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NATURE OF PROCEEDINGS

On December 1, 2010, Petitioner Edward Miller filed suit (the "Federal Action") in the U.S. District Court for the Southern District of Texas (the "District Court") against the directors (collectively, the "Director Defendants") of nominal defendant Pinpoint Bearings, Inc. ("Pinpoint"), alleging claims under federal securities law and derivative claims for breach of fiduciary duty under Delaware law. *In re Pinpoint Bearings, Inc. S'holders Litig.*, No. 4952-VCM, slip op. at 7, (Del. Ch. Jan. 12, 2011). The following day, three additional plaintiffs each filed derivative suits (the "Original Delaware Actions") in the Delaware Court of Chancery (the "Court of Chancery") for breach of fiduciary duty (similar to Petitioner's claims in the Federal Action), all of which were later consolidated under the caption *In re Pinpoint Bearings, Inc. Shareholders Litigation*. *Id.* at 7, 8. Pinpoint and the Director Defendants filed a motion on December 13, in the Federal Action to stay that action in favor of the consolidated Original Delaware Actions. *Id.* at 8. In support of their motion, the Director Defendants relied on the recently adopted exclusive forum provision (the "Bylaw") in Pinpoint's bylaws. *Id.*

On December 15, Petitioner filed suit in the Court of Chancery (the "Miller Delaware Action"), alleging the same derivative fiduciary duty claims originally asserted in the Federal Action. *Id.* At the same time, Petitioner filed a motion for a modified Order of Consolidation, which would consolidate the Miller Delaware Action with the already-consolidated Original Delaware Actions. *Id.* at 9. Petitioner also filed a motion to stay (the "Delaware Motion to Stay")

the consolidated Original Delaware Actions and the Miller Delaware Action in favor of the previously filed Federal Action. *Id.* The Director Defendants responded by moving for an injunction barring Petitioner from prosecuting any derivative or fiduciary claims in any forum other than the Court of Chancery. *Id.* The Court of Chancery granted the Order of Consolidation, denied the Delaware Motion to Stay, and granted the Director Defendant's motion for an injunction. *Id.* at 8.20-21. To date, the District Court has not ruled on the Director Defendants' motion to stay. *Id.* at 8.

Pursuant to Delaware Supreme Court Rule 42, the Court of Chancery certified Petitioner's application for interlocutory appeal on January 14, 2011. Order of Certification, *In re Pinpoint Bearings, Inc. S'holders Litig.*, No. 4952-VCM (Jan. 14, 2011). On January 18, this Court accepted Petitioner's interlocutory appeal. Order of Interlocutory Appeal, *In re Pinpoint Bearings, Inc. S'holders Litig., appeal docketed*, No. 17, 2011 (Jan. 18, 2011).

SUMMARY OF ARGUMENT

This Court should reverse both the Court of Chancery's denial of the Delaware Motion to Stay and the grant of the injunction on the Federal Action. First, the Bylaw is void as a matter of law. The Court of Chancery improperly validated the Bylaw by borrowing from limited liability company ("LLC") and contract law instead of applying corporate law. Furthermore, Delaware law requires such a provision be included in a corporation's *charter*, not its bylaws. Finally, even if otherwise valid, the Bylaw should not be applied to Petitioner because he had a vested right to file suit in the forum of his choosing because the Director Defendants' breach of a fiduciary duty arose before the Bylaw's enactment.

Second, the Bylaw should be rejected on equitable grounds. The Court of Chancery erred in applying the business judgment rule to the Bylaw's adoption. Instead, the Bylaw should receive strict scrutiny under the entire fairness test. Alternatively, if this Court finds the entire fairness test unsuitable, enhanced judicial scrutiny under the *Unocal/Unitrin* standard is appropriate. The Bylaw cannot withstand either the entire fairness or *Unocal/Unitrin* tests. As a result, this court should follow *McWane* and exercise its discretion to stay all Delaware proceedings in favor of the previously filed Federal Action because it involves the same parties, the same issues, and the District Court is capable of doing swift and total justice.

STATEMENT OF FACTS

At issue in this case is the validity of an exclusive forum provision added unilaterally to the bylaws of a corporation by its board of directors while the corporation was actively violating the False Claims Act (the "FCA"). *Pinpoint*, No. 4952-VCM at 1; 31 U.S.C. § 3729 (2009). *Pinpoint* is a Delaware corporation with its headquarters and approximately 8,000 employees in Houston, Texas. *Pinpoint*, No. 4952-VCM at 4. *Pinpoint's* 88 million outstanding shares are currently trading at approximately \$46 per share on the New York Stock Exchange, making its current market capitalization approximately \$4 billion. *Id.* *Pinpoint* has over 28,000 shareholders hailing from each of the fifty states. *Id.* *Pinpoint* manufactures roller ball bearings for aerospace applications, with the U.S. military as its primary customer. *Id.*

The Director Defendants unilaterally adopted the Bylaw on June 10, 2010, prior to the formal OIG investigation, but over a year after the FCA violations began. *Id.* at 2. The Director Defendants gave no prior notice of their intention to adopt the Bylaw to shareholders or the public. The Bylaw purports to require any derivative action or other claim of breach of fiduciary duty owed by any director be litigated in the Court of Chancery. *Id.* at 2-3.

In early September 2010, a whistleblower at *Pinpoint* contacted the Office of Inspector General of the U.S. (the "OIG") regarding a pattern of cost-cutting measures employed on several of *Pinpoint's* contracts with the U.S. military. *Id.* at 5. These government contracts required a variety of tests to be conducted on each

component. *Id.* The whistleblower, a longtime Pinpoint engineer, learned that three mid-level managers misrepresented to Pinpoint's government clients that all testing was performed, when in fact some of the testing was regularly omitted. *Id.* at 5,6.

The OIG formally launched an investigation and notified Pinpoint on September 8, 2010. *Id.* at 6. Pinpoint launched an internal investigation, which confirmed that improper cost-cutting measures were employed on a number of government contracts from early 2009 through October 2010. *Id.* On November 30, 2010, Pinpoint entered into a settlement with the OIG, resulting in an acknowledgment of five separate FCA violations, a payment of \$500 million in fines and penalties, and the termination of three mid-level managers who implemented the scheme. *Id.* Also on November 30, after the market closed for the day, Pinpoint issued a press release publicly announcing the OIG investigation for the first time and disclosing the terms of the settlement. *Id.* at 6, 7.

The next day, on December 1, 2010, Pinpoint's stock price fell \$5 per share from \$51 to \$46, where it has remained ever since. *Id.* at 7. This equaled a loss of some \$440 million in market capitalization as a result of the news of the OIG investigation and settlement. *Id.* Also on December 1, Petitioner Edward Miller filed the Federal Action against the Director Defendants, alleging claims under federal securities law and derivative claims for breach of fiduciary duty under Delaware law. *Id.* Petitioner, a resident of Houston, owns 5,000 shares of Pinpoint common stock, worth about \$230,000, and was a Pinpoint employee for 20 years before retiring in 2004. *Id.* at 3,4.

ARGUMENT

I. THE BYLAW IS VOID AS A MATTER OF LAW.

A. Question Presented

Whether the Court of Chancery erred by (1) applying LLC and contracts law to a corporate law issue; (2) validating an exclusive forum provision adopted as a bylaw instead of a charter amendment; and (3) denying Petitioner's vested right to bring suit in a forum of his choosing.

B. Standard of Review

The Court of Chancery's factual findings receive this Court's deference, while issues of law are subject to *de novo* review. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1995) (*Cede II*).

C. Merits of Argument

1. **The Court of Chancery improperly analogized corporate bylaws to LLC agreements in order to facilitate the injection of contract law principles into an issue of corporate law, because no corporate law exists that would support the Bylaw.**

The validity of the Bylaw is an issue of corporate law. Indeed, the Court of Chancery appropriately relied on corporate law when it found that the Director Defendants had the right to unilaterally amend the bylaws. *Pinpoint*, No. 4952-VCM at 12. However, when analyzing the validity of the Bylaw itself, the Court of Chancery improperly turned to and relied on LLC law and contracts law.

- a. **The Court of Chancery improperly analogized LLC agreements to corporate bylaws.**

The Court of Chancery first relied on this Court's decision in *Elf Atochem North Am., Inc. v. Jaffari* to justify its validation of the Bylaw. *Pinpoint*, No. 4952-VCM at 11 (citing *Elf Atochem North*

Am., Inc. v. Jaffari, 727 A.2d 286, 287 (Del. 1999)). In *Elf Atochem*, this Court enforced the exclusive forum provision contained in an LLC agreement, thereby forcing the dispute be resolved in California. *Elf Atochem*, 727 A.2d at 287. In doing so, this Court went to great lengths explaining the origins of the LLC as an entity, the Delaware LLC Act (the "LLC Act"), and how the roots of each lie in the law of limited partnerships ("LP"). *Id.* at 290-91. In particular, *Elf Atochem* explains that LLCs, like LPs, are allowed great flexibility with respect to their organizational structure and that the "basic approach of the [LLC Act] is to provide members with broad discretion in drafting" the LLC agreement. *Id.* This Court emphasized that the statutes explicitly state that it is the policy of both the LLC Act and the Delaware Limited Partnership Act "to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." *Id.* at 291 (quoting 6 Del. C. § 18-1101(b)); see also 6 Del. C. § 17-1101(c).

With this background and policy in mind, this Court explained that only when the LLC Act prohibits a clause in an LLC agreement will that clause be invalidated. *Elf Atochem*, 727 A.2d at 292. These "mandatory" LLC Act provisions are usually "intended to protect third parties, not necessarily the contracting [LLC] members." *Id.* This is in line with the LLC Act's freedom of contract policy, as members had an opportunity to contract for the terms of their LLC agreement. Thus, because there was nothing in the LLC Act prohibiting exclusive forum provisions, this Court upheld the exclusive forum provision in the LLC agreement. *Id.* at 287.

Following the logic of *Elf Atochem*, the Court of Chancery analogized an LLC agreement to corporate bylaws, noting that neither is filed with the Delaware Secretary of State, yet they both have "contractual force in defining the investors' governance expectations." *Pinpoint*, No. 4952-VCM at 11. The Court of Chancery erred here in two ways.

First, unlike the LLC Act, the Delaware General Corporation Law ("DGCL") contains no similar freedom of contract policy statement. Instead, as many scholars have noted, and Delaware courts seem to accept, "corporate law limits contractual freedom by imposing certain mandatory rules." Sara Lewis, Note, *Transforming the "Anywhere but Chancery" Problem into the "Nowhere but Chancery" Solution*, 14 STAN. J.L. BUS. & FIN. 199, 208 (2008).

Second, the mandatory provisions of the DGCL are not intended to primarily protect third parties. True, some DGCL provisions, such as § 281(b)(i), seek to protect third parties such as creditors. 8 Del. C. § 281(b)(i) (2010). However, several of the DGCL's provisions are intended to protect shareholders. For example, the LLC Act allows the LLC agreement to eliminate the fiduciary duty of loyalty owed between members. 6 Del. C. § 18-1101 (2010). However, the duty of loyalty owed by directors to shareholders may not be eliminated under the DGCL. 8 Del. C. § 102(b)(7) (2010). In addition, other rights of shareholders, such as the right to examine corporate books and records, may not be eliminated. 8 Del. C. § 220 (2010).

Thus, LLC agreements are not the same as bylaws. Unlike the LLC Act, the DGCL seeks to restrict contractual freedom by imposing more

mandatory rules. Then, through those mandatory rules, the DGCL aims to protect the corporation's shareholders in addition to third parties. Unlike the DGCL, an LLC's "shareholders" - its members - are not intended to be protected by the mandatory provisions of LLC Act.

b. The Court of Chancery improperly relied on contract law to validate the Bylaw.

After making the inappropriate analogy between LLCs and Corporations, the Court of Chancery tried to validate the Bylaw by following U.S. Supreme Court decisions in two contracts cases. The Court of Chancery first cites *The Bremen v. Zapata Off-Shore Co.*, in which the Supreme Court validated an exclusive forum provision in a commercial contract between two international corporations. *Pinpoint*, No. 4952-VCM at 11 at 13 (citing *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 12 (1972)). Despite noting the historical distaste for such clauses, the Court held that an exclusive forum provision, "made in an arm's-length negotiation by experienced and sophisticated businessmen" shall be enforced "absent some compelling and countervailing reason" to render it void, such as "fraud, undue influence, or overweening bargaining power." *The Bremen*, 407 U.S. at 10, 12.

However, the Court of Chancery recognized that unlike in *The Bremen*, the *Pinpoint* Bylaw would bind "some 28,000 *Pinpoint* shareholders scattered among each of the fifty States and who in aggregate own 88 million shares of *Pinpoint* stock," rather than two sophisticated business entities. *Pinpoint*, No. 4952-VCM at 13. The Court of Chancery turned to *Carnival Cruise Lines, Inc. v. Shute*, in which the Supreme Court enforced an exclusive forum provision

contained in the contracts printed on the back of a couple's Carnival Cruise Line tickets. *Id.* (citing *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991)). The Court in *Carnival Cruise* refined the analysis of *The Bremen*, rejecting the idea that an exclusive forum provision was unenforceable simply because it was not the subject of bargaining or because the plaintiffs were physically and financially incapable of pursuing the case in the exclusive forum. *Carnival Cruise*, 499 U.S. at 593-94. Thus, the Court of Chancery was "not troubled that the [Director Defendants] acted unilaterally in adopting the Bylaw." *Pinpoint*, No. 4952-VCM at 13.

The Court of Chancery errs here because the validity of the Bylaw should be governed by principles of corporate law, not blind analogies to contract law. Neither the Court of Chancery nor the Director Defendants have identified any precedent supporting an exclusive forum clause in a corporation's bylaws. Nor can they, as no state or federal court in the U.S. has ever enforced such a clause. In fact, the only time the validity of such a provision was tried, it was found invalid. *Galaviz v. Berg*, 2011 U.S. Dist. LEXIS 1626 (N.D. Cal. Jan. 3, 2011).

The Court of Chancery tried to legitimize its injection of contract law into this corporate law issue by noting that corporate bylaws are often referred to as "internal governance contract[s]." *Pinpoint*, No. 4952-VCM at 13. This completely misses the point. The cases that the Court of Chancery relied on do not apply, or validate the application of, contract law when resolving corporate law disputes. Instead, those cases use "internal governance contract," or

simply "contract," to explain that corporate charters and bylaws are similar to contracts between the stockholders and the corporation; the terms are merely descriptive. *CA, Inc. v. AFSCME*, 953 A.2d 227, 239 (Del. 2008); *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 492 (Del. Ch. 1995). Further, that same descriptive comparison is used to explain that courts use general rules of contract *interpretation* when examining the meaning of charters and bylaws. *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990).

Even if introducing contract law into this corporate matter was appropriate, the cases cited by the Court of Chancery do not support the adoption of the Bylaw. In both *The Bremen* and *Carnival Cruise*, the exclusive forum provisions in question were present in the original contracts. *The Bremen*, 407 U.S. at 2-3; *Carnival Cruise*, 499 U.S. at 587-88. Also in both cases, all parties to the contracts had knowledge of the provisions and consented to them. *The Bremen*, 407 U.S. at 3; *Carnival Cruise*, 499 U.S. at 590. Neither of these factors exists in the current case. The Bylaw was not in the original bylaws to which Petitioner could be said to have "consented" to upon purchase of his shares, nor was it later adopted with his knowledge or consent. Even more troubling is that the Court of Chancery validated the Bylaw, even though it was approved *after* the breach occurred, by the very same directors that are defendants in this case.

Thus, because of the improper application of LLC and contracts law, and the lack of other authority supporting the adoption of the Bylaw, this court should overrule the Court of Chancery and invalidate the Bylaw.

2. If otherwise valid, the Bylaw is void as a matter of law because it was improperly added to Pinpoint's bylaws rather than its charter.

Shareholders have the right to bring derivative actions on behalf of a corporation against its directors. *Alabama By-Products Corp. v. Cede & Co. ex rel. Shearson Lehman Bros.*, 657 A.2d 254, 265 (Del. Ch. 1995). The DGCL dictates that charters may contain provisions "defining, limiting, and regulating the power of...the shareholders..." and that bylaws may contain provisions "not inconsistent with law or with the *certificate of incorporation, relating to the...rights or powers of [the] shareholders...*" 8 Del. C. § 102(b)(1) (2010); 8 Del. C. § 109(b) (2010) (emphasis added)]. Exclusive forum provisions such as the Bylaw do not simply "relate to" the rights of shareholders. They clearly seek to limit and/or regulate a shareholder's right to bring derivative actions against directors in certain jurisdictions. Thus, if otherwise valid, exclusive forum provisions must be permitted only in corporate charters, not bylaws.

The court in *In re Revlon, Inc. S'holder Litig.* recognized this requirement. 990 A.2d 940, 960 (Del. 2010). In *Revlon*, the court discussed the problem of frequently filing, aggressive plaintiffs' attorneys in derivative actions. *Id.* at 959-60. The court noted several mechanisms by which courts address this problem, and suggested another alternative: judicial oversight of these "frequent filers." *Id.* at 960. *Revlon* suggested that if attorneys try to avoid judicial oversight by filing in various jurisdictions, "boards of directors and stockholders" could "respond with *charter* provisions selecting an exclusive forum for intra-entity disputes" if they believe that a

“particular forum would provide an efficient and value-promoting locus for dispute resolution.” *Id.* (emphasis added).

The Bylaw is out of line with the suggested use of such a provision in *Revlon*. First, *Revlon* only contemplates a situation in which both the board of directors and stockholders consent to the adoption of an exclusive forum provision. *Id.* Obviously, the shareholders were excluded from having any role in the Bylaw’s adoption. *Pinpoint*, No. 4952-VCM at 2. The Director Defendants have no explanation as to why shareholders were completely left out of this process. Thus, the process by which the Bylaw was adopted conflicts with *Revlon*.

Second, the form in which the Bylaw was adopted conflicts with *Revlon*, which only contemplates the adoption of exclusive forum provisions in corporate charters, not bylaws. *Revlon*, 990 A.2d at 960. This appears to recognize the fact that the Bylaw would “limit or restrict” shareholders’ rights, as discussed above. It is also in line with *Revlon*’s process requirement that shareholders be involved in the adoption of such provisions, as the DGCL requires amendments to corporate charters be passed by vote of the shareholders. 8 Del. C. § 242 (2010).

The Court of Chancery never gave these charter versus bylaw considerations any thought. However, this Court should follow *Revlon* and require that exclusive forum provisions be added to the charter rather than bylaws because they limit or restrict shareholders’ rights, and therefore shareholders should have the opportunity to consent to such provisions.

3. Petitioner had a vested right to bring his claim in any proper jurisdiction because the breach occurred prior to the Bylaw's adoption.

Even if this Court deems the Bylaw to be valid in the abstract, it should be declared invalid as applied to the Petitioner because the Petitioner had a vested right to bring this suit in any appropriate forum of his choosing. The breach of fiduciary duty the Petitioner alleges stems from conduct that began in early 2009, well over a year before the Bylaw's adoption on June 10, 2010. *Pinpoint*, No. 4952-VCM at 2,5. Because the breach occurred prior to the Bylaw's adoption, Petitioner's right to bring suit in any appropriate forum under the original bylaws vested when the breach occurred. It would fly in the face of fundamental fairness to allow the Director Defendants to unilaterally and without notice adopt the Bylaw after their breach was ongoing for over a year, thereby restricting the forum in which the Petitioner may bring suit against them for that breach.

The Director Defendants will undoubtedly argue that this Court has already "held that where a corporation's by-laws put all on notice that the by-laws may be amended at any time, no vested rights can arise that would contractually prohibit an amendment." *Kidsco*, 674 A.2d at 492 (citing *Roven v. Cotter*, 547 A.2d 603, 608 (Del. Ch. 1988)). However, "a vested right to proceed under the original by-laws might arise in some circumstances." *Kidsco*, 674 A.2d at 493.

If ever there were circumstances under which a vested right to proceed under the original bylaws existed, this is it. First, to say that the corporation's shareholders were "put on notice" would place an incredible burden on shareholders. This is not a case in which the

directors, acting within their powers to amend the bylaws, made a routine change to the bylaws, such as changing the director voting structure to require staggered board elections. Because those changes are common among corporations, shareholders could legitimately be on notice that such a change could occur. Instead, this case involves the adoption of an exclusive forum provision in a corporation's bylaws, a novel idea which had almost never before been considered in the corporate context. So even the most cautious and intelligent investor, with total and complete information, would not have had "notice," actual or implied, of the potential for the addition of the Bylaw upon purchase. *Id.* at 492. To hold otherwise would essentially require shareholders have a psychic ability to foresee potentially new corporate governance mechanisms that currently exist only in theory, if at all.

Second, even if the stockholders were effectively put on notice of the possibility that the Bylaw could be adopted, the adoption occurred long after the breach from which the Petitioner's cause of action stems. While the Director Defendants will likely claim they did not know about the FCA violations until after they adopted the Bylaw, the facts are silent as to whether or not that is true. As a shareholder, Petitioner did not find out about the violations or settlement until months after the Director Defendants knew. *Pinpoint*, No. 4952-VCM at 7. So it is unfair to allow the *Director Defendants* to limit where the Petitioner can bring his case, when he had no knowledge of the ongoing FCA violations at the time of the Bylaw's adoption, and thus no opportunity to file before its adoption.

II. IF THE BYLAW IS VALID AS A MATTER OF DELAWARE CORPORATION LAW, ITS ADOPTION SHOULD BE REVIEWED UNDER THE ENTIRE FAIRNESS TEST OR UNOCAL/UNITRIN STANDARD, NOT THE BUSINESS JUDGMENT RULE.

A. Question Presented

Whether the Bylaw's adoption should be reviewed under a test of heightened judicial scrutiny, as required when there is a breach of fiduciary duty by directors, or under the business judgment rule.

B. Standard of Review

As stated in part I, the Court of Chancery's factual findings receive this Court's deference, while issues of law are subject to *de novo* review. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1995) (*Cede II*).

C. Merits of Argument

1. The Court of Chancery inappropriately applied the business judgment rule standard of judicial review.

The business judgment rule is improper because it protects directors from personal liability for breaches of the duty of care, which is not at issue in this case. *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985). Petitioner alleges that the Director Defendants breached their duty of oversight, liability for which falls under the breach of directors' duty of good faith, a subset of the duty of loyalty. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 1996). Oversight liability does not require directors to know the details of all the corporation's inner workings. *Id.* at 368. Instead, liability is triggered when there is a complete failure to put "a reasonable information reporting system" in place, or a knowing failure to monitor this system, "thus disabling [directors] from being informed of the risks or problems requiring their attention." *Id.* at 368-70.

Either failure must demonstrate "that the directors knew they were not discharging their fiduciary obligations." *Id.* at 370. The failure must be either "sustained or systematic" to establish the requisite lack of good faith. *Id.* At 369 (quoting *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996)).

The Director Defendants breached their fiduciary duty of good faith by failing to oversee product testing compliance, and that failure was sustained for over a year and a half. *Pinpoint*, No. 4952-VCM at 6. No facts suggest that the Director Defendants implemented a reasonable information reporting system to ensure that government testing requirements were met at all times. The Director Defendants' actions fall under an example of bad faith perfectly: "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Stone*, 911 A.2d at 369. Despite knowing how crucial this compliance was, the Director Defendants did nothing to ensure it took place. The Director Defendants' failure to oversee the testing compliance meets the sustained requirement as it went on for over a year and a half undetected, and continued into October 2010, after the initiation of the OIG Investigation. *Pinpoint*, No. 4952-VCM at 6. Thus, this evidence of a breach of fiduciary duty rebuts the presumption that the business judgment rule should apply.

Furthermore, none of the business judgment rule's three main purposes - (1) encouraging risk-taking, (2) avoiding judicial meddling, or (3) encouraging directors to serve - are applicable here. Denise Ping Lee, *The Business Judgment Rule: Should It Protect*

Nonprofit Directors?, 103 COLUM. L. REV. 925, 945 (2003). First, the business judgment rule serves to encourage directors to take risks by investing shareholders' money in product innovation and design, not risking it on legal penalties by violating government testing requirements. Second, the business judgment rule seeks to prevent judges from substituting their judgment for that of the directors regarding business decisions; surely, that should not be extended to protect non-business decisions that facilitate illegal activity. Third, the business judgment rule aims to encourage directors, particularly outside directors, to serve on corporate boards without the fear of personal liability for what amount to bad business decisions later. There is no concern of discouragement in this case; as long as directors carry out their fiduciary duties adequately and do not violate federal laws, they will not be faced with the issue before us.

2. Strict scrutiny under the entire fairness test should be applied.

Once the presumption of the business judgment rule is rebutted, as it is here, this Court should apply strict scrutiny under the entire fairness test. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1371 (quoting *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988)). The entire fairness test has two parts: (1) fair dealing, and (2) fair price. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). Although there are two aspects to this test, entire fairness "must be examined as a whole." *Id.*

The first part of the entire fairness test - fair dealing - involves several factors relating to the transaction: its timing,

initiation, negotiation, disclosure to directors, and obtainment of shareholders' and directors' approval. *Id.* Shareholders expect boards of directors to act fairly when making contracts that bind both parties to a specific code of conduct. As previously noted, if a company wants to adopt an exclusive forum provision, it should be adopted in the charter in the interest of fairness, if not as a matter of law. No stockholder would have been on notice of the potential change via the Bylaw because its adoption defies tradition and shareholders' expectations.

The fair dealing factors do not save this Bylaw on equitable grounds. First, the timing of the Bylaw enactment is suspect; it occurred during the ongoing testing noncompliance, a contemporaneous measure to retroactively protect against liability for the failure of oversight. Second, the Director Defendants initiated the Bylaw's enactment - the very people it seeks to protect. Third, the record does not reflect whether all directors received disclosure of the Bylaw before its adoption. Fourth, the Bylaw was only approved by the Director Defendants - how many of which, we do not know - while it was never given to shareholders for approval. Shareholders were not included at any point of the Bylaw enactment process and received no notice that this process was even taking place, yet are expected to be bound by it. This is a prime example of unfair dealing.

The second prong of the entire fairness test, fair price, is an economic inquiry based on the corporation's "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Id.* As the record

is silent on most of Pinpoint's financial records, market value is the primary focus of our fair price inquiry. Because no investor could have foreseen the Bylaw's adoption, shareholders undoubtedly paid more for their Pinpoint shares than they would have if they could have foreseen it. The Bylaw restrains shareholder rights, causing the market value of the shares to decrease. In addition to decrease in value, the Bylaw makes the shares less desirable and more difficult to sell should a shareholder want to do so. The Bylaw protects the Director Defendants from legal sanctions while the lower share value makes it unlikely that shareholders will exercise market sanctions, such as disposing of shares or waging a proxy battle, to check their behavior. Thus, because the Bylaw was not included in the value of the shares prior to its adoption, the price is not fair to shareholders.

3. **Alternatively, enhanced judicial scrutiny under the *Unocal/Unitrin* standard is still more appropriate than the permissive business judgment rule.**

The protection and deference provided by the business judgment rule cannot be extended to the Defendant Directors due to their defensive, unilateral enactment of the Bylaw. "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). Thus, the measure must be both (1) reasonable, and (2) in proper proportion to the threat posed. Reasonableness requires "a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed." *Unitrin*, 651 A.2d at

1373 (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)). The defensive action was not proportional if it was coercive or preclusive. *Unitrin*, 651 A.2d at 1390. Failure on either of the two prongs removes the review from the realm of the business judgment rule and triggers the *Unocal/Unitrin* standard.

The possibility of shareholder derivative suits is not a new or looming threat. It is a natural consequence of directorial misconduct, thus the logical and appropriate way to curb it is for directors to actively and directly engage in carrying out their fiduciary duties. Using a bylaw provision to make it even more difficult for shareholders to succeed in holding the directors accountable for their misconduct oversteps the bounds of reasonableness, especially when the only danger Pinpoint faced was due to the Defendant Directors' lack of oversight.

Upholding the Bylaw would remove much of the adversarial quality of shareholder derivative actions by giving a significant advantage to directors who have breached their fiduciary duties. The Bylaw allows the Director Defendants to act in contravention of two general principles: first, that "litigation should be confined to the forum in which it was first commenced," and second, that "a defendant should not be permitted to defeat the plaintiff's choice of forum in a pending suit..." *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Engineering Co.*, 263 A.2d 281, 283 (Del. 1970).

The Bylaw is an unnecessarily strong tactic used to reduce the threat of shareholder-initiated litigation against the Director Defendants. Shareholders already face collective action problems when

deciding whether or not to bring derivative suits. The Bylaw exacerbates this problem by further disincentivizing shareholders from filing suit since the only forum available is likely to be very inconvenient for Pinpoint's shareholders who live outside of Delaware. Pinpoint's shareholders live across the country, in all fifty states, all of which have courts of competent jurisdiction. *Pinpoint*, No. 4952-VCM at 4. Although incorporated in Delaware, Texas is Pinpoint's principal place of business and location where the harms, lack of oversight and continued failure to comply with government testing requirements, took place. *Id.* at 4,5. Allowing the location where the harm actually occurred and where all the parties are located to be the appropriate forum for the suit is more predictable and efficient than allowing directors to make one-sided bylaws to select a distant, detached forum.

The Bylaw is just another one of the Director Defendants' ploys to discourage shareholders by raising the hurdles to litigation higher still, thereby ensuring that their directorial misconduct will go practically unchecked and their tenure unchallenged. This is precisely the indefinite entrenchment problem that Delaware courts warned about. *Kidsco*, 674 A.2d at 493. There is no evidence that shareholder derivative litigation in jurisdictions outside of Delaware is in fact inconvenient, inefficient, or unpredictable. Thus, the Bylaw is an unwarranted and disproportionate action by the Director Defendants.

4. Under the *McWane* analysis, judicial discretion should be exercised freely in favor of the stay on the Delaware Action.

The Bylaw cannot withstand strict scrutiny under the entire fairness test or enhanced judicial scrutiny under the *Unocal/Unitrin* standard. Therefore, it is invalid and inoperative, and a conventional *McWane* analysis applies. *McWane*, 263 A.2d 281. *McWane* involved a breach of contract claim between two companies that each filed suit, the first in Alabama federal court, the second in Delaware state court. *Id.* at 282. This Court had to decide whether to stay the Delaware action in favor of the prior-filed Alabama action between the same parties over the same issues. *Id.* After a review of the facts and circumstances, the Court granted the stay of the Delaware action. *Id.* at 284. This Court held in *McWane* that it will exercise its discretion and stay a Delaware proceeding in favor of an already pending action involving the same issues and the same parties if it is being tried in a court capable of doing "prompt and complete justice." *Id.* at 283.

The case at hand meets all three requirements of *McWane*. First, the pending Federal Action predates the current action by twelve days. *Pinpoint*, No. 4952-VCM at 7-8. Second, it is obvious that the District Court is capable of doing prompt and complete justice. Third, the same parties and same issues are involved. Petitioner and the Director Defendants are parties in both the Federal and Consolidated Delaware Actions and both actions involve litigation over the Director Defendants' breach of the fiduciary duty of oversight. *Pinpoint*, No. 4952-VCM at 7-8.

Additionally, a review of the facts and circumstances warrants the reversal of the injunction against Petitioner pursuing the Federal Action. The following facts and circumstances were examined in *McWane* to determine whether a stay on a prior action would be granted: where the parties executed the contract; where the disputed action took place; which state's law governed; how much contact there was with the state of incorporation; and whether the same discovery, pretrial, and trial advantages were available in both forums. *McWane*, 263 A.2d at 283. Here, the parties did not mutually agree to execute a contract; instead the Director Defendants unilaterally created the Bylaw. The failure to oversee testing compliance happened in Texas. Although Delaware law governs the action, this is only because Delaware is Pinpoint's state of incorporation with no further contact beyond that. Access to discovery material is considerably more convenient in Texas since that is where the liability arose.

The Director Defendants' motion to enjoin Petitioner from pursuing his derivative claims in the District court does not resolve the Director Defendants' convenience, efficiency, or predictability concerns. Pinpoint is already familiar with competent legal counsel in Houston. *Pinpoint*, No. 4952-VCM at 6. Even if the injunction is upheld, Pinpoint will still be involved in two legal disputes. Litigating in two unrelated forums will lead to increased costs which will inevitably be passed on to shareholders whom have already suffered at the hands of the Director Defendants' breach. The competence and impartiality of the District Court judge are not at issue, so there is no cause for concern that he or she will not

accurately apply Delaware law. It is unnecessary to bifurcate the fiduciary claim from the federal claim, thus the injunction preventing Petitioner from pursuing both claims in the Federal Action should be reversed.

CONCLUSION

For the reasons stated above, this Court should reverse both the Court of Chancery's denial of the Delaware Motion to Stay and the grant of the partial stay on the Federal Action.

Respectfully Submitted,

/s/

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