# IN THE SUPREME COURT OF THE STATE OF DELAWARE

EDWARD MILLER,		
	)	No. 17, 2011
Plaintiff Below-	)	CD-ROM Version To Be Filed
Appellant	)	
	)	On appeal from
	)	Civil Action No. 4958-VCM
V.	)	in the Court of Chancery
	)	of the State of Delaware in
MICHAEL SANCHEZ, CLARE MITCHELL,	)	and for New Castle County
BRENDAN ELLSWORTH, TIMOTHY	)	_
FLETCHER, MARSHA FRANKLIN,	)	
DAPHNE KEYES AND ERIC LAM,	)	
	)	
Defendants Below-	)	
Appellees	)	
	)	

# APPELLANT'S OPENING BRIEF

Dated: February 11, 2011 Team G

Counsel for the Plaintiff Below-

Appellant

# TABLE OF CONTENTS

TABLE OF C	ITATI	ONS	iii
NATURE OF	PROCE	EDINGS	1
SUMMARY OF	ARGU	MENT .	2
STATEMENT	OF FA	CTS	3
ARGUMENT			5
I.	beca	use it	adopted forum-restricting bylaw is invalid violates Delaware corporate and contract law and ly limits shareholder rights
	Α.	Questi	on Presented5
	В.	Scope	of Review5
	С.	Merits	of Argument5
		1.	The Bylaw is invalid as a matter of Delaware corporate law because a bylaw cannot place substantive limitations on shareholder rights5
		2.	The Bylaw is contractually invalid because it does not reflect shareholder intent and lacks shareholder consent
		3.	The Bylaw is unreasonable and unjust because it will likely preclude Miller's federal claims11
II.	to,	and car	ely, the Board's adoption of the Bylaw is subject nnot survive, elevated judicial scrutiny under entire fairness test or the <i>Unocal</i> test13
	Α.	Questi	on Presented13
	В.	Scope	of Review13
	С.	Merits	of Argument13
		1.	The Board's adoption of the Bylaw is subject to entire fairness review because it was inherently self-interested and disloyal14
		2.	The Board's adoption of the Bylaw cannot survive entire fairness review because the Bylaw was not the product of fair dealing and will not fairly affect the value of Pinpoint stock

	a. The Board's adoption of the Bylaw fails to satisfy the fair dealing requirement18
	b. The Board's adoption of the Bylaw fails to satisfy the fair price requirement19
3.	Alternatively, the Board's adoption of the Bylaw is subject to enhanced scrutiny under <i>Unocal</i> because it was a defensive action relating to the Board's control of Pinpoint
4.	The Board's adoption of the Bylaw fails <i>Unocal</i> step one because no danger to corporate policy and effectiveness existed
5.	The Board's adoption of the Bylaw fails <i>Unocal</i> step two because it was not a proportional response to the "threat" posed
CONCLUSION	

# TABLE OF CITATIONS

Page(s)	)
AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986)	5
Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182 (Del. 2010)	9
CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227 (Del. 2008)	7
Capital Group Cos. v. Armour, 2004 WL 2521295 (Del. Ch.)	8
Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991)	9
Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993)	5
Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923 (Del. 1990)	9
Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000)	0
eBay Domestic Holdings, Inc. v. Newmark, 2010 WL 3516473 (Del. Ch.)	2
Emerald Partners v. Berlin, 726 A.2d 1215 (Del. 1999)	4
Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001)	5
Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985)	8
Galaviz v. Berg, 2011 WL 135215 (N.D. Cal.)	1
Gantler v. Stephens, 965 A.2d 695 (Del. 2009)	7
Havens v. Attar, 1997 WL 55957 (Del. Ch.)	7

#CR-Manor Care v. Fugee, 2010 WL 780020 (Del. Super. Ct.)9
Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983)9
<pre>In re Revlon, Inc. Shareholders Litig., 990 A.2d 940 (Del. Ch. 2010)</pre>
Ingres Corp. v. CA, Inc., 8 A.3d 1143
Maldonado v. Flynn, 417 A.2d 378 (Del. Ch. 1980)12
Marrese v. Am. Acad. of Orthopaedic Surgeons, 470 U.S. 373 (1985)12
Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786 (Del. Ch. 2007)22
Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988)18, 19
M/S Bremen v. Zapata Off-Shore Co. (The Bremen), 407 U.S. 1 (1972)8
Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003)24
Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989)24, 25
Sassano v. CIBC World Mkts. Corp., 948 A.2d 453 (Del. Ch. 2008)9
Stroud v. Grace, 606 A.2d 75 (Del. 1992)
Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995)20, 21, 23, 24
Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)passim
Waggoner v. Laster, 581 A.2d 1127 (Del. 1990)9
Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)

Wood v. State, 815 A.2d 350 (Del. 2003)9
STATUTES
15 U.S.C. § 78aa (2006)11
28 U.S.C. § 1738 (2006)12
Del. Code Ann. tit. 8, § 102(b)(1) (2011)6
Del. Code Ann. tit. 8, § 109(a) (2011)6
Del. Code Ann. tit. 8, § 109(b) (2011)6
Del. Code Ann. tit. 8, § 242(a)-(b) (2011)
OTHER AUTHORITIES
Joseph A. Grundfest, Professor, Stanford Law School, Pileggi Lecture: Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches (Oct. 6, 2010)25

## NATURE OF PROCEEDINGS

This is an interlocutory appeal from an order of the Delaware Court of Chancery denying Plaintiff Below-Appellant Edward Miller's motion to stay proceedings in that court in favor of his earlier-filed claims in the United States District Court for the Southern District of Texas. Miller also appeals the Chancery Court's order enjoining him from proceeding on his earlier-filed state law claims in the Texas district court. Miller challenges the validity of an exclusive forum bylaw on which the Chancery Court's judgments were based.

On December 1, 2010, Miller filed derivative fiduciary claims under Delaware law and federal securities claims under the Securities Exchange Act of 1934 against Pinpoint Bearings, Inc. and its directors in Texas district court. Thereafter, multiple shareholders commenced separate actions in Delaware, asserting state law claims identical to those in Miller's federal action. Following consolidation of these claims, Miller initiated his own action in Delaware, moved to join the Delaware proceedings, and moved to stay all proceedings in Delaware. Defendants then moved to enjoin Miller from prosecuting any derivative or fiduciary claims in any court other than the Chancery Court.

Upholding the exclusive forum bylaw, the Chancery Court entered judgments denying Miller's stay motion and granting defendants' injunction motion on January 12, 2011. Miller then applied to the Chancery Court for certification of an interlocutory appeal from its opinion, which the Chancery Court granted on January 14, 2011. This Court accepted Miller's interlocutory appeal on January 18, 2011.

## SUMMARY OF ARGUMENT

- I. This Court should hold the board-imposed exclusive forum bylaw to be invalid as a matter of Delaware law. First, under Delaware corporate law, the board cannot limit the rights of shareholders in a bylaw amendment. Second, the Bylaw is invalid as a contractual matter. The Bylaw does not reflect the intent of the shareholders, nor did the shareholders consent to its adoption. Finally, the Bylaw is unreasonable and unjust because it restricts the shareholders' ability to use legitimate derivative actions to hold corporate fiduciaries accountable.
- II. Even if the Bylaw is held to be valid in the abstract, it is invalid as adopted by the Board and applied in this action. The Board's unilateral adoption of a bylaw limiting where fiduciary claims against the Board can be brought was an inherently self-interested action raising significant loyalty concerns, especially since the Bylaw was adopted after the Board had presided over extensive illegal activity at Pinpoint for over a year. Entire fairness is therefore the appropriate standard of review, and the Board can show neither fair dealing nor fair price. Alternatively, the Board's adoption of the Bylaw was a defensive action that entrenched the Directors by reducing their fiduciary accountability, triggering enhanced Unocal scrutiny, under which the Board's actions fail both the reasonableness and the proportionality tests.

## STATEMENT OF FACTS

Appellant Edward Miller, a lifetime resident of Houston, Texas, is a retired employee and shareholder of Pinpoint Bearings, Inc. Mem. Op. 3-4. Miller worked for Pinpoint for twenty years, over the course of which he acquired 5,000 shares of Pinpoint common stock. Mem. Op. 3-4. Pinpoint is a Delaware corporation with corporate headquarters and manufacturing operations in Houston. Mem. Op. 4. Appellees are Pinpoint's seven directors (the "Directors" or the "Board"). Mem. Op. 5.

In early 2009, three Pinpoint managers began regularly omitting certain performance and safety stress tests on specialty bearings manufactured by Pinpoint for use in United States military aircraft.

Mem. Op. 5. Pinpoint's contracts with the military, its largest customer, required Pinpoint to perform these tests and to certify that they had been performed with satisfactory results. Mem. Op. 5.

Pinpoint repeatedly made false representations to the military in these certifications. Mem. Op. 6.

Subsequently, in June of 2010, the Board adopted a bylaw (the "Bylaw") that, among other things, designates the Court of Chancery of the State of Delaware (the "Chancery Court") as the exclusive forum for all derivative and breach of fiduciary duty claims brought against Pinpoint directors or officers. Mem. Op. 2. The Board acted unilaterally, without consulting or notifying the shareholders, in adopting the Bylaw. See Mem. Op. 13.

In September of 2010, the Office of Inspector General of the United States (the "OIG") launched an official investigation into

Pinpoint's testing omissions. Mem. Op. 6. After a special investigation committee and outside counsel found "a pattern of improper and undisclosed cost-cutting steps," Pinpoint settled with the OIG. Mem. Op. 6. Under the settlement, Pinpoint admitted to five separate violations of the False Claims Act, agreed to pay \$500 million in fines and penalties, and committed to firing the responsible managers. Mem. Op. 6. The announcement of this settlement triggered a dramatic decline in the value of Pinpoint stock (from which it has not recovered) and caused Pinpoint's market capitalization to fall by \$440 million. See Mem. Op. 7 n.10.

On December 1, 2010, Miller sued the Directors in the United States District Court for the Southern District of Texas (the "District Court") for breaching their fiduciary duty of oversight under Delaware law and for violations under the Securities Exchange Act of 1934. Mem. Op. 4, 7. On the basis of the Board-enacted forum-restricting Bylaw, the Chancery Court enjoined Miller's fiduciary claims from proceeding in the District Court. Mem. Op. 19-21. The Chancery Court also denied Miller's motion to stay breach of fiduciary duty claims, copied nearly verbatim from Miller's federal suit, that were brought by other plaintiffs in the Chancery Court after Miller brought them in the District Court. Mem. Op. 7-8, 8 n.12, 19-21.

#### ARGUMENT

I. The Board-adopted forum-restricting bylaw is invalid because it violates Delaware corporate and contract law and unreasonably limits shareholder rights.

#### A. Question Presented

Whether a bylaw adopted unilaterally by corporate directors that mandates where shareholders must bring derivative or fiduciary claims is valid under Delaware law.

#### B. Scope of Review

"The construction or interpretation of a . . . by-law is a question of law subject to de novo review by this Court." Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 926 (Del. 1990).

#### C. Merits of Argument

The Board's unilaterally adopted forum-restricting bylaw is invalid a matter of Delaware corporate law because it places substantive limitations on shareholder rights. Moreover, the Bylaw is invalid as a contractual matter because it lacks shareholder consent and is not a reflection of shareholder intent. Finally, the Bylaw is unreasonable and unjust because it restricts shareholders' ability to pursue all relevant causes of action.

1. The Bylaw is invalid as a matter of Delaware corporate law because a bylaw cannot place substantive limitations on shareholder rights.

The Chancery Court's analysis in determining that the Pinpoint Directors had the legal authority under the Delaware General Corporation Law (the "DGCL") to adopt the Bylaw is incomplete. The Chancery Court cites DGCL section 109, which provides that the power

to amend bylaws rests with a corporation's stockholders. Mem. Op. 12. A corporation's bylaws may contain "any provision . . . relating to . . . the rights or powers of its stockholders, directors, officers or employees." Del. Code Ann. tit. 8, § 109(b) (2011) (emphasis added). A corporation may, in its charter, grant corporate directors the ability to amend bylaws. See id. § 109(a). Focusing only on these provisions of the DGCL, the Chancery Court concluded that the Board had the power to amend Pinpoint's bylaws and that the Bylaw "clearly 'relates' to the power of Pinpoint stockholders." Mem. Op. 12.

The Chancery Court's opinion overlooks DGCL section 102(b)(1), which addresses corporate charters. Section 102(b)(1) provides that a corporation's charter may contain provisions "limiting and regulating the powers of the corporation, the directors, and the stockholders." \$ 102(b)(1) (emphasis added). The plain reading of sections 109 and 102(b)(1) together make it clear that while bylaws may include provisions relating to shareholder rights, only charters may include provisions limiting such rights.

CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008) is not inconsistent with the conclusion that only a charter amendment may limit the rights of shareholders. There, this Court was asked to review a shareholder-proposed amendment that would have required the board of directors to reimburse, through the corporation, reasonable shareholder proxy expenses incurred in connection with electoral nominating campaigns. Id. In determining the scope of shareholder authority to amend corporate bylaws, this Court concluded

that the shareholders' power was "limited by the board's management prerogatives under Section 141(a)." Id. at 232. However, this Court rejected CA's argument that the proposed bylaw amendment limited a substantive board power and thus, under a combined reading of Sections 109 and 102(b)(1), could only be properly enacted in CA's charter.

Id. at 234. This Court explained that by CA's reasoning most bylaws might be found to limit "the otherwise unlimited discretionary power of the board." Id.

CA, Inc. v. AFSCME is readily distinguishable from the present case. Here, this Court is faced with a board action that limits shareholders substantive rights as opposed to a shareholder attempt to limit board members' procedural rights. Shareholders, unlike boards of directors, do not possess unlimited discretionary power. In fact, shareholders possess a very limited set of rights. One of the most fundamental shareholder rights is the right to pursue derivative suits to assure that corporate managers abide by their fiduciary duties. The board-imposed exclusive forum bylaw thus limits the important substantive right of shareholders to maintain derivative actions.

 The Bylaw is contractually invalid because it does not reflect shareholder intent and lacks shareholder consent.

Neither the assumption of validity accorded corporate bylaws generally, nor the presumed legitimacy that attaches to contractual choice of forum clauses in the commercial context, require judicial enforcement of the Board-mandated exclusive forum Bylaw, unilaterally

<sup>&</sup>lt;sup>1</sup> The Bylaw limits shareholders' substantive rights not merely by limiting their choice of venue, but by restricting their ability to bring certain claims. See infra pp. 11-12.

imposed by the Directors after a lengthy period of corporate misconduct and completely absent shareholder consent.

Bylaws generally are "presumed to be valid." Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985). Similarly, in the commercial context, contractual choice of forum clauses are "presumptively valid." Ingres Corp. v. CA, Inc., 8 A.3d 1143, 1146 (Del. 2010). Nowhere in Delaware's jurisprudence, however, have these two principles been construed as establishing presumptive validity for exclusive forum selection provisions inserted as board amendments to corporate bylaws.

In holding forum selection clauses "presumptively valid,"

Delaware courts have adopted the Supreme Court's reasoning in M/S

Bremen v. Zapata Off-Shore Co. (The Bremen), 407 U.S. 1 (1972). See,
e.g., Capital Group Cos. v. Armour, 2004 WL 2521295, at \*6 n.39 (Del.

Ch.); Ingres, 8 A.3d at 1146 n.9. Importantly, the presumption

attaches "when [the forum selection clause] is the product of 'a

freely negotiated private . . . commercial agreement [which]

contemplated the claimed inconvenience.'" Capital Group Cos., 2004 WL
2521295, at \*6 (quoting The Bremen, 407 U.S. at 16). Here, the Bylaw
was not "freely negotiated." Id. Rather, it was adopted at a board

meeting without shareholder notice or consent. Mem. Op. 17 n.39.

Delaware has not explicitly adopted the Supreme Court's reasoning in Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991) that forum selection clauses that are not freely negotiated may nonetheless be enforceable. In fact, one of the only Delaware cases to cite Carnival Cruise Lines quotes the dissent's proposition that contracts

of adhesion deserve heightened scrutiny. HCR-Manor Care v. Fugee,
2010 WL 780020 (Del. Super. Ct.), on reconsideration, 2010 WL 1175209

(Del. Super. Ct.) (quoting Carnival Cruise Lines, 499 U.S. at 600

(Stevens, J., dissenting)). In any event, Carnival Cruise Lines dealt with form passage contracts printed on the back of passengers' cruise liner tickets, a context completely different from exclusive forum selection clauses inserted into corporate bylaws by a board of directors without shareholder consent.

Principles of contractual analysis under Delaware law make clear that the exclusive forum bylaw in question is invalid. "Corporate charters and bylaws are contracts among a corporation's shareholders." Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1188 (Del. 2010). Therefore, general rules applicable to contract interpretation also apply to bylaws. See Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 928 (Del. 1990); see also Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 342-43 (Del. 1983) ("Our analysis starts with the principle that the rules which are used to interpret . . . contracts . . . are applicable when construing corporate charters and bylaws."); Sassano v. CIBC World Mkts. Corp., 948 A.2d 453, 462 (Del. Ch. 2008).

In interpreting contracts, Delaware courts "must give effect to the intent of the parties." Waggoner v. Laster, 581 A.2d 1127, 1134 (Del. 1990). Moreover, contract formation requires mutual assent. Wood v. State, 815 A.2d 350 (Del. 2003) (citing Restatement (Second) of Contracts § 18 (1979)). In the context of corporation law, the DGCL recognizes shareholder consent as obligatory for valid charter

amendments (which, as discussed *supra* pp. 7-9, are the appropriate place for provisions limiting shareholder power). Section 242 states, in relevant part, that any "change in . . . the rights of stockholders" requires a majority vote of stockholders. See Del. Code Ann. tit. 8, § 242(a)-(b) (2011). Thus, in *In re Revlon, Inc.*Shareholders Litig., 990 A.2d 940, 960 n.8 (Del. Ch. 2010), the Chancery Court suggested that "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with *charter* provisions selecting an exclusive forum for intra-entity disputes." Revlon, 990 A.2d at 960 n.8 (emphasis added).

Conversely, where corporate director defendants unilaterally adopt an exclusive forum bylaw following a period of malfeasance "there is no element of mutual consent to the forum choice at all, at least with respect to shareholders who purchased their shares prior to the time the bylaw was adopted." Galaviz v. Berg, 2011 WL 135215 (N.D. Cal.). While the Chancery Court is correct that Galaviz was decided as a matter of federal common law, Mem. Op. 15, its reasoning is compelling and should apply here. The shareholders cannot be deemed to have intended to restrict their rights through an exclusive forum bylaw enacted unilaterally by the Board in the wake of corporate misconduct. Nor can shareholders be deemed to have consented to such a bylaw. The perniciousness of corporate fiduciaries presiding over misconduct and then acting unilaterally to make it more difficult for shareholders to hold them accountable differentiates the Bylaw in this

case from other contract based venue provisions generally. *Cf. Galaviz*, 2011 WL 135215, at \*4; see also infra at pp. 14-17.

# 3. The Bylaw is unreasonable and unjust because it will likely preclude Miller's federal claims.

More than just mandating a particular venue, the Bylaw ensures that derivative plaintiffs with legitimate state and federal law claims will be required to litigate in multiple fora. Moreover, the Bylaw makes it likely that only the first litigated claim will ever be heard.

Courts should not enforce an otherwise valid forum selection clause if its application would be "unreasonable and unjust." Ingres Corp. v. CA, Inc., 8 A.3d 1143, 1146 (Del. 2010) (quoting M/S Bremen v. Zapata Off-Shore Co. (The Bremen), 407 U.S. 1, 15 (1972)). A forum selection clause is unreasonable if "enforcement would . . . seriously impair the plaintiff's ability to pursue his cause of action."

Ingres, 8 A.3d at 1146, n.9 (citation omitted).

Here, the board-imposed bylaw is unreasonable and unjust because if enforced it would prevent or seriously impair Miller's ability to pursue all relevant claims against the Directors.

Federal courts have exclusive jurisdiction of claims arising under the Securities Exchange Act of 1934. Securities Exchange Act of 1934, 15 U.S.C. § 78aa (2006) ("[t]he district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.").

Moreover, "judicial proceedings [of state courts] shall have the same full faith and credit in every court within the United States."

28 U.S.C. § 1738 (2006). The Supreme Court has held that § 1738 requires federal courts to apply state laws of claim preclusion in determining whether a final judgment in state court bars subsequent litigation of federal claims that could not have been raised in state court. Marrese v. Am. Acad. of Orthopaedic Surgeons, 470 U.S. 373, 380-81 (1985).

Delaware state courts have held that the doctrine of res judicata "bar[s] litigation between the same parties if the claims in the later litigation arose from the same transaction that formed the basis of the prior adjudication." Maldonado v. Flynn, 417 A.2d 378, 381 (Del. Ch. 1980) (citation omitted).

Miller's state and federal claims arise out of the same transaction, since Miller's federal claims were made "in connection with the conduct complained of" in the Delaware action. Mem. Op. 4. Thus, were Delaware to reach a judgment unfavorable to the shareholders on the state law claims, the District Court in Texas would be compelled to preclude the federal securities claims. Such an outcome would be unreasonable and unjust.

<sup>&</sup>lt;sup>2</sup> This would be true whether the District Court stays the Texas action in favor of the Delaware action or proceeds in Texas but reaches a judgment after the Chancery Court.

# II. Alternatively, the Board's adoption of the Bylaw is subject to, and cannot survive, elevated judicial scrutiny under either the entire fairness test or the *Unocal* test.

#### A. Question Presented

Whether a forum-restricting bylaw adopted unilaterally by a board after a prolonged period of corporate malfeasance should be subjected to elevated scrutiny under either the entire fairness standard or the Unocal standard.

#### B. Scope of Review

The Chancery Court's conclusions as to the appropriate level of scrutiny to apply to a contested bylaw "implicate[] a question of law" and are reviewable de novo. See Stroud v. Grace, 606 A.2d 75, 90-91 (Del. 1992).

#### C. Merits of Argument

The Board's unilateral adoption of a forum-restricting bylaw and its attempt to enforce that bylaw in this action<sup>3</sup> are either self-interested actions that violate the Directors' fiduciary duty of loyalty or defensive actions that serve to keep the Directors in office. Either strict scrutiny under the entire fairness test or, alternatively, enhanced scrutiny under the *Unocal* test is therefore the appropriate standard of review. The Board's adoption of the Bylaw cannot withstand either form of elevated judicial scrutiny.

Therefore, even if the Bylaw is valid in the abstract, it is invalid as adopted by the Board and applied in this action.

<sup>&</sup>lt;sup>3</sup> Miller hereinafter refers to "the Board's adoption of the Bylaw" as shorthand for "the Board's adoption of the Bylaw and its attempt to enforce the Bylaw in this action."

# 1. The Board's adoption of the Bylaw is subject to entire fairness review because it was inherently self-interested and disloyal.

Challenged board conduct is subject to entire fairness review when it is inherently self-interested or when a plaintiff makes a preliminary showing that the directors' conduct violated their fiduciary duties of care, loyalty, or good faith. See Emerald Partners v. Berlin, 787 A.2d 85, 93 (Del. 2001); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

First, some challenged directorial actions are, by their very nature, immediately subject to entire fairness review. See Emerald Partners, 787 A.2d at 93 (describing a class of transactions that "require judicial review pursuant to the entire fairness standard ab initio."). Such actions trigger entire fairness review because the "inherently interested nature of those transactions are inextricably intertwined with issues of loyalty." Id. In other words, entire fairness is the appropriate standard where a "self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation." See AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986).

Second, the party challenging a board's decision can make a preliminary showing of a loyalty violation, triggering entire fairness review, by alleging facts that raise a question as to whether the board's decision was self-interested, as when the directors engage in self-dealing or receive a personal benefit that is not received by the stockholders generally. See Emerald Partners v. Berlin, 726 A.2d 1215, 1221-22 (Del. 1999); Cede, 634 A.2d at 361-62. More broadly,

the duty of loyalty requires corporate fiduciaries to place the best interests of the corporation before any conflicting self-interest.

See Cede, 634 A.2d at 361.

Here, the Pinpoint Board's adoption of the Bylaw is subject to entire fairness review. Pinpoint's directors have an obvious personal interest in avoiding the personal liability that might result from breach of fiduciary duty lawsuits against them, and they have attempted to obstruct the right of shareholders to bring such suits by adopting the forum-restricting bylaw. Pinpoint has over 28,000 shareholders hailing from each of the fifty states. Mem. Op. 4 n.6. Shareholders who otherwise would have brought meritorious fiduciary claims will be prevented from doing so by the expense and inconvenience of having to litigate out of state against a board that has now manufactured for itself the additional advantage of never having to litigate such claims anywhere else.

The Directors' adoption of a bylaw that has this deterrent effect on fiduciary litigation against the Directors and this limiting effect on directorial liability was thus an "inherently interested" action fraught by its very nature with issues of loyalty. Emerald Partners, 787 A.2d at 93. Because the Directors acted unilaterally, their adoption of the Bylaw was also an instance of a "self-interested corporate fiduciary . . . set[ting] the terms of a transaction and caus[ing] its effectuation." AC Acquisitions, 519 A.2d at 111. The Board's adoption of the Bylaw therefore warrants entire fairness review ab initio.

Moreover, other facts on record raise a question as to whether the Director's adoption of the Bylaw was consistent with their fiduciary duty of loyalty. The Directors adopted the Bylaw in June of 2010, over a year after the beginning of the pattern of testing omissions that culminated in the OIG settlement. Mem. Op. 2, 5-6. The occurrence of such extensive internal misconduct over such a long period of time was bound to give rise to breach of fiduciary duty claims against the Directors for improper oversight. Against this backdrop, the self-interested nature of the Board's adoption of a bylaw that hinders fiduciary litigation and directorial liability is especially apparent, raising significant loyalty concerns and triggering entire fairness review.

Finally, by eliminating the possibility of litigating shareholder fiduciary claims against themselves in non-Delaware fora, the Directors placed their own interests before the interests of Pinpoint and its shareholders. A corporation and its shareholders benefit from the service of board members who abide by their fiduciary duties, and shareholder fiduciary suits serve as a check against fiduciary violations. The Bylaw weakens this essential check at the expense of Pinpoint and its shareholders, while delivering a significant personal benefit to the Directors. Furthermore, by unilaterally enacting the Bylaw, which sets the very terms of how the Directors themselves are held accountable as fiduciaries, the Directors have engaged in the kind of self-dealing that also implicates significant loyalty concerns.

The Chancery Court failed to see the Bylaw's effects on fiduciary accountability or the myriad loyalty concerns surrounding the Board's adoption of the Bylaw because it focused too narrowly on how the Bylaw does not limit the types of claims that can be brought in the Chancery Court and does not expressly exculpate the Board from liability. See Mem. Op. 17. The Chancery Court therefore erred in reviewing the Director's adoption of the Bylaw under the business judgment rule. Mem. Op. 18.

It might be objected that the entire fairness standard developed in the context of mergers and similar corporate transactions, and is therefore inapplicable to the adoption of a corporate bylaw. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (providing classic formulation of entire fairness standard against backdrop of conflict of interest merger). However, "[Delaware Supreme Court] decisions have applied the entire fairness standard in a nontransaction context." Gantler v. Stephens, 965 A.2d 695, 708 n.33 (Del. 2009). Indeed, entire fairness has been applied where, as here, a board decided to give itself a litigation advantage relative to shareholders. See Havens v. Attar, 1997 WL 55957, at \*11-\*14 (Del. Ch.) (advancement of litigation expenses to individual directors).

 The Board's adoption of the Bylaw cannot survive entire fairness review because the Bylaw was not the product of fair dealing and will not fairly affect the value of Pinpoint stock.

Once entire fairness review applies, the fiduciary has the burden of demonstrating that the challenged action was "entirely fair" to the shareholders. See Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del.

1983). Entire fairness consists of both "fair dealing" and "fair price." *Id.* at 711. The Pinpoint directors' adoption of the Bylaw fails on both prongs of this analysis.

# a. The Board's adoption of the Bylaw fails to satisfy the fair dealing requirement.

Fair dealing relates to "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." Id. at 711; see also Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) ("[Fair dealing] also embraces the duty . . . owed by corporate fiduciaries to disclose all material information relevant to corporate decisions from which they may derive a personal benefit.").

The Pinpoint board's adoption of the Bylaw cannot satisfy the fair dealing requirement. Here, a bylaw that limits shareholder rights was "initiated," "structured," and "approv[ed]" unilaterally by self-interested directors who did not bother to consult the shareholders. See Weinberger, 457 A.2d at 711. It is no response to say that Pinpoint's charter, per DGCL section 109(a), permits directors to enact bylaws, since the validity of the Directors' adoption of this Bylaw is the precise issue before this Court. See Order 1-2, Jan. 18, 2011; Order 1-2, Jan. 14, 2011; Mem. Op. 12.

Moreover, the "tim[ing]," Weinberger, 457 A.2d at 711, of the Bylaw's adoption was highly suspicious; a provision making it more difficult to sue the Directors for breaching their fiduciary duties was passed by the Directors while extensive internal wrongdoing at Pinpoint was

unfolding, see Mem. Op. 2, 5-6. Finally, since the Directors had a personal interest in the weakening of fiduciary accountability they accomplished through their decision to adopt the Bylaw, Mills suggests that the Director's fair dealing obligation also included a duty to disclose to the shareholders their intention to adopt the Bylaw. 559 A.2d at 1280.

# b. The Board's adoption of the Bylaw fails to satisfy the fair price requirement.

A board must also demonstrate the fairness to the stockholders of the "economic and financial" aspects of the challenged action, including its effect on "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." Weinberger, 457 A.2d at 711.

The Pinpoint board has not shown that its adoption of the Bylaw will affect share prices fairly. The Directors may have thought that the Bylaw would promote "convenience, efficiency, and relative predictability" by confining all derivative and fiduciary litigation to the Chancery Court, Mem. Op. 17, and this may bear some relation to "economic and financial" matters, Weinberger, 457 A.2d at 711.

However, the Board's adoption of the Bylaw is likely to devalue Pinpoint stock, especially in the sense of its "intrinsic or inherent value," id., since stock in a company that restricts the ability of its shareholders to hold their directors accountable as fiduciaries will be less desirable, ceteris paribus, to potential investors than other equity investments. At the very least, the burden remains on the Directors to show how the Bylaw will have a fair effect on the

value of Pinpoint stock; their mere invocation of "convenience" and "efficiency" fails to do so.

 Alternatively, the Board's adoption of the Bylaw is subject to enhanced scrutiny under *Unocal* because it was a defensive action relating to the Board's control of Pinpoint.

Unocal scrutiny applies where a board takes a defensive action, which can include the adoption of bylaws, in response to a "perceived threat to corporate policy and effectiveness which touches upon issues of control." See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1372 n.9 (Del. 1995) (citations omitted); Chesapeake Corp. v. Shore, 771 A.2d 293, 323-24 (Del. Ch. 2000) (applying Unocal scrutiny to board-adopted bylaw). This heightened form of judicial review originally emerged in the context of defensive measures enacted by corporate boards in response to hostile tender offers, where the "omnipresent specter that a board may be acting primarily in its own interests" warranted close judicial scrutiny of such measures. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949, 954 (Del. 1985).

The Pinpoint board's adoption of the Bylaw should be reviewed under Unocal scrutiny. A bylaw enacted unilaterally by the Directors that restricts where shareholders can bring fiduciary suits against those Directors is a defensive measure; it aims to protect the Directors from liability by repelling such suits. This is especially true since the Bylaw was enacted after the safety and performance testing omissions had been occurring at Pinpoint for over a year, Mem. Op. 2, 5-6, posing a specific threat to the Pinpoint board in the form of potential fiduciary suits for improper oversight. Moreover, these

general and specific threats of fiduciary liability "touch upon issues of control," Unitrin, 651 A.2d at 1372 n.9, because corporate directors held liable for breaching their fiduciary duties, or even just embattled in fiduciary litigation, are less likely to hold onto their seats. Especially here, where the Directors presided over Pinpoint as it repeatedly defrauded the United States government, jeopardizing Pinpoint's relationship with a customer that accounts for 60% of its revenues, the Directors' continued control of the company would be at issue. See Mem. Op. 5-6. The Chancery Court therefore erred in holding that the Bylaw "does not serve to perpetuate the Director Defendants' control of the Company" and in examining the Directors' adoption of the Bylaw under the business judgment rule.

Mem. Op. 7-8.

It might be objected that <code>Unocal</code> should not be applied outside the context of tender offers or similar transactions. First, Delaware courts have placed no such limitation on <code>Unocal's domain</code>, and have suggested a broad role for enhanced scrutiny. <code>See Unitrin</code>, 651 A.2d at 1374 ("The Unocal standard is a flexible paradigm that jurists can apply to the myriad of 'fact scenarios' that confront corporate boards."); <code>eBay Domestic Holdings</code>, <code>Inc. v. Newmark</code>, 2010 WL 3516473, at \*21 (Del. Ch.) ("The intermediate standard of review [i.e. <code>Unocal</code>] is not limited to the historic and now classic paradigm."). Second, the same "specter" of self-interested board behavior is present in the case of a board-adopted bylaw that inhibits fiduciary accountability as it is in the case of board-adopted tender offer defensive tactics,

so applying *Unocal* here is equally appropriate. *See Unocal*, 493 A.2d at 954.

4. The Board's adoption of the Bylaw fails *Unocal* step one because no danger to corporate policy and effectiveness existed.

Under *Unocal* step one, the Directors must demonstrate that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed." *Id.* at 955. In other words, directors must identify the "proper *corporate* objectives served by their actions," *Mercier v. Inter-Tel (Del.)*, *Inc.*, 929 A.2d 786, 807 (Del. Ch. 2007) (emphasis added), and cannot point merely to future threats to policies that are not specific to their corporation, *cf. eBay*, 2010 WL 3516473, at \*21-\*24 (holding that risk of future erosion of craigslist's free services oriented business model was not a proper corporate purpose under *Unocal* step one).

Here, there is no cognizable danger to corporate policy and effectiveness. The Bylaw will effectively discourage meritorious derivative suits, which enable shareholders to pursue litigation beneficial to the corporation where self-interested directors are unwilling to do so. It will also discourage earnest breach of fiduciary duty suits against individual directors, which assure that the corporation is well-managed. While the Bylaw might therefore address a "danger" to the Board's attempt to improperly dominate Pinpoint's litigation agenda or to individual directors having to litigate outside of Delaware, it could not reasonably be believed to serve any acceptable corporate objective.

Moreover, as in *eBay*, the future risk of litigating outside of Delaware cannot seriously be posited as a threat specific enough to Pinpoint that defensive measures to eliminate that risk are justified. Rather than a danger to any distinct Pinpoint policy, litigating in multiple fora is simply a fact of life for any corporation of Pinpoint's size and reach, see Mem. Op. 4-5.

Finally, even if the Board's burden of showing a "good faith and reasonable investigation" for Unocal step one purposes would be "materially enhanced" in a tender offer context in light of the advice given to Pinpoint's majority-independent board by Jackson and Sheehan at the June 10, 2010 board meeting, that rationale is absent here.

See Unocal, 493 A.2d at 955; Mem. Op. 5, 17 n.39. A majority-independent board's approval of defensive measures put in place in response to a hostile tender offer might mitigate the entrenchment concerns that underlie the application of Unocal scrutiny to such measures, since an outside director's interest in retaining a board seat is less than an inside director's interest in retaining an executive position. This logic does not extend, however, to the present case, since the defensive measure relevant here—the Bylaw—weakens fiduciary liability, and independent as well as inside directors have a strong interest in avoiding fiduciary liability.

5. The Board's adoption of the Bylaw fails Unocal step two because it was not a proportional response to the "threat" posed.

Under step two of *Unocal*, the Board must demonstrate that its defensive measure was "reasonable in relation to the threat posed." *Unocal*, 493 A.2d at 955. Under this "proportionality" test, the court

examines whether the defensive measure was "preclusive" or "coercive," and, if it is neither, whether it was within a "range of reasonableness." Unitrin, 651 A.2d at 1387-88 (citation omitted). A defensive measure is coercive if it forces a management-sponsored course of action on the shareholders. Id. at 1387. In assessing the reasonableness of the defensive action, the court "evaluat[es] . . . the importance of the corporate objective threatened; alternative methods of protecting that objective; impacts of the 'defensive' action, and other relevant factors." Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989) (citation omitted).

The Board's adoption of the Bylaw was coercive and therefore fails Unocal's proportionality test. Since the Board unilaterally adopted a bylaw adverse to shareholder interests without seeking shareholder approval or consent, it was a "management-sponsored" course of action that was forced upon the shareholders. The fact that the shareholders in theory could have mobilized to repeal the Bylaw is immaterial; it is not a necessary condition of coerciveness that the shareholders be unable to respond after the fact to the board's defensive measure. See generally Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 935 (Del. 2003) (discussing definitions of shareholder coercion under Delaware law).

Second, even if the Bylaw was not coercive, it was not within a range of reasonable responses to the perceived threat. Avoiding non-Delaware litigation is not an acceptable "corporate objective," let alone one important enough to justify its "impact[]" of weakened

fiduciary accountability and its adverse effects on the corporation.

Paramount, 571 A.2d at 1154; see also supra pp. 22-23. There were also "alternative methods" to the Board's unilateral adoption of the Bylaw that may have achieved the same objective without so thoroughly trampling shareholder rights. Paramount, 571 A.2d at 1154.

Shareholder consent could have been sought, for example, by proposing the Bylaw as a charter amendment requiring shareholder approval. The Bylaw could also have taken an "elective" rather than "mandatory" form, or could have attempted to make some other provision to allow earnest derivative or fiduciary claims to proceed in the shareholder's forum of choice. See Joseph A. Grundfest, Professor, Stanford Law School, Pileggi Lecture: Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches (Oct. 6, 2010).

## CONCLUSION

For the foregoing reasons, Appellant respectfully requests this Court to hold (1) that the exclusive forum bylaw is not a proper subject for action by boards of directors as a matter of Delaware law, or (2) that the exclusive forum bylaw is invalid as adopted and applied in this action under either entire fairness or *Unocal* review. Accordingly, Appellant asks that the Court remand to the Chancery Court for further proceedings on the motions.