

IN THE SUPREME COURT OF THE STATE OF DELAWARE

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

---

EDWARD MILLER, )  
)  
Plaintiffs Below- )  
APPELLANT, )  
)  
v. )  
)  
MICHAEL SANCHEZ, CLARE MITCHELL, ) On Appeal from the  
BRENDAN ELLSWORTH, TIMOTHY FLETCHER, ) Court of Chancery of  
MARSHAL FRANKLIN DAPHNE KEYES AND ) the state of Delaware in  
ERIC LAM, ) and for New Castle County  
) Civil Action No. 4958-VCM  
Defendant's Below- )  
APPELLEES )  
)  
AND )  
)  
PINPOINT BEARINGS, INC., )  
)  
Nominal Defendant Below- )  
APPELLEE. )

---

**APPELLANT'S OPENING BRIEF**

TEAM I  
FEBRUARY 11, 2011

TABLE OF CONTENTS

TABLE OF CITATIONS..... iii

NATURE OF PROCEEDINGS..... 1

SUMMARY OF ARGUMENT..... 2

STATEMENT OF FACTS..... 3

ARGUMENT..... 5

I. THIS COURT SHOULD REVERSE THE LOWER COURT’S DENIAL OF MILLER’S MOTION TO STAY BECAUSE A UNILATERALLY ADOPTED EXCLUSIVE FORUM BYLAW VIOLATES DELAWARE CORPORATE LAW, IS INCONSISTENT WITH CONTRACT LAW, AND IS UNREASONABLE IN ITS APPLICATION..... 5

    A. QUESTION PRESENTED ..... 5

    B. SCOPE OF REVIEW ..... 5

    C. MERITS OF ARGUMENT ..... 5

        1. The Exclusive Forum Bylaw Is Inconsistent With Delaware General Corporate Law And Is Not Procedural In Nature. .. 6

        2. A Unilaterally Imposed Exclusive Forum Bylaw Violates Basic Contractual Principles. .... 9

        3. The Bylaw Should Not Be Upheld Because Enforcement Would Be Unreasonable And Violate The Public Policy Of Texas. 13

II. THIS COURT SHOULD REVERSE THE COURT OF CHANCERY, GRANT APPELLANT’S MOTION TO STAY, AND DENY APPELLEE’S MOTION TO ENJOIN BECAUSE THE PINPOINT BOARD ACTED OUT OF SELF-INTEREST WHEN IT ADOPTED THE BYLAW TO PROTECT ITSELF FROM DERIVATIVE SUITS, THEREBY BREACHING ITS FIDUCIARY DUTIES..... 15

    A. QUESTION PRESENTED..... 15

    B. SCOPE OF REVIEW ..... 15

    C. MERITS OF ARGUMENT ..... 15

        1. The Court of Chancery Should Have Applied Entire Fairness Review Because The Board Breached Its Fiduciary Duty and Lost The Business Judgment Presumption. .... 16

            a. The Director Defendants breached the duty of care by a failure to exercise oversight that in turn led to waste. .... 17

b.	The Director Defendants breached the duty of loyalty because they insulated themselves from liability. . .	19
2.	The Unocal standard of review should be applied because the Board adopted the Bylaw as an improper defensive measure. ....	21
a.	The adoption of the Bylaw was a self-interested defensive measure. ....	22
b.	The possibility of shareholder suits outside of Delaware does not constitute a threat to corporate policy. ....	23
c.	The Boards response was coercive. ....	23
d.	The enactment of the bylaw was unreasonable and improper. ....	24
3.	The Bylaw Fails Under Business Judgment Review .....	24
CONCLUSION.....		25

TABLE OF CITATIONS

**United States Supreme Court Cases**

*Carnival Cruise Lines, Inc. v. Shute*,  
499 U.S. 585 (1991) ..... 10, 11

*Kamen v. Kemper Fin. Serv., Inc.*,  
500 U.S. 90 (1991) ..... 23

*Lauro Lines v. Chasser*,  
490 U.S. 495 (1989) ..... 13

*M/S Bremen v. Zapata Off-Shore Co.*,  
407 U.S. 1 (1972) ..... 10

**United States Court of Appeals Cases**

*Coastal Steel Corp. v. Tilghman Wheelabrator, LTD.*,  
709 F.2d 190(3d Cir. 1983) ..... 13

*Wiljef Transp., Inc. v. NLRB*,  
946 F.2d 1308 (7th Cir. 1991) ..... 9

**United States District Court Cases**

*Galaviz v. Berg*,  
--- F. Supp. 2d. ----, 2011 WL 135215 (N.D. Cal. 2011). ... 10, 12

*Hadley v. Shaffer*,  
2003 WL 21960406 (D. Del. 2003) ..... 13

**Delaware Supreme Court Cases**

*Aronson v. Lewis*,  
473 A.2d 805 (Del. 1984) ..... 7

*Brehm v. Eisner*,  
746 A.2d 244 (Del. 2000) ..... 5

*CA, Inc. v. AFSCME Employees Pension Plan*,  
953 A.2d 227 (Del. 2008) ..... 6, 8, 9

*Cede & Co. v. Technicolor, Inc.*,  
634 A.2d 345 (Del. 1993) ..... 16

*Dunlap v. State Farm Fire & Cas. Co.*,  
878 A.2d 434 (Del. 2005) ..... 15

*Elf Atochem North Am., Inc. v. Jaffari*,  
727 A.2d 286 (Del. 1999) ..... 10, 11, 12

*Elia Corp. v. Paul N. Howard Co.*,  
391 A.2d 214 (Del. 1978). ..... 13

<i>Emerald Partners v. Berlin,</i> 787 A.2d 85 (Del. 2001) .....	20
<i>Frantz Mfg. Co. v. EAC Indus.,</i> 501 A.2d 401 (Del. 1985) .....	6
<i>In re Walt Disney,</i> 906 A.2d 27 (Del. 2006) .....	17
<i>Ingres Corp. v. CA, Inc.,</i> 8 A.3d 1143 (Del. 2010) .....	13
<i>Ivanhoe Partners v. Newmont Mining Corp.,</i> 535 A.2d 1334 (Del. 1987) .....	20
<i>Nixon v. Blackwell,</i> 626 A.2d 1366 (Del. 1993) .....	16
<i>Paramount Communications, Inc., v. Time, Inc.,</i> 571 A.2d 1140 (Del. 1989) .....	22
<i>Spiegel v. Buntrock,</i> 571 A.2d 767 (Del. 1990) .....	7
<i>Sterling v. Mayflower Hotel Corp.,</i> 93 A.2d 107 (Del. 1952) .....	12
<i>Stone ex rel. AmSouth Bancorporation v. Ritter,</i> 911 A.2d 362 (Del. 2006) .....	18
<i>Unitrin Inc., v. American General Corp.,</i> 651 A.2d 1361 (Del. 1995) .....	21
<i>Unocal Corp. v. Mesa Petroleum Co.,</i> 493 A.2d 946 (Del. 1985) .....	21, 22
<i>Versata Enterprises, Inc. v. Selectica, Inc.,</i> 5 A.3d 586 (Del. 2010) .....	23, 24
<i>Walker v. Res. Dev. Co.,</i> 791 A.2d 799 (Del. 2000) .....	12
<i>White v. Panic,</i> 783 A.2d 543 (Del. 2001) .....	5, 15, 18, 19

**Delaware Chancery Court Cases**

*Baker v. Impact Holding, Inc.*,  
2010 WL 1931032 (Del. Ch. 2010) ..... 13, 14

*Gaskill v. Gladys Belle Oil Co.*,  
146 A. 337 (Del. Ch. 1929) ..... 6

*Glazer v. Zapata Corp.*,  
658 A.2d 176 (Del. Ch. 1993) ..... 18

*In re Caremark Intern. Inc.*,  
698 A.2d 959 (Del. Ch. 1996) ..... 18

*In re Pinpoint Bearings, Inc.*,  
Del. Ch., C.A. No. 4958-VCM, McCloskey, C. (January 12, 2011)  
(Mem. Op.) ..... 1, 3, 4, 5

*In re Revlon, Inc.*,  
990 A.2d 940 (Del. Ch. 2010) ..... 8

*Kidsco Inc. v. Dinsmore*,  
674 A.2d 483 (Del. Ch. 1995) ..... 22, 23, 24

*Solomon v. Armstrong*,  
747 A.2d 1098 (Del. Ch. 1999) ..... 17, 20

*Twin Bridges Ltd. Partnership v. Draper*,  
2007 WL 2744609 (Del. Ch. 2007) ..... 20

**Federal Statutes**

15 U.S.C. § 78j(b)(2010) ..... 1

28 U.S.C § 1332(c)(1) (2010) ..... 14

31 U.S.C. § 3729 (2010) ..... 19

**State Statutes**

6 Del C. § 18-101 *et seq.* (2010) ..... 12

8 Del C. § 102(b)(7)(2010) ..... 8

8 Del C. § 242(b)(2010) ..... 12

8 Del. C. § 102(b)(1)(2010) ..... 7

8 Del. C. § 102(b)(2010) ..... 7

8 Del. C. § 109(b)(2010) ..... 6, 9

**Secondary Authorities**

Edward Welch & Robert S. Saunders, *Freedom and its limits in the Delaware general corporation law*, 33 Del. J. Corp. L. 845 (2008).. 12

Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 Del. J. Corp. L. 57 (2009).. 25

Kent Greenfield, *Law, Politics, and the Erosion of Legitimacy*, 55 N.Y.L. Sch. L. Rev. 481 (2011)..... 21

## NATURE OF PROCEEDINGS

Plaintiff-Appellant Edward Miller ("Miller") owns shares in Pinpoint Bearings, Inc., ("Pinpoint") a Delaware Corporation. *In re Pinpoint Bearings, Inc.*, Del. Ch., C.A. No. 4958-VCM, McCloskey, C. (January 12, 2011) (Mem. Op.) at 4. On December 1, 2010, Miller filed a derivative action in the Southern District of Texas (the "Federal Action"). *Id.* In this action, Miller alleged fiduciary violations and violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2010), against the Directors ("Director Defendants") of Pinpoint. *In re Pinpoint Bearings, Inc.*, C.A. No. 4958-VCM at 4.

On December 2, 2010, three other Pinpoint shareholders filed separate derivative actions in the Delaware Court of Chancery alleging the same causes of action in the Federal Action. *Id.* at 7. The Chancery Court consolidated these claims. *Id.* Miller filed a separate Delaware action and moved to stay the Delaware proceedings in favor of the Federal Action. *Id.* at 1.

The Chancery Court rejected Miller's Motion to Stay and enjoined Miller from proceeding in the Federal Action because the Court found that Pinpoint's Exclusive Forum Bylaw required all derivative and fiduciary violations be heard in Delaware. *Id.* at 2.

The Court upheld the validity of Pinpoint's Bylaw, because the Bylaw is valid under Delaware corporate law and its adoption was equitable. *Id.* at 19. On January 12, 2011 Pinpoint filed a notice of appeal in the Supreme Court of Delaware. *In Re Pinpoint Bearings, Inc.*, Del. Supr., No. 4958-VCM, Holland, J. (January 18, 2011)(ORDER).

## SUMMARY OF ARGUMENT

I. The Exclusive Forum Bylaw enacted by Pinpoint is invalid as a matter of law because it violates Delaware General Corporate Law, which provides that limitations on shareholder rights and director liability must be included in the certificate of incorporation. Furthermore, an exclusive forum bylaw is invalid because its substantive nature violates Delaware law. Additionally, unilaterally adopted exclusive forum bylaws violate basic contractual principles because such bylaws are not bargained for and lack mutual consent. Lastly, this bylaw is invalid because its application is unreasonable, since it effectively denies Miller his day in court, and it violates the public policy of Texas. For these reasons, this Court should reverse the lower court's ruling.

II. The board passed the Exclusive Forum Bylaw in an act of self-preservation, thus breaching the duty of loyalty owed to its shareholders. This Court must examine the actions of the board through the entire fairness test, under which the Bylaw fails because it is an improper attempt to undermine derivative suits brought by shareholders. In the alternative, this court should apply the *Unocal* standard of review because of the essentially defensive and self-interested nature of the Board's adoption of the Bylaw. Under the *Unocal* standard, the Bylaw also fails because of its coercive nature. Finally, even if this Court applies business judgment review, the Bylaw again fails because a board decision based on selfishly preserving its position can have no rational business purpose.

## STATEMENT OF FACTS

The Parties: Pinpoint, a Delaware corporation, is headquartered in Houston, Texas, and specializes in manufacturing equipment associated with aerospace applications. *In re Pinpoint Bearings, Inc.*, C.A. No. 4958-VCM at 4. Pinpoint employ 8,000 people in factories in Houston. *Id.* Pinpoint has a market capitalization of \$4 billion and is traded on the New York Stock Exchange. *Id.* at 4.

Plaintiff Miller has been an employee of Pinpoint for twenty years. *Id.* Additionally, Miller has resided in Houston his entire life. *Id.* Miller presently owns 5,000 shares of Pinpoint common stock, worth about \$230,000.00. *Id.* at 3. Miller acquired his shares through stock option plans provided to him by Pinpoint. *Id.* at 4. Plaintiffs Richard Patrick, Harold Kohn, and Eileen Webb each own 200 or fewer shares of Pinpoint common Stock. *Id.* at 3.

Pinpoint's Negligence: In early September 2010, a long time Pinpoint Engineer informed the Inspector General of the United States ("OIG") that Pinpoint was using improper cost cutting measures on several of contracts with the U.S. military, one of Pinpoint's principal customers. *Id.* at 4-5. Problems arose when three of Pinpoint's mid-level managers were found to be regularly omitting contractually required testing. *Id.* at 5. Pinpoint's activities were deemed fraudulent because Pinpoint was falsely representing to the military that all contractually required tests had been performed in its billing and invoice submissions. *Id.* at 6. Formal notice was given to Pinpoint about the investigation on September 8, 2010. *Id.* Pinpoint appointed two independent directors to a special committee,

which determined that there was a pattern of improper and undisclosed cost-cutting steps. *Id.* On October 28, 2010, Pinpoint negotiated a settlement with the OIG for \$500,000,000.00. *Id.* On November 30, 2010, Pinpoint issued a press release after the close of the stock market disclosing the OIG investigation and the terms of the settlement. *Id.* at 7. After the press release, Pinpoint's stock fell, resulting in a loss of approximately \$440,000,000.00 in market capitalization. *Id.* The stock has not recovered the lost value. *Id.*

The Exclusive Forum Bylaw: Three months prior to the revelation of Pinpoint's fraudulent activity, the Pinpoint Board adopted the Bylaw, which designated the Delaware Court of Chancery as the sole and exclusive forum for any derivative actions brought by shareholders of Pinpoint. *Id.* at 2. Miller's challenge to the validity of the Bylaw is the reason for the appeal to this Court. *Id.*

Litigation Ensues: The Delaware Plaintiffs' requested a consolidation of Miller's first filed Federal Action with their three separately filed derivative suits in Delaware, both of which alleged fiduciary oversight by Pinpoint's Director Defendant's. *Id.* at 8. The Chancery Court granted this request. *Id.* On December 13, 2010, Pinpoint and Director Defendants filed a motion to stay Miller's Federal Action in favor of the consolidated Delaware action. *Id.*

Two days after the Director Defendant's filing, Miller filed a separate derivative fiduciary claim in Delaware alleging the same violation found in the Federal Action. *Id.* at 8. Miller also filed a motion to consolidate with the other three derivative claims along with a second motion to stay the consolidated Delaware action in favor

of his original Federal Action. *Id.* at 9. The Court granted the consolidation, but denied Miller's request to stay the Consolidated Delaware Action. *Id.* at 20. On January 14, 2011, the Court of Chancery granted Appellant's application for interlocutory appeal. *In re Pinpoint Bearings, Inc.*, Del. Ch., No. 4958-VCM, 2011, McCloskey, C. (January 14, 2011) (ORDER).

#### ARGUMENT

I. THIS COURT SHOULD REVERSE THE LOWER COURT'S DENIAL OF MILLER'S MOTION TO STAY BECAUSE A UNILATERALLY ADOPTED EXCLUSIVE FORUM BYLAW VIOLATES DELAWARE CORPORATE LAW, IS INCONSISTENT WITH CONTRACT LAW, AND IS UNREASONABLE IN ITS APPLICATION.

##### A. Question Presented

Whether the Court of Chancery erred in denying Miller's Motion to Stay and in granting Director Defendants' Motion to Enjoin because a unilaterally imposed exclusive forum bylaw violates Delaware General Corporate Law, the fundamental rules of contract law, and is unreasonable in application.

##### B. Scope of Review

This Court reviews Chancery Court's legal interpretation of bylaws and statutes *de novo*. *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000). This Court should draw all reasonable inferences in the Appellant's favor. *White v. Panic*, 783 A.2d 543, 549 (Del. 2001). In addition, inferences must flow logically from the facts alleged. *Id.*

##### C. Merits of Argument

This is a case about whether a self-interested board can insulate itself from fiduciary claims by unilaterally enacting an exclusive forum bylaw, which limits shareholder rights in direct opposition to both the Delaware General Corporate Law ("DGCL") and Common law. They

cannot. Therefore, this Court should reverse the lower court's ruling upholding the validity of Pinpoint's Exclusive Forum Bylaw (the "EFB") for the following three reasons. First, a unilaterally adopted exclusive forum bylaw is invalid as a matter of Delaware Corporate Law. Second, an exclusive forum bylaw is an overextension of basic contractual principles and Supreme Court precedent. Third, even if the EFB is found valid, the EFB should not be enforced because it is unreasonable in application and violates the public policy of Texas.

**1. The Exclusive Forum Bylaw Is Inconsistent With Delaware General Corporate Law And Is Not Procedural In Nature.**

The EFB fails under DGCL because it violates the limited rights of shareholders and, thus, exceeds the scope of a proper bylaw provision. While bylaws are presumed valid, a bylaw that is inconsistent with DGCL or common law is void. *Frantz Mfg. Co. v. EAC Industries*, 501 A.2d 401, 407 (Del. 1985). Bylaws may not be inconsistent with the law relating to the corporation's business, the conduct of its affairs, or the rights or powers of shareholders. 8 Del. C. § 109(b)(2010). Furthermore, bylaw provisions are subordinate to the certificate of incorporation ("COI"). *Gaskill v. Gladys Belle Oil Co.*, 146 A. 337, 340 (Del. Ch. 1929).

Additionally, the EFB fails because the EFB is inherently a substantive amendment and, thus, is not procedural in nature, as suggested by the lower court. A bylaw that relates to the rights of shareholders may only be procedural in nature. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 239 (Del. 2008). Therefore, the EFB because it is inconsistent with Delaware Corporate Law.

A bylaw provision that limits the rights of shareholders violates

section 109(b) of the DGCL because restrictions on shareholder rights must be located in the COI under section 102(b) of the DGCL. 8 Del. C. § 102(b)(2010). A COI may contain:

Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, *limiting* and regulating the powers of the corporation, the directors, and the *stockholders* . . . .

8 Del. C. § 102(b)(1)(2010) (*emphasis added*).

Here, the EFB violates § 102(b)(1) because it limits the shareholders ability to hold the board members accountable through derivative suits and for fiduciary violations. In a derivative action shareholders sue to compel the corporation to bring an action enforcing the corporation's own rights against its fiduciaries or third persons. *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990). The Delaware Supreme Court has described the importance of derivative suits as a "potent tool to redress the conduct of a torpid or unfaithful management." *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (*overruled on other grounds*). Therefore, forcing litigation to take place in compliance with a board enacted exclusive forum bylaw would be defeating the very purpose of the derivative suit and instead giving a blameworthy corporation unfair advantage in the litigation process. Thus, limitations on where shareholders can enforce their rights should be in the COI to be compliant with § 102(b).

Furthermore, the lower court's reliance on *In re Revlon* to justify exclusive forum bylaws lacks merit because the *Revlon* court supported exclusive forum provisions that comply with § 102(b)(1). *In re Revlon* established that an exclusive forum bylaw must be in the COI to be valid. The court stated:

" if board 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."

*In re Revlon, Inc. Shareholders Litig.*, 990 A.2d 940, 960-961 (Del.Ch. 2010) (citing 8 Del C. § 102(b)(1)). As illustrated, *Revlon* explicitly states that an exclusive forum provision must be stated within the COI to validly limit shareholder rights. *Id.* Therefore, the lower court improperly relied on *Revlon* because under *Revlon*, § 102(b)(1) requires that an exclusive forum provision be included in the COI and not a bylaw. Since the exclusive forum provision is in a bylaw and not the COI, the EFB should not be enforced here.

Additionally, the EFB violates § 102(b)(7) of the DGCL because any limitations on a board's liability must be included in the COI. Section 102(b)(7) allows for corporations to include provisions in the COI that limit the liability of corporate directors in some instances. 8 Del C. § 102(b)(7)(2010). However, allowing an exclusive forum bylaw would violate § 102(b)(7) because such a bylaw improperly eliminates the liability of directors for claims arising in all other venues. The limitation arises because the EFB limits Director Defendants' liability to Delaware. Claims may be brought in Delaware, but a shareholder who finds Delaware a burdensome forum may be forced to forego pursuing valid claims. Limiting the board's liability can only be done via the COI. Therefore, the EFB violates § 102(b)(7).

Finally, while a bylaw may deal with the rights and powers of shareholders, a bylaw can only be procedural. *CA, Inc.*, 953 A.2d at 239. In *CA, Inc.*, the Court examined a shareholder-proposed bylaw

that required the board to reimburse shareholders for expenses associated with the elections. *Id.* The Court found that the proposed bylaw was not procedural because it commandeered managerial function and forced the board to act without any discretion. *Id.*

The EFB is not procedural because it restricts substantive rights by forcing shareholders to litigate in a specific forum. Shareholders will have no discretion when evaluating where to bring a claim because of the EFB. The implications of the EFB are inherently substantive because the choice of forum can drastically impact a case and place an undue burden on the plaintiff shareholders. Therefore, just as in *CA, Inc.*, the EFB usurps shareholder discretion by commandeering where they may litigate. Therefore, the EFB is not a procedural measure.

The EFB fails as a matter of law because under the DGCL, any restriction on shareholder rights must be included in the COI, not within a bylaw. Additionally, the EFB is invalid because any restriction on director liability must be included in the COI. Finally, the EFB fails because it is substantive nature. Therefore, the EFB is invalid as a matter of law.

**2. A Unilaterally Imposed Exclusive Forum Bylaw Violates Basic Contractual Principles.**

Even if the EFB is valid under DGCL, the EFB is invalid because the lower court misapplied contract law and Supreme Court precedent in its analysis of the EFB. A bylaw that is inconsistent with Delaware state law and federal law is void. *Wiljef Transp., Inc. v. NLRB*, 946 F.2d 1308, 1311 (7th Cir. 1991); *see generally* 8 Del. C. § 109(b). While exclusive forum provisions were once judicially disfavored, courts have routinely upheld the validity of exclusive forum

provisions in contractual scenarios. *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 14-15 (1972); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991)(upholding a forum selection clause in a contract of adhesion); *Elf Atochem North Am., Inc. v. Jaffari*, 727 A.2d 286, 287 (Del. 1999)(upholding a forum selection provision in an LLC agreement). However, a recent federal case, dealing with a similar fact pattern, held that an exclusive forum provision enacted as a bylaw by a board of directors is invalid because the bylaw lacked shareholder consent. *Galaviz v. Berg*, --- F. Supp. 2d. ----, 2011 WL 135215, at 3 (N.D. Cal. 2011).

The lower court imprudently rejected the reasoning of *Galaviz* and supported its finding that forum selection provisions are acceptable in corporate bylaws by extending the reasoning of *Carnival* and *Elf*. However, the lower court erred because whereas the parties in *Elf* and *Carnival* possessed some bargaining power, the shareholders here possessed none. Therefore, exclusive forum bylaws are inconsistent with Delaware Law and Federal law.

In *Carnival*, the United States Supreme Court validated forum provisions in adhesion contracts when passengers sued the cruise line for damages due to slip and fall injuries. *Carnival*, 499 U.S. at 585. The forum selection clause on the tickets required litigation of all disputes in Florida. *Id.* The passengers disputed the validity of the clause claiming fraud and overreaching. *Id.* The Supreme Court ruled against the passengers and held that the cruise line properly obtained their consent to the clause because plaintiffs had been given notice of the provision and had the opportunity to not purchase the ticket if

they did not agree with the provision. *Id.* at 593.

Unlike passengers in *Carnival*, who had some form of bargaining power, Pinpoint shareholders possessed none. The *Carnival* passengers had the option of not purchasing the tickets if they did not agree with the provisions of the contract. Miller, conversely, had no opportunity to bargain because the board enacted the EFB long after Miller had invested significant amount of money in the company. If Miller had notification of the provision earlier he could have chosen not to invest. At this point, however, liquidation would be his only remedy. Being forced to liquidate his shares at a steep loss as a way to voice disapproval of the EFB does not reasonably constitute bargaining, even the inferred bargaining in *Carnival*.

Just as *Carnival* is inapposite, so too is *Elf* because a forum selection clause found in an LLC operating agreement is substantially different than a unilaterally imposed bylaw of a corporation. In *Elf*, the plaintiff attempted to bring claims in Chancery against fellow LLC members when the LLC agreement contained a forum selection clause designating California. *Elf*, 727 A.2d at 289. The Court noted the broad freedom of LLC members to contract away rights and upheld the validity of the clause because all the parties to the LLC agreement, including plaintiff, had freely agreed to it. *Id.* at 291.

Unlike the parties in *Elf*, Miller possessed no bargaining power and was forced to consent to the forum selection provision after he was already a shareholder. As the court in *Galaviz* noted, "a party's consent to a written agreement may serve as consent to all the terms therein. . . but it does not follow that a contracting party

thereafter may unilaterally add or modify existing contractual provisions unilaterally." *Galaviz*, --- F. Supp. 2d. at ----, 2011 WL 135215, at 4. Conversely, the parties in *Elf* knew from the beginning that they were subject to a forum selection clause. Thus, the parties in *Elf* freely consented to forum clause, whereas Miller did not. Therefore, *Elf* does not support the lower court's finding and this Court should not extend the holding of *Elf* to corporate bylaws.

In addition *Elf* is inapplicable because LLCs and corporations differ greatly as business entities under Delaware law. The Delaware LLC Act, 6 Del C. § 18-101 *et seq.* (2010), provides LLC members with broad discretion in drafting an LLC Operating Agreement and assures enforcement of the agreement according to its terms. *Elf Atochem*, 727 A. 2d at 291. An LLC member's rights begin and typically end with the Operating Agreement. *Walker v. Res. Dev. Co.*, 791 A.2d 799, 812-3 (Del. 2000). Delaware corporations, on the other hand, are subject to far more government regulation than an LLC. Edward Welch & Robert S. Saunders, *Freedom and its limits in the Delaware general corporation law*, 33 Del. J. Corp. L. 845, 855 (2008). Corporations do, however, have some leeway with contract rights when those rights are enacted or amended in the COI. *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 117 (Del. 1952). Bylaws, on the other hand, cannot be used to limit shareholder rights because bylaws can be unilaterally enacted, whereas amending the COI requires a vote by both the board and shareholders. 8 Del C. § 242(b) (2010). Thus, holding of *Elf* does not support allowing exclusive forum provisions in corporate bylaws.

Miller possessed no bargaining power in this case. Therefore,

the contractual analyses of the forum selection provisions in *Carnival* and *Elf* do not apply to exclusive forum bylaws in a corporate setting. Therefore, this Court should reverse the lower court's ruling.

**3. The Bylaw Should Not Be Upheld Because Enforcement Would Be Unreasonable And Violate The Public Policy Of Texas.**

Even if this Court finds that exclusive forum bylaws are generally valid, the EFB should not be enforced for important policy considerations. A court should not enforce a provision when the party objecting to its enforcement can demonstrate the following. First, that the enforcement of the provision would be "unreasonable and unjust." *Ingres Corp. v. CA, Inc.*, 8 A.3d 1143, 1146 (Del. 2010). Second, that the enforcement of the provision would violate the strong public policy of the forum. *Baker v. Impact Holding, Inc.*, 2010 WL 1931032 at 3 (Del. Ch. 2010); see also *Hadley v. Shaffer*, 2003 WL 21960406 at 4 (D. Del. 2003) (citing *Coastal Steel Corp. v. Tilghman Wheelabrator, LTD.*, 709 F.2d 190, 202 (3d Cir. 1983), overruled on other grounds by *Lauro Lines v. Chasser*, 490 U.S. 495 (1989)).

The EFB is unreasonable because it effectively deprives shareholders of their day in court. A forum selection clause is unreasonable when the clause would put one of the parties at an unreasonable disadvantage so as to seriously impair their ability to pursue a cause of action. *Elia Corp. v. Paul N. Howard Co.*, 391 A.2d 214, 216 (Del. 1978). Here, the Bylaw impairs Miller's ability to pursue his derivative action. This deprivation stems from Miller possibly having to forgo litigation because Delaware will likely be a burdensome forum for him. Miller resides and works in Texas and, thus, may have difficulty finding Delaware counsel to represent him.

Furthermore, he may find frequent travel to Delaware costly, and he also may struggle to transport all the requisite evidence to Delaware. All the witnesses and discovery needed in this suit will most likely be in Texas, thus, litigation in Delaware will seriously impair Miller's ability to pursue his cause of action. The forum selection bylaw is unreasonable on this basis and should not be enforced.

Finally, the EFB should not be enforced because enforcement would violate the public policy of the Miller's chosen forum. *Baker*, 2010 WL 1931032 at 3. A forum selection bylaw violates Texas public policy because it prevents the state from regulating a corporation located within its own borders. Both Pinpoint and Miller reside in and are citizens of Texas. 28 U.S.C. § 1332(c)(1)(2010)(a corporation shall be deemed to be a citizen . . . of the State where it has its principal place of business."). Texas has an interest in establishing and developing corporate case law in order to be better equipped to handle corporate matters in its jurisdiction.

Texas also has an interest protecting Miller because he is a tax-paying citizen. In both respects, Texas has a heightened interest in litigating this matter because the Pinpoint's negligence occurred in Texas, and both parties reside in Texas. While incorporated in Delaware, Pinpoint is headquartered has the majority of its employees in Texas. Therefore, the State has a vested interest in ensuring that shareholders of a Texas company may redress their grievances in Texas. The EFB violates the public policy of Texas because it deprives its citizens of their day in court and should therefore be rescinded.

The EFB violates the DGCL and fails as a matter of law because by

limiting shareholder rights it is effectively substantive in nature. Additionally, the lower court erred when it upheld the EFB under general contractual principles and common law because it was unilaterally imposed and cannot reasonably be construed as a contract for which the shareholders bargained. Lastly, the EFB unreasonably deprives Texas citizens the right to seek redress against a corporate citizen of their own state, violating the public policy of a coequal sovereign state. For these reasons this Court should rescind the EFB.

**II. THIS COURT SHOULD REVERSE THE COURT OF CHANCERY, GRANT APPELLANT'S MOTION TO STAY, AND DENY APPELLEE'S MOTION TO ENJOIN BECAUSE THE PINPOINT BOARD ACTED OUT OF SELF-INTEREST WHEN IT ADOPTED THE BYLAW TO PROTECT ITSELF FROM DERIVATIVE SUITS, THEREBY BREACHING ITS FIDUCIARY DUTIES.**

**A. Question Presented**

Whether the lower court erred when it applied the business judgment rule to evaluate the Director Defendant's decision to adopt the EFB and instead should have evaluated the EFB under the heightened standards of entire fairness or *Unocal* because the facts strongly suggest that self-interested Directors could have adopted the EFB.

**B. Scope of Review**

This Court reviews the Court of Chancery's decisions involving questions of law *de novo*. *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 438 (Del. 2005). This Court must determine whether the trial judge erred in its application of the law. *Id.* This Court should draw all reasonable inferences in the appellant's favor. *White v. Panic*, 783 A.2d 543, 549 (Del. 2001).

**C. Merits of Argument**

This case is about whether this Court should invalidate a Bylaw

that was adopted to protect Directors from a breach of one of their fiduciary duties. They should. Therefore, this Court must find that the lower court erred by applying the business judgment rule for the following reasons. First, the Director Defendant's action is subject to review under entire fairness because the Director Defendants acted in a self-interested manner in breach of their fiduciary duties. In the alternative, *Unocal* is the appropriate standard of review because the Board's actions were not reasonable and proportional to the Board's purpose in adopting the EFB. Finally, even under business judgment review, the Director Defendants failed to show any purposeful reason for enacting the EFB.

**1. The Court of Chancery Should Have Applied Entire Fairness Review Because The Board Breached Its Fiduciary Duty and Lost The Business Judgment Presumption.**

The Board's adoption of the Exclusive Forum Bylaw should be reviewed under entire fairness because the Director Defendants adopted the Bylaw after having acted with gross negligence in failing to exercise proper oversight in the execution of the company's contracts with the U.S. Military. Entire fairness review applies, instead of the business judgment rule, if the directors have breached any of their fiduciary duties of good faith, loyalty, or due care. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993); *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993). If a plaintiff successfully raises a reasonable doubt as to whether the directors have breached a fiduciary duty, entire fairness applies. *Orman v. Cullman*, 794 A.2d 5, 22(Del. Ch. 2002). Under entire fairness, the burden then shifts to the directors to demonstrate that they made an

independent, informed decision, in good faith. *Solomon v. Armstrong*, 747 A.2d 1098, 1111 (Del. Ch. 1999) *aff'd*, 746 A.2d 277 (Del. 2000).

Here, a breach of the duty of loyalty renders the business judgment rule inapplicable for review of the bylaw enactment. The loyalty breach arises out of a duty of care breach because the evidence reasonably shows that the Director Defendants adopted the EFB in order to mitigate their personal liability for a breach of care sounding in gross negligence due to the directors' failure to exercise oversight of the internal workings of Pinpoint. Also, because Director Defendants' failure of oversight led directly to the company losing a half billion dollars in the settlement, the directors' duty of care violation also sounds in corporate waste. The Director Defendants put their interests in front of the company, thereby breaching their duty of loyalty and triggering entire fairness.

**a. The Director Defendants breached the duty of care by a failure to exercise oversight that in turn led to waste.**

The Director Defendants breached the duty of care because the board either knew or should have known that three of Pinpoint's mid-level managers had engaged in long-term fraud with respect to Pinpoint's government contracts. A breach of the duty of care occurs upon a showing of the board's failure to inform itself on issues over which it might have to exercise business judgment; a showing of corporate waste also constitutes a breach. *In re Walt Disney*, 906 A.2d 27, 74 (Del. 2006).

The board has a duty to stay reasonably informed about the workings of the corporation and to maintain systems for regularly acquiring such information. *In re Caremark Intern. Inc.*, 698 A.2d

959, 971 (Del. Ch. 1996). A sustained failure to monitor potentially "liability creating activity" constitutes a negligent failure of oversight. *Id.* at 971; accord *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006). In *Caremark*, a healthcare company became the object of a multi-year government investigation because of revelations of widespread fraud resulting in a \$250,000,000.00 fine. 698 A.2d at 971. Plaintiffs alleged negligent failure of oversight and waste but the Court held in favor of the board ruling that sufficient systems of oversight existed. *Id.*

Here, the Director Defendants breached their duty to inform themselves through a failure of oversight because the Directors did not ensure that the mid-level managers were complying with proper safety testing. This failure led to an investigation by the OIG. Additionally, the Special Committee confirmed that Pinpoint had engaged in a pattern of improper cost-cutting steps. The Director Defendants had an obligation to maintain oversight, but unlike in *Caremark*, Pinpoint failed to do so. Therefore, the Director Defendants breached their duty of care.

Additionally, due to the breach, the board committed massive corporate waste due to the enormous cost of the settlement and the resulting loss in share value. Directors commit corporate waste "when they authorize an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993); *White*, 783 A.2d at 554. In *White*, plaintiff claimed waste alleging that the corporation agreed to a one-

sided settlement for which it received inadequate consideration. *Id.* In particular, the corporation gave a loan to an officer against whom a personal judgment had been rendered. In turn the officer gave the company stock options that the plaintiff agreed were valuable. *Id.* Plaintiff claimed the stock options failed as consideration, but the court did not agree and ruled that the options sufficed. *Id.* at 555.

Here, the settlement did constitute waste because Pinpoint did not receive sufficiently valuable consideration for the \$500,000,000.00 settlement. While Pinpoint avoided litigation, the settlement amount greatly outweighs any benefit because the maximum penalty that Pinpoint could have incurred under the Act was \$10,000.00 plus three times the government's damages from the violation. 31 U.S.C. § 3729 (2010). However, the government would not have been able to prove damages because every Pinpoint product provided to the Military to date has performed satisfactorily. Since the government would not have been able to recover any damages, Pinpoint received no consideration for the settlement. Therefore, the \$500,000,000.00 settlement constitutes waste. Thus, the waste and the failure of oversight constituted a breach of the duty of care.

**b. The Director Defendants breached the duty of loyalty because they insulated themselves from liability.**

The Board's unilateral adoption of the Bylaw was a self-interested action of self-preservation and, therefore, is a violation of the duty of loyalty. Directors breach their duty of loyalty when they place their interests before those of the company. *Orman*, 794 A.2d at 23. A director is interested when he expects to benefit or actually does benefit from a board's action. *Id.* Furthermore,

compliance with the letter of the law will not necessarily insulate a board from liability for breach of loyalty. *Twin Bridges Ltd. Partnership v. Draper*, 2007 WL 2744609 at 21 (Del. Ch. 2007). Directors must scrupulously avoid any conflict between their duty and their self-interest. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987). Ultimately, when a board's fiduciary duties potentially conflict with the directors' own self-interests, the board will lose the protective presumption of the business judgment rule. *Solomon*, 747 A.2d at 1111; *Emerald Partners v. Berlin*, 787 A.2d 85, 93 (Del. 2001).

In *Solomon*, Shareholders brought derivative claims alleging, *inter alia*, that Director Defendants stood on both sides of a decision to split off a subsidiary of GM because individually they possessed shares of the split-off company and stood to benefit financially from the deal. 747 A.2d at 1118. The Court held in favor of the Board because of its routine participation in decisions involving competing shareholder interests and because the number of shares ultimately involved could not qualify as material to the directors. *Id.*

While the facts here differ, the Director Defendants did have a material interest in the EFB because the EFB limits their liability for fiduciary claims for which they would otherwise be personally liable. Considering the fact that the Director Defendants could be found liable for the losses resulting from their duty of care violation discussed above, \$500,000,000.00 is material.

The Director Defendants enacted the EFB to insulate themselves from liability because Delaware law favors management and directors.

Kent Greenfield, *Law, Politics, and the Erosion of Legitimacy*, 55 N.Y.L. Sch. L. Rev. 481 (2011). For example, if they were found liable in the Texas District Court, damages there may have greatly exceeded what they would otherwise have been in Delaware. There is an appearance of self-interest in the adoption of the EFB and, therefore, the business judgment rule is rebutted. Thus, the Director Defendant's action should be examined under entire fairness.

Finally, under entire fairness the Director Defendants actions fail because they will not be able to demonstrate that the adoption of the EFB was entirely fair to the company or to the shareholders. The adoption of the EFB was not fair because the EFB was adopted unilaterally by the Director Defendants without shareholder approval.

**2. The *Unocal* standard of review should be applied because the Board adopted the Bylaw as an improper defensive measure.**

This Court should review the Directors decision to adopt the Bylaw under the *Unocal* standard of review because the Board adopted the Bylaw as a defensive measure in anticipation of a tide of shareholder derivative and fiduciary claims against which the board self-interestedly sought to insulate itself. The *Unocal* decision yielded a standard of review for judicial scrutiny of defensive measures taken by boards in response to prospective takeovers and merger actions. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). The *Unocal* standard was later expanded to include defensive actions taken in response to perceived threats to corporate policy. *Unitrin Inc., v. American General Corp.*, 651 A.2d 1361 (Del. 1995). This court has recognized the flexibility of the *Unocal* standard in a range of contexts. *Paramount Communications, Inc., v.*

*Time, Inc.*, 571 A.2d 1140, 1153 (Del. 1989). Therefore, this Court may properly extend the *Unocal* standard here because the Board's actions constituted a defensive measure taken to insulate themselves.

Under *Unocal*, the plaintiff has the burden to establish that there was a "specter" of self-interest when the board adopted the defensive measure. *Unocal*, 493 A.2d at 954. Once self-interest has been established, the burden shifts to the board to show that the board acted reasonably and proportionally to defend a legitimate corporate interest against a perceived threat to corporate policy. *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 495 (Del.Ch. 1995). Here, the specter of self-interest arises in the apparent self-protective nature of the adoption of the Bylaw.

**a. The adoption of the Bylaw was a self-interested defensive measure.**

The specter of self-interest appears because the Directors adopted the EFB to protect themselves from fiduciary duty and derivative claims that would result from the settlement with the U.S. government. In *Kidsco*, shareholder sought to stop enforcement of a Bylaw, claiming that the Board unilaterally and defensively enacted it in order to delay a Shareholder meeting to vote on a merger and the elect a new Board. 674 A.2d at 488. The Court applied *Unocal* because of the reasonable possibility that the board's self-interest in preserving its position motivated its decision. *Id.* at 491.

Here, there is sufficient evidence to establish the existence of a specter of self-interest. As discussed above, the board's conduct reasonably infers an awareness of their fiduciary violations in managing the company. If the board knew that it was vulnerable to

derivative claims, the enactment of the Bylaw - which, as a practical matter, benefits the board personally - can reasonably be seen as self-interested. Therefore, the adoption of the bylaw was a defensive measure because the bylaw in effect protects the board from liability. Therefore, the Director Defendants actions constitute a self-interested defensive measure pursuant to triggering *Unocal*.

**b. The possibility of shareholder suits outside of Delaware does not constitute a threat to corporate policy.**

A derivative suit in other forums is not a valid threat to corporate policy under *Unocal*. *Unocal* requires that the Board show that it had reasonable grounds to believe that a threat to corporate policy existed. *Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586, 601 (Del. 2010). Examples of valid threats to corporate policy include impending merger offers and proxy contests. *Kidsco*, 674 A.2d at 496. Additionally, appropriation of Net Operating Losses qualified as a threat to corporate policy. *Versata Enterprises, Inc.*, 5 A.3d at 601. Derivative suits, on the other hand, protect the interests of the company. *Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90 (1991). Therefore, derivative suits are not a threat to corporate policy.

**c. The Boards response was coercive.**

Even assuming that there was a valid threat to corporate policy, the Director Defendants' actions still fails under *Unocal* because the board's response was coercive and draconian. A defensive measure is disproportionate and unreasonable *per se* if it is draconian, meaning that it coerces and/or precludes Shareholder rights. *Versata Enterprises, Inc.*, 5 A.3d at 601.

In *Kidsco*, a bylaw was proportional to the threat because the

delay was only 25 days and at that point everyone who would have voted without the delay would still be able to vote. 674 A.2d at 496. The defensive measure was ruled not draconian because the preclusion of the vote was temporary, and no other rights were compromised. *Id.* Here, the preclusive effect of the EFB on the shareholders rights is permanent, as is the coercive effect of the forum limitation. The EFB is preclusive and coercive and, therefore, disproportionate.

Therefore, this Court should reverse Chancery and apply *Unocal* because the Board adopted the Bylaw as an improper defensive measure. Additionally, the effects of the Bylaw are permanent, thus making it coercive method of forum limitation.

**d. The enactment of the bylaw was unreasonable and improper.**

Under *Unocal*, if a defensive measure is neither coercive nor preclusive, this court should scrutinize the "range of reasonableness" of the board's action in response to a perceived threat. *Versata*, 5 A.3d at 601. The EFB is unreasonable because the Director Defendants could have adopted such a measure in an equitable manner by putting the EFB up to a shareholder vote, and amended the COI. Here, the shareholders did not have any knowledge of the adoption of this Bylaw, yet, they are the most affected by its implementation. Thus, the implementation of this Bylaw is unreasonable.

**3. The Bylaw Fails Under Business Judgment Review**

Even if this Court declines to apply a heightened standard of review, the lower court's application of the business judgment rule was flawed because no rational relationship exists between the EFB and its goals of "convenience, efficiency, and predictability." According

to a large amount of recent commentary and scholarship, Delaware Corporate Law lacks predictability and "coherence." Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 Del. J. Corp. L. 57, (2009); Kent Greenfield, *Law, Politics, and the Erosion of Legitimacy*, 55 N.Y.L. Sch. L. Rev. 481, (2011). Without predictability, there can be neither convenience nor efficiency because both are predicated on the ability to anticipate the outcome of potential litigation. The EFB fails under the rational purpose prong of business judgment analysis.

The Director Defendants passed the EFB in order to insulate itself from liability, thus, breaching the duty of loyalty. Under entire fairness, the EFB fails because it is an improper attempt to undermine derivative suits brought by shareholders. Under the *Unocal*, the EFB fails because of the essentially defensive and deeply self-interested nature of the board's adoption of the Bylaw. Finally, even if this Court applies business judgment review, the EFB again fails.

#### CONCLUSION

For the foregoing reasons, this Court should reverse the Court of Chancery's ruling

February 11, 2010

Respectfully submitted,

---

Team I

Attorneys for Appellants