate Miller's 10(b) claims in Texas, rather than litigating all claims in the one Texas case. Second, Miller's claim will not burden the litigation process because the Director Defendants perform their duties in Texas where Pinpoint is headquartered. Additionally Miller, who is adequate to represent Pinpoint and the shareholders, resides in Texas. All necessary parties are in Texas. Further in the interest of uniformity and consistency, the internal affairs doctrine insures the substantive Delaware laws are applied to the fiduciary duty claim. And the Fifth Circuit recognizes that Delaware's particularity of pleading requirements control the claim. Midwestern Teamsters Pension Trust Fund v. Deaton, 2009 U.S. Dist. LEXIS 50521, \*17 (S.D. Tex. May 7, 2009).

Next, inquiry into the Director Defendants' self interest must be undertaken. Miller has five thousand shares of Pinpoint stock thus at least twenty five times the interest held by Webb, Patrick, and Kohn respectively. As such, Miller has greater stake in Pinpoint, and is better suited to zealously advocate on Pinpoint's behalf. Miller is less susceptible to accede to a "sweetheart settlement" in favor of the Director Defendants. Webb, Patrick, and Kohn, having nominal interest in Pinpoint are weaker advocates against the Director Defendants. Additionally Webb, Patrick and Kohn know Miller will

proceed with the 10(b) direct class action that protects their interest in Pinpoint stock. Under these circumstances, identification of Miller's Texas action as a threat to Pinpoint is unreasonable.

Enforcement of the Forum Bylaw fails the first prong under the Unocal standard. Without a reasonable identification of a threat to Pinpoint, a response was not warranted and could not be proportionate. Enforcement of the Forum Bylaw further fails the proportionality prong for several reasons. The Forum Bylaw is mandatory removing the board's managerial authority to make a litigation decision, here forum choice, which is impermissible. Enforcement of the Forum Bylaw is triggered without any consideration into the best interest of Pinpoint. Additionally, enforcement of the Forum Bylaw closes the door to the courthouse on the lion's share of Pinpoint's shareholders. Therefore the Forum Bylaw fails the Unocal standard in equity.

#### **CONCLUSION**

For the foregoing reasons, this Court should hold the Forum Bylaw is invalid as matter of Delaware law. Alternatively, this Court should hold the Forum Bylaw cannot be equitably enforced. Finally, Miller respectfully requests this Court to reverse the interlocutory opinion and order of the Court of Chancery.