

IN THE SUPREME COURT OF THE
STATE OF DELAWARE

EDWARD MILLER,)	
)	
Plaintiff Below,)	
Appellant,)	
)	
v.)	
)	
MICHAEL SANCHEZ, CLARE MITCHELL,)	No. 17, 2011
BRENDAN ELLSWORTH, TIMOTHY)	
FLETCHER, MARSHA FRANKLIN,)	
DAPHNE KEYES AND ERIC LAM,)	Court Below:
)	Court of Chancery of the
Defendants Below,)	State of Delaware in and
Appellees,)	for New Castle County
)	
and)	Chancellor McCloskey
)	
PINPOINT BEARINGS, INC.,)	C.A. No. 4958-VCM
)	
Nominal Defendant Below,)	
Appellee.)	

APPELLANT'S OPENING BRIEF

Filed by Team R
Counsel for Appellant

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NATURE OF PROCEEDINGS

This is an appeal from a decision in the Court of Chancery by Chancellor Jamie McCloskey finding a forum exclusivity bylaw, see *Appendix*, enacted by the directors of Pinpoint Bearings, Inc. ("Pinpoint" or "Appellee") legally valid and binding on shareholder plaintiffs, and thus denying shareholder plaintiff Edward Miller's ("Miller" or "Appellant") motion to stay derivative proceedings in this forum.

Miller, petitioner below, commenced a derivative action ("Federal Action") stating federal and state law claims on December 1, 2010 in the United States District Court for the Southern District of Texas. On December 2, 2010, three different plaintiffs ("Delaware Plaintiffs") each filed in the Court of Chancery virtually the same fiduciary oversight claims that Miller had filed a day earlier. These three plaintiffs consolidated their claims on December 8, 2010. On December 13, 2010 the Company and the director defendants moved to stay Appellant's Federal Action in favor of the consolidated Delaware action.

On December 15, 2010 Miller filed his own Delaware complaint ("Miller Delaware Action") and moved to have his Delaware Action consolidated with the complaint filed earlier in Delaware court by the Delaware Plaintiffs. Miller also moved to stay the consolidated action in favor of the Federal Action. The Company and director defendants then moved for an injunction barring Miller from prosecuting his

derivative or other fiduciary claims against the Director defendants in Texas or any other forum other than Delaware.

On January 12, 2011, the Court of Chancery ruled that the forum selection bylaw was legally valid and thus denied Miller's motions to stay the Delaware consolidated action and granted the Pinpoint directors' motion for an injunction barring Miller from proceeding with his Federal Action.

Appellants filed this appeal on January 14, 2011.

SUMMARY OF ARGUMENT

I. The Chancery Court incorrectly concluded that the forum selection bylaw was legally valid under Delaware law. To the extent the lower court also based its opinion on federal common law principles of contract law, the opinion should be reversed for legal error.

Delaware statutory law grants corporations rights and powers that can be limited by corporate charter amendments, but the exercise of those rights and powers can be procedurally modified by bylaws. In this case, the Pinpoint directors sought to limit their own discretion to manage the affairs of the business by use of a bylaw when that sort of limitation can only be valid if enacted as a charter amendment.

The board also violated Delaware common law by enacting a contractual arrangement that could potentially commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders. Delaware common law prevents both shareholders and

directors from binding a board to a course of action that in the board's business judgment is not in the corporation's interest.

The bylaw also finds no support in federal common law regarding contractual forum selection clauses. There is a presumption that such clauses are enforceable, but that presumption does not apply in this case since the provision was not freely bargained for and expressly agreed to.

Because the bylaw is legally invalid for any of the above reasons, for the sake of judicial efficiency and comity, the litigation should go forward in the forum in which the case was first filed since that court is capable of doing complete justice.

II. Alternatively, even if the bylaw is valid as a matter of Delaware corporation law, it unreasonably infringes on shareholders rights and must be vacated on equitable grounds.

The Chancery Court incorrectly applied business judgment review to the board's decision to adopt the bylaw. Even as the Chancery acknowledged that the bylaw was passed in exercise of 109(b) authority to pass bylaws relating to the power of shareholders, it disregarded prior rulings that confine the business judgment presumption to board exercise of its 141(a) authority. Further, the policy objectives of the business judgment rule would not be furthered by application in this context.

The proper standard of review is reasonableness when, as here, a corporate board acts so as to alter the allocation of power between

directors and shareholders. The power to bring derivative action against the board of directors serves to check management overreaching in the same way as the power to elect directors serves to check poor business management. When the board is acting not in furtherance of the business and affairs of the corporation, but in a way that impairs the shareholder's ability to check management power, the standard of review is reasonableness.

When the proper reasonableness standard is applied, the reasons given by the board for passing the bylaw prove to be unsubstantiated. The exclusive forum bylaw will not promote efficiency and, perversely, will ultimately increase the likelihood of related litigation in multiple forums. On balance, the hardship that the bylaw places on shareholders is unjustified, and it must be vacated by this Court.

STATEMENT OF FACTS

Pinpoint Bearings, Inc. ("Pinpoint") is a specialized manufacturing company headquartered in Texas and incorporated in Delaware. (Op. 4.) Pinpoint sells its highly engineered bearings to the United States military and commercial aircraft manufacturers. This derivative lawsuit originated from Pinpoint's failure to comply with performance and safety testing requirements imposed by its military contracts. (Op. 5.) These compliance failures began at least as far back as early 2009 and continued through October 2010. (Op. 6.)

When a Pinpoint employee informed the Office of Inspector General of the United States ("OIG") of Pinpoint's testing failures, the OIG

launched an investigation in September of 2010 which resulted in an admission five separate violations of the False Claims Act and a \$500m settlement payment between Pinpoint and the OIG on November 30, 2010. (Op. 6.) Appellant Miller filed his derivative complaint on December 1, 2010 before any other derivative complaints were filed in any other courts. (Op. 7.) Miller's complaint alleged breaches of fiduciary duties and violations of federal securities laws regarding the failure to disclose Pinpoint's failure to comply with the testing requirements. (Op. 7.) After three other Pinpoint shareholders copied Miller's complaint and filed it as their own derivative actions in Delaware, the Chancery Court consolidated those three complaints into one action and Pinpoint then moved in the U.S. District court to stay those parts of Miller's action that pertained to breaches fiduciary duties, in favor of the consolidated Delaware action. (Op. 8.) The basis for Pinpoint's motion to stay is a forum selection bylaw, see Appendix, unilaterally enacted by the Pinpoint board which prohibits any derivative action outside of Delaware courts. The bylaw was adopted by the board in June 2010, after the wrongdoing began which formed the heart of the \$500m OIG settlement. (Op. 2.) Pinpoint seeks concurrent litigation involving the same facts in two distant forums; litigating a securities action in federal district court in Texas, and a fiduciary duty action in Delaware state courts. The federal district court in Texas has yet to rule on Pinpoint's motion to stay the Miller action in that court.

When Appellant Miller realized that Pinpoint was attempting to force his action into Delaware courts, Miller filed his own Delaware complaint ("Miller Delaware Action") and sought to consolidate this action with the action brought by the Delaware Plaintiffs. Predicting that the Miller Delaware Action would be consolidated with the Delaware Plaintiffs' action, Miller also moved to stay that consolidated action in favor of the nearly identical, previously filed Federal Action in Texas.

The Chancery Court granted Pinpoint's motion to stay Miller's Federal Action on January 12, 2011. This appeal from that decision followed.

ARGUMENT

- I. THE EXCLUSIVE FORUM BYLAW IS INVALID UNDER DELAWARE CORPORATE LAW BECAUSE IT IS OUTSIDE THE PERMISSIBLE SCOPE OF RELEVANT STATUTORY AND COMMON LAW, AND IS A UNILATERALLY ADOPTED CONTRACT PROVISION THAT FINDS NO SUPPORT UNDER FEDERAL COMMON LAW PRINCIPLES.

Question Presented

Under Delaware law, may corporate directors unilaterally adopt a bylaw restricting future derivative suits to a single forum when the bylaw is adopted after the wrongdoing alleged in the suit has taken place?

Scope of Review

A Chancery Court opinion on the legal validity of a bylaw can be overturned unless it is "free from legal error." *Black v. Hollinger Intern, Inc.*, 872 A.2d 559, 567 (Del. 2005). As set forth below, the Chancery Court's opinion contains a number of legal errors, any one of which is grounds for this court to overturn the lower court ruling.

Merits of Argument

A. Delaware Law Does Not Permit Bylaws Which Impermissibly Limit The Directors' Ability to Manage The Affairs of The Business.

- 1. The forum selection bylaw is invalid under Delaware statutory law because corporate provisions that mandate substantive decisions and limit the board's discretion to manage the affairs of the corporation must be included within the charter, not the bylaws.*

"Bylaws of a corporation are presumed to be valid" but any "bylaw that is inconsistent with any statute or rule of common law is void." *Frantz Mfg., Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985). Under Delaware corporate law, "bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights and powers or the rights or powers of its stockholders, directors, officers or employees." Del. Code Ann. tit. 8, § 109(b) (2009). As the Delaware Supreme Court has stated on many occasions, "[i]t is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made." *CA, Inc. v. AFSCME*, 953 A.2d 227, 235 (Del. 2008). Given the statutory language and the principle that bylaws are for procedures, not for substantive decisions, the bylaw at issue in this case must be declared invalid as outside the scope of section 109(b). A bylaw that defines shareholder powers cannot be said to merely "relate" to the powers or rights of shareholders and directors. The bylaw takes away the shareholder's power to sue in any court and the director's power to decide in the future whether certain cases are best brought in Delaware. See Del.Code Ann. tit. 8, § 122 (2009). Under section 102(b), charter provisions may contain, "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders...if such provisions are not contrary to the laws of this

State." Del.Code Ann. tit. 8, § 102(b) (2009). Given the substantive nature of the forum selection bylaw, it would be most properly placed in the corporation's charter amendments, not in its bylaws since the forum selection provision defines and limits the powers of the corporation, its directors, and its shareholders. Including the forum selection bylaw in the charter amendments would also be consistent with section 141 which mandates that "the business and affairs of every corporation" shall be managed "by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." Del.Code Ann. tit. 8, § 141 (2009). A fair reading of that section indicates that corporate provisions that severely limit the discretion of the board in managing the affairs of the business should be in the charter, not in the bylaws. This makes logical sense because if shareholders wanted to limit the powers and discretion of the board, they could not unilaterally pass a bylaw because the directors could pass their own bylaw restoring those very powers. Thus, if a corporation's shareholders and directors decide to limit each other's rights and powers, as has been attempted in the forum selection bylaw, they must do so consensually by passing a charter amendment. Pinpoint has not done so in this case, and "a corporation's by-law which is repugnant to a statute, must always give way to the superior authority of the statute." *Kerbs v. California Eastern Airways*, 90 A.2d 652, 659 (Del. 1952).

2. *The forum selection bylaw is invalid under Delaware common law because a corporation may not enact bylaws which prevent the board from exercising its business judgment in discharging its fiduciary duties.*

Even if the bylaw in question does not facially violate Delaware statutory law, Delaware courts resolve difficult questions relating to the proper scope of bylaws by resorting "to different tools, namely, decisions of this Court and of the Court of Chancery that bear on this question" *CA, Inc.*, 953 A.2d at 234. In this case, the forum selection bylaw at issue violates Delaware common law because Delaware law prohibits "contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders." *Id.* at 238; see also *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

Just as in *CA, Inc.*, the proposed bylaw would "prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them" to act differently. 953 A.2d at 239. For example, even if the directors of Pinpoint had decided that the case could best be defended in the state of Texas, where the wrongdoing occurred, where the company is headquartered and presumably where most if not all the witnesses are located, this bylaw would still force the suit into Delaware courts despite the directors' exercise of managerial judgment. *Quickturn* and *Paramount* both involved cases where directors impermissibly limited

their ability to exercise their fiduciary duties and the same problem exists in this case.

There is no question that the directors are free to adopt bylaws which would determine the process by which the proper forum for a suit could be decided, but they are not free to specify the forum in advance, for any potential suit, without knowledge of the particular facts which would require them to exercise their fiduciary duties to chose a different forum. As this court has said, "Although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders." *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998). Pinpoint's directors have impermissibly attempted to chart the course of future conduct by committing themselves to litigating every future derivative suit in Delaware only. A simple alternative to this mandatory bylaw would be an elective forum selection charter provision. An elective forum selection clause would provide the board a type of fiduciary out clause that would allow it to decide in specific circumstances which court is best positioned to litigate a case in the best interests of shareholders and the corporation.

B. Contrary To The Opinion Below, The Bylaw's Validity And Enforceability Do Not Find Support In Federal Law Because It Was Not an Expressly Agreed Upon Provision Between Consenting Parties.

Corporate bylaws are "contracts among the shareholders of a corporation and the general rules of contract interpretation are held to apply." *Centaur Partners, IV v. National Intergroup, Inc*, 582 A.2d 923, 928 (Del. 1990). Contract law is important to this case because the lower court based its ruling on a presumption that forum selection clauses are valid based on two United States Supreme Court cases. Mem. Op. 12, 13; see *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991); *M/S Breman v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972). Both of those cases are easily distinguished from the case before this court. Furthermore, where federal courts have spoken directly on the issue of director imposed forum selection bylaws, they have struck down the bylaws as unenforceable. *Galaviz v. Berg*, 2011 WL 135215 (N.D.Cal. 2011).

In declaring the Pinpoint bylaw enforceable, the Chancery Court relied on the United States Supreme Court's ruling in *M/S Breman v. Zapata Off-Shore Co.* for the proposition that contractual choice-of-forum clauses should control a dispute "absent a strong showing that it should be set aside." *M/S Breman*, 407 U.S. at 9-10. The crucial difference between *Breman* and this case is that *Breman* involved "a freely negotiated" contract provision between two consenting companies, whereas the contract clause at issue here is a unilaterally imposed term that shareholders neither bargained for nor consented to. *M/S Breman*, 407 U.S. at 17. The distinction is important because if the bylaw was not freely negotiated, then the *M/S Breman* presumption that the clause is valid does not apply. Delaware courts use the same

presumption but have applied it only when the "contracting parties have expressly agreed upon a legally enforceable forum selection clause." *Ingres, Corp. v. CA, Inc.*, 8 A.3d 1143, 1145 (Del. 2010). Since there is no express agreement in this case between shareholders and the directors, the presumption does not apply under either federal or Delaware law.

The Chancery Court also relied on the Supreme Court's ruling in *Carnival Cruise v. Shute* as evidence that bargaining is not essential for a forum selection clause to be binding. 499 U.S. 585. Although this is true, it does answer the question before this court because the shareholders in this case are in a very different position than the Carnival Cruise passengers whose tickets contained the forum selection clause. The Court in *Carnival Cruise* noted that although the passengers did not bargain for the clause, they at least "had notice of the forum-selection provision" before agreeing to its terms by purchasing the tickets. *Id.* at 490, 594-95. In this case, the Pinpoint shareholders never had notice, nor could they have had notice, of the forum selection bylaw before they purchased their shares because the bylaw did not exist. *Carnival Cruise* would be a factually similar case only if the company had enacted the forum selection clause after passengers had boarded the ship and set sail. In such a situation there is no doubt that a court would hold the clause unenforceable, and the same result is compelled by the facts before this court.

In the only case to date to rule on the validity of a Delaware corporate bylaw imposing a single forum for all derivative claims, the

United States District Court for the Northern District of California ruled that directors who served on the board during corporate wrongdoing cannot unilaterally adopt a binding contract provision to restrict venue when the bylaw is passed after the wrongdoing has occurred. *Galaviz*, 2011 WL 135215. The *Galaviz* court acknowledged that it was answering "a question of first impression, in that no court has previously ruled on the enforceability of a venue provision for derivative actions contained in corporate bylaws." *Id.* No Delaware court has addressed the question of forum selection bylaws, and the only Delaware court to contemplate a similar question expressed confidence that such a forum selection cause could only exist as a charter amendment. *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 960 (Del. Ch. 2010).

C. Because The Bylaw Is Invalid And The Litigation Has Commenced in Another Court Capable of Rendering Complete Justice, This Court Should Stay Proceedings in Favor of The First Filed Complaint.

Appellant initiated this legal proceeding by filing his complaint in United States District Court for the district in which the company has its headquarters and where the wrongdoing took place. Even though "a Delaware action will not be stayed as a matter of right by reason of a prior action pending in another jurisdiction involving the same parties and the same issues" discretion to stay a later filed action "should be exercised freely in favor of the stay when there is a prior action pending elsewhere, in a court capable of doing prompt and

complete justice, involving the same parties and the same issues.”

McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng’g Co., 263 A.2d 281, 283 (Del. 1970). All of those factors exist in this case: there is an action already filed in Texas, the Texas district court is capable of hearing both the fiduciary and the securities claim, and that action involves the same issues and parties. Delaware law recognizes that “as a general rule, litigation should be confined to the forum in which it is first commenced” and that policy is “impelled by considerations of comity and the necessities of an orderly and efficient administration of justice.” *Id.* at 283. On some occasions Delaware courts have ignored the *McWane* rule when the first filed complaint is hastily drafted or fails to assert the full range of issues raised in a second-filed complaint. *Biondi v. Scrushy*, 820 A.2d 1148, 1150 (Del.Ch. 2003). In this case however, according to the lower court’s record, the Delaware Plaintiffs copied Miller’s first-filed complaint almost verbatim and thus the facts relied on in *Biondi* to ignore the *McWane* requirement do not exist in this case.

II. THE EXCLUSIVE FORUM BYLAW CAUSES AN UNJUSTIFIED INFRINGEMENT ON THE RIGHTS OF PINPOINT SHAREHOLDERS.

Question Presented

Pinpoint is a Delaware corporation with corporate headquarters, manufacturing operations, and over 8,000 employees in Houston, Texas. In June 2010—just months before Pinpoint was formally investigated by the U.S. Office of Inspector General for ongoing violations of the False Claims Act—Pinpoint’s board adopted a bylaw identifying a court over one thousand miles away as the exclusive forum for any derivative action brought on behalf of the corporation. Can Pinpoint’s exclusive forum bylaw survive equitable scrutiny by this court?

Scope of Review

This court reviews the Chancery’s findings of law de novo. See *Merrill v. Crothall-American, Inc.*, 606 A.2d 96, 100 (Del. 1992).

Merits of Argument

A. The Proper Standard Of Equitable Review For The Exclusive Forum Bylaw Is Reasonableness, Not Business Judgment.

1. *The bylaw does not deal solely with the “business and affairs” of the corporation, so it does not presumptively receive the protection of the business judgment rule.*

Delaware Corporations Law § 141(a) vests in Pinpoint's board the power to manage "the business and affairs" of the corporation, Del. Code Ann. tit. 8 § 141(a) (2010), and in exercising this power, the board is presumptively protected by the business judgment rule. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746 (Del. Ch. 2005) *aff'd*, 906 A.2d 27 (Del. 2006). The Delaware courts have made clear, however, that the scope of the business judgment rule is coterminous with the scope of § 141(a). *Id.*; see also *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) ("[T]he 'business judgment' rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under [section] 141(a)." (emphasis added)). By implication, when Pinpoint's board acts pursuant to authority outside § 141(a), the board is not presumed to enjoy the protection of the business judgment rule.

Delaware Corporations Law § 109(b), coupled with an enabling charter provision, vests in Pinpoint's board the power to adopt corporate bylaws "relating to the business of the corporation, the conduct of its affairs, and ... the rights or powers of its shareholders." Del. Code Ann. tit. 8 § 109(b) (2010) (emphasis added). With respect to the "business and affairs" of the corporation, sections 109(b) and 141(a) overlap, but unlike 141(a), 109(b) also grants the board authority to alter the powers of shareholders. Given the identical language in each provision with respect to the "business and affairs" of the corporation, 109(b)'s additional grant of power -

to adopt bylaws relating to the power of shareholders - must be distinct from the power to manage "business and affairs" and therefore beyond the scope of the business judgment rule as circumscribed by *Disney* and *Zapata*.

If Pinpoint were to pass a bylaw dealing solely with the business and affairs of the corporation, then, consistent with *Disney* and *Zapata's* delineation of the business judgment rule, that decision would receive business judgment deference. See, e.g., *Underbrink v. Warrior Energy Serv. Corp.*, 2008 WL 2262316 (Del. Ch.) (giving business judgment deference to director-adopted bylaw that mandated payment of certain director expenses). But the exclusive forum bylaw, in reducing the legal options available to shareholders seeking to bring derivative or fiduciary duty claims against the directors, goes beyond the scope of 141(a). Even the Chancery admitted as much when it said, "[t]he Bylaw clearly relates to the power of Pinpoint stockholders." (Op. 12.) Accordingly, the Bylaw was passed pursuant to authority not found in 141(a), and therefore is not presumptively protected by the business judgment rule.

2. *Giving business judgment deference to the board's decision to adopt the bylaw would not further the policy objectives of the business judgment rule.*

The business judgment rule is designed to insulate directors from personal liability for business decisions that result in corporate loss. *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996). The range of decisions that qualify protection under the business judgment rule is broad, including the decision to incur debt,

Havens v. Attar, 1997 WL 55957, 13 (Del. Ch.), expenditure of corporate funds to purchase assets, *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 140 n.96 (Del. Ch. 2009), and hiring and compensating executives, *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 771-72 (Del. Ch. 2005). In each of these cases, the board's decision of how to manage the business, though having substantial ramifications on the value of a shareholders' stock, was not second-guessed by the courts. And although the business judgment rule insulates corporate directors from personal liability for even "egregiously risky" business decisions, this protection encourages reasonable risk-taking, which ultimately operates to the benefit of shareholders. *Gagliardi*, 683 A.2d at 1052.

The same policy objectives would not be accomplished, however, by giving business judgment deference to the Pinpoint board's decision to adopt the exclusive forum bylaw. Whereas board decisions regarding the business of the corporation imply the risk of business loss, the primary consequence of the board's bylaw decision here was to take away a power previously enjoyed by Pinpoint shareholders. There was not, as in *Havens*, the risk that taking on additional debt could lead to corporate insolvency. 1997 WL 55957 at 11. There was not, as in *Citigroup*, the risk that purchased securities would suddenly lose value to the tune of billions. 964 A.2d at 138. There was not, as in *Disney*, the risk that the directors were spending corporate money to overcompensate unqualified executives. 907 A.2d at 749-750. In fact, in the final analysis, when Pinpoint directors adopted the exclusive

forum bylaw, there was no "business risk" created that the directors would need protection from. The court does not need to fear, as it might in true business judgment contexts, that second-guessing the board will discourage risk-taking or innovation in corporate management because judicial invalidation of Pinpoint's exclusive forum bylaw will not even mean personal liability for the directors; rather, it will simply reinstate this court's normal *McWane* analysis and refer litigation of the merits to the District Court of Texas. *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281 (Del. 1970). Where second-guessing board action will not lead directly to personal liability, a rule designed to assure directors that personal liability will not arise from second-guessing of business decisions is utterly out of place.

3. *The bylaw relates to the allocation of power between directors and shareholders with respect to governing the corporation; accordingly, the Bylaw must be reviewed for reasonableness.*

So that shareholders can protect themselves from management overreaching, the broad grant of power under § 141(a) is counterbalanced by two shareholder "checking" mechanisms: through board elections, shareholders can prevent future business losses by removing ineffectual directors; through the derivative lawsuit, shareholders can recoup losses resulting from management abdication of fiduciary duty. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660 (Del. Ch. 1988); *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1205 (Del. Ch. 1987); *Agostino v. Hicks*, 845 A.2d 1110, 1116 (Del. Ch.

2004). In *Blasius*, the Delaware Chancery considered a board's decision to increase the number of seats on its board and fill them with incumbent-friendly directors. Skeptical of board action that altered "allocation, between as a class and the board, of effective power with respect to governance of the corporation," the Chancery carefully scrutinized the substance of the board decision. Similarly, in *Aprahamian v. HBO & Co.*, the Chancery was asked to review board action that bore upon the shareholder's capacity to check management power by submitting written consents. See 531 A.2d at 1205. Without inquiring into the motivations of the directors (as the since-rejected *Blasius* standard would dictate), the *Aprahamian* court refused to grant business judgment deference and placed the burden on the *directors* to justify their decision. See 531 A.2d at 1206-07. Although the court did not explicitly identify its standard of review, the level of scrutiny applied fell somewhere between business judgment and the *Blasius* "compelling interest" standard. Recently, in *In re Dollar Thrifty S'holder Litig.*, the Delaware Chancery clarified that such intermediate scrutiny, in its various forms, essentially requires an inquiry into the "reasonableness" of board action. See 2010 WL 5648895 (Del. Ch.) (explaining that reasonableness review represents the middle ground between business judgment and entire fairness).

In *Agostino v. Hicks*, the Delaware Chancery recognized that shareholder derivative suits serve a similarly important role in maintaining the proper balance of power between principal and agent. 845 A.2d at 1116. The court observed that shareholder derivative

suits were devised by the courts because "directors and officers of a corporation may not hold themselves accountable to the corporation for their own wrongdoing." *Id.* As was true of the *Blasius* and *Aprahamian* courts' conception of the shareholder franchise, the derivative action was recognized to serve as "a necessary check on the behavior of directors that serve in a fiduciary capacity to shareholders." *Id.* Given the Delaware courts' skepticism of board action that disturbs the allocation of power between director and shareholder, it must examine all such power distortions under a common standard of review. Here, where Pinpoint's exclusive forum bylaw impairs the shareholder's ability to exercise one of the two checking mechanisms available to him, the court must, as it did in *Aprahamian*, place the burden on the director defendants to demonstrate the reasonableness of their action.

B. Under Reasonableness Review, The Exclusive Forum Bylaw Is Invalid Because Its Restraint On Shareholder Rights Is Disproportional To Its Purported Corporate Objectives.

Under intermediate "reasonableness" review, the decision of the Pinpoint directors to adopt the exclusive forum bylaw will be sustained only if it served a reasonable corporate purpose and does not disproportionately infringe on the rights of shareholders. See *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1205 (Del. Ch. 1987); see also *In re Dollar Thrifty S'holder Litig.*, 2010 WL 5648895 (Del. Ch.). Because the 3 reasons given for adopting the bylaw - (1) efficiency and convenience, (2) avoidance of related litigation in multiple venues, and (3) the benefit of having Delaware courts apply Delaware

governance standards - are unreasonable in light of the particular facts of this case, and because (4) the bylaw disproportionately impairs the power of shareholders to check management overreaching, the bylaw must be vacated as unreasonable.

1. *For Pinpoint directors and shareholders, litigation in Delaware will not be efficient or convenient.*

Pinpoint has its corporate headquarters and manufacturing operations in Houston, Texas, so it will be inefficient and costly to conduct fact-intensive investigation overseen by a Delaware court without physical jurisdiction over the relevant parties.

2. *Enforcement of the bylaw will not avoid related litigation in multiple venues.*

Contrary to the board's claim that the exclusive forum bylaw will prevent concurrent litigation in multiple venues, the bylaw actually ensures that duplicative litigation will occur more frequently. Whenever multi-claim litigation comprising claims both inside and outside the scope of the Bylaw is initiated outside Delaware, the claims covered by the Bylaw will be severed and litigated separately in Delaware. This perverse result is exemplified in the case at bar - whereas application of *McWane* to refer the parties to the District Court in Texas would result in a single multi-claim lawsuit, enforcement of the bylaw will result in related litigation in multiple venues.

3. *The Bylaw does not avoid the uncertainty inherent in one forum's application of another jurisdiction's law.*

Although the bylaw avoids the problem of having federal courts interpret Delaware law, it will often also require Delaware courts to interpret the laws of other jurisdictions, so the gain in legal certainty is not as great as the board claims. Here, although the expertise of the Delaware courts will be valuable in ascertaining the scope of the directors' fiduciary duties, the underlying misconduct will be evaluated in light of the False Claims Act, a federal statute that, by the board's logic, should be entrusted to a Federal Court.

4. *On balance, the hardship this bylaw places on shareholders is not justified.*

Not only does the bylaw fail to accomplish the objectives claimed by the board, it also weakens the shareholders' power to check management abuse. Although the bylaw affects only the range of forums in which a claim can be brought (rather than the range of substantive claims available) the ultimate ramification on shareholder checking power is the same. Litigation in Delaware when all witnesses and discoverable information are located in Houston, Texas will mean greater discovery costs for plaintiff's firms in Delaware. Greater discovery costs will mean greater risk for firms working on a contingency fee basis. Greater risk will mean that, at the margins, some cases that would have been brought against directors will become economically infeasible, even where director abuse has taken place. In other words, the bylaw will effect to deprive shareholders of the

opportunity to bring derivative suits that would have otherwise been brought in a jurisdiction closer to home.

In conclusion, in simplistically labeling the Bylaw as a "procedural" limitation on shareholder power, and in perfunctorily accepting the board's specious reasons for adopting the bylaw, the Chancery was in error. Accordingly, the bylaw is unreasonable and must be invalidated on equitable grounds.

CONCLUSION

For the foregoing reasons, Appellants respectfully request that this Court reverse the Chancery Court's ruling and grant appellants motion to stay all proceedings in Delaware courts, and lift the injunction barring the federal action from proceeding in the United States District Court for the Southern District of Texas.

APPENDIX

Pinpoint Bearings, Inc. bylaw amendment:

Article 12. Forum. The Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the corporation to the corporation or the corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law or the corporation's certificate of incorporation or bylaw, or (iv) any other action asserting a claim governed by the internal affairs doctrine.