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Case No. 5051-CC

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

GEORGE GRAYSON, Plaintiff, v. IMAGINATION STATION, INC., AND RICHARD H. COLLINS Defendant.	)	Civil Action No. 5051-CC

PLAINTIFF GEORGE GRAYSON'S ANSWERING BRIEF IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS

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NATURE AND STAGE OF PROCEEDINGS

This action challenges the validity of acts taken by defendant Richard Collins, a stockholder, director and the CEO of Imagination Station, Inc. ("IStation" or the "Company") to implement self interested transactions without obtaining approval from the Company's valid board of directors. Plaintiff, George Grayson, the second largest stockholder and director of IStation, alleges that Collins willfully and knowingly acted in violation of plaintiff's rights under a stock voting agreement dated December 15, 2006 (the "Voting Agreement") when Collins manipulated the board selection process and refused to recognize Douglas C. Kittelson as one of Grayson's two board designees. Collins also caused the Company to violate its contractual obligations to Grayson. Through his manipulation of the corporate election process to obtain approval of the self-interested transactions, Collins also violated his fiduciary duties to Grayson, the Company and its other stockholders.

Plaintiff seeks declaratory, injunctive and monetary relief against both defendants for their violation of 8 *Del. C.* §141 (by taking corporate acts without having obtained the necessary approvals of the Company's board of directors) and breach of the Voting Agreement, and seeks declaratory, injunctive and monetary relief against Collins for his breach of his fiduciary duties as a director and officer of IStation.

Plaintiff filed his original Verified Complaint on November 6, 2009. Defendants responded to the original complaint by filing a mirror-image action in Texas and a motion in Delaware to stay or dismiss this action in favor of its Texas action. Defendants' motion also sought dismissal of Counts II and III pursuant to Court of Chancery Rules 12(b)(6) and 23.1. By agreement, the parties briefed defendants' motion to dismiss or stay in favor of the Texas action first and preserved all arguments relating to Rules 12(b)(6) and 23.1 for a later time. In an oral ruling on March 10, 2010, the Court denied defendants' motion to stay and instructed the parties

to submit a stipulated trial scheduling order. That order was entered on March 16, 2010 and set this matter for trial on October 25, 2010. Subsequently, the parties stipulated to a stay of the Texas action pending the resolution of this action.

In an effort to moot defendants' Rule 23.1 arguments contained in their original motion to dismiss, plaintiff amended his original complaint. While Grayson contends that his claims are not derivative, he alleged demand futility in his amended complaint recognizing the possibility that a small portion of the relief he requests may be deemed derivative by the Court. Defendants answered plaintiff's Amended Verified Complaint on April 19, 2010, and contemporaneously filed a motion to dismiss Count II (breach of fiduciary duty) for failure to make a demand pursuant to Rule 12(b)(6) and Count III (violation of 8 *Del. C* §141) for failure to state a claim pursuant to Rule 23.1. Discovery is ongoing.

This is plaintiff's answering brief in opposition to defendants' motion to dismiss.[1]

[1] Plaintiff's amended complaint is cited herein as ("Am. Comp. ¶__").

STATEMENT OF FACTS

Defendants portray this action a simple breach of contract arising out of a dispute over the parties' respective rights and obligations pursuant to the Company's ByLaws and the Voting Agreement. Collins' conduct, however, crossed the line from simple breach of contract to breach of fiduciary duty once he manipulated the timing of meetings and relied on technical corporate bylaws to act in direct contravention of actions taken by the Company's board of directors and to effect approval of unfair interested transactions.

In defendants' opening brief, the factual allegations regarding Collins' own wrongful conduct that form the basis of plaintiff's claims for breach of fiduciary duty (Count II) and violation of 8 *Del. C.* § 141 (Count III) are ignored. In particular, defendants gloss over or ignore the following facts, which they have admitted in their Answer: Kittelson's appointment to the Board of Directors was approved unanimously at the September 4, 2008 Board Meeting (the "September 2008 Board Meeting")[2]; Collins' appointment of Sandra Thomas did not occur until after the September 2008 Board Meeting, in disregard of the Board's approval of Kittelson's appointment[3]; a 2008 annual shareholders' meeting, at which Kittelson could have been elected to the board, did not take place[4]; the 2009 annual shareholders' meeting was delayed and held past the date required by the Bylaws[5]; and Collins refused to recognize Kittelson as a Board Member until after the September 11, 2009 Board Meeting (the "September 2009 Board Meeting") at which Collins obtained approval of several self-interested transactions between

[2] Am. Comp. ¶27; Ans. ¶27.
[3] Am. Comp. ¶30; Ans. ¶30.
[4] Am. Comp. ¶31; Ans. ¶31.
[5] Am. Comp. ¶38; Ans. ¶38.

himself and the Company that resulted in the dilution of Grayson and all other stockholders, and provided significant economic benefits to Collins.[6]

I. PARTIES

Grayson is the founder and creator of IStation and from 1998 until October of 2007, he served as the Company's chairman and CEO. Prior to the September 2009 Board Meeting, Grayson held approximately 32% of the Company's stock. If the Board's action from the September 2009 Board Meeting are upheld, Grayson will still hold at least 23% of the Company's stock.

IStation is a privately held Delaware corporation with approximately 20 million shares outstanding held by approximately 50 different persons. The Company provides internet based software and services for educators designed to improve student performance and productivity.

Collins' involvement with IStation began in 1999 when he initially invested in the company. In October of 2007, Collins succeeded Grayson as the Company's Chairman and CEO. Prior to the September 2009 Board Meeting, Collins held 42% of the Company's outstanding stock. If permitted to stand, the Board's actions at the September 2009 Board Meeting would have the effect of increasing Collins' ownership to 52%.

II. THE VOTING AGREEMENT

In December 2006, the Company underwent a recapitalization which entailed Collins and Randall Goss agreeing to make additional investments in IStation (the "2006 Recapitalization" or the "Recapitalization"). Prior to the Recapitalization, plaintiff owned and controlled all the voting stock of the Company. In return for their investments, Grayson agreed to enter into the Voting Agreement, which created a five member Board on which Grayson had the right to designate two directors, Collins and Goss each had the right to designate one director, and the

[6] Am. Comp. ¶¶2, 37, 42, 43; Ans. ¶¶37, 42, 43.

fifth director was to be elected by a vote of all stockholders. Collins and Goss each elected themselves to the Board and Grayson elected himself and Juana Daniels. The fifth member elected to the Board was Robert Blevins, who serves as the Company's President and whose wife and son also work for the Company.

Approximately a year after the Voting Agreement was executed, a special meeting of the Board was called with no apparent purpose or agenda. At that meeting, Collins and Goss announced that Grayson had been terminated as CEO and replaced by Collins. Collins also announced that he entered into an agreement with Goss to purchase one half of Goss' stock in IStation for $1 million. At that time, Goss had only owned his stock in the Company for about three and a half years.

III. GRAYSON ANNOUNCES DANIELS' RESIGNATION AND KITTELSON'S APPOINTMENT TO THE BOARD IS APPROVED AT THE SEPTEMBER 2008 BOARD MEETING.

At the September 2008 Board Meeting, Grayson advised the Board that his second Board appointee, Juana Daniels, had resigned and Grayson appointed Kittelson to the Board as his second designee. Am. Comp. ¶27. Kittelson's appointment was approved unanimously by all Board members. Am. Comp. ¶27. Defendants do not dispute this. Ans. ¶27. Subsequently at that meeting, Collins sought approval of certain self-interested transactions. Am. Comp. ¶28. Kittelson raised concern about the transaction and Collins ultimately withdrew his request. Am. Comp. ¶28.

Recognizing that the interested transactions might not obtain Board approval with Kittelson on the Board, Collins devised a plan to obtain approval without Kittelson's participation. Am. Comp. ¶¶29-30. Despite the unanimous Board approval of Kittelson as Grayson's second Board designee, Collins claimed, within days of the September 28 Board Meeting, that the seat to which Kittelson had just been appointed was vacant and Collins, as

Chairman, had the unilateral right to fill it. In Kittelson's place, Collins purported to appoint Sandra Thomas as a director, a woman with whom he had a romantic relationship. Am. Comp. ¶¶30 & 34. The purported appointment of Thomas was accomplished solely by an email sent out from Steve Good, the Company's counsel, to Kittelson.[7] The corporate records do not reflect any formal action to appoint Thomas.

Good's email indicated that, pursuant to the Bylaws, Collins had the authority to appoint Thomas to fill the Board of Director seat that was previously held by Daniels and that Thomas would hold that seat until a new director was elected at a shareholder meeting. Am. Comp. ¶30. Good's email further indicated that a shareholder meeting would take place some time after October 15, 2008. Am. Comp. ¶30. Ultimately, a shareholder meeting was never held in 2008.

IV. THE 2009 SHAREHOLDER MEETING WAS HELD AFTER THE TIME REQUIRED UNDER THE BYLAWS.

Section 2 of the company's By-laws require the annual shareholder meeting to be held in March of each year or otherwise be held on another date at the convenience of the directors. Am. Comp. ¶38. Collins sent out a notice in December, 2008 that the 2009 annual shareholder meeting would be held on March 25, 2009. Am. Comp. ¶31. The annual meeting did not take place as originally noticed. Instead, without any Board action or explanation, the annual meeting was delayed until September 14, 2009. Am. Comp. ¶38.

On September 6, 2009, shortly after notice of the annual meeting was distributed, Collins sent out notice of the September 2009 Board Meeting. Am. Comp. ¶35. A copy of the notice was not sent to Kittelson. On the agenda for the meeting, among other items, was approval of certain transactions, including a $3 million dollar loan transaction between Collins and the

[7] Am. Comp. Exhibit C.

company that resulted in the dilution of other stockholders (the "Dilutive Transactions"). The notice did not include any information explaining the terms of the Dilutive Transactions.

Grayson attempted to have Kittelson's status as a director confirmed but Collins denied that Kittelson was or would be a director until the next stockholders meeting was held. Am. Comp. ¶36-37. By delaying the annual meeting, Collins had ensured the approval of his interested transactions. Goss and Blevins were both beholden to and controlled by Collins. Thomas, as Collins' paramour, obviously would approve the transactions. On the other hand, Collins knew that if he permitted Kittelson to participate as a Board member any vote on the interested transactions was likely to result in a deadlock. [8] With Thomas filling the seat which should have been held by Kittelson, the only opposition Collins could face was from Grayson, who could be out voted.

V. AN INVALIDLY CONSTITUTED BOARD APPROVES THE $3 MILLION DOLLAR SELF-DEALING TRANSACTION AT THE SEPTEMBER 2009 BOARD MEETING.

Collins went forward with the September 11, 2009 Board meeting with Thomas purportedly in the contested seat. Grayson and Kittelson attempted to attend by telephone. Collins refused to permit Kittelson to attend and disconnected Kittelson and Grayson from the meeting. Am. Comp. ¶41. Thus, neither Grayson nor Kittelson participated in the meeting. Nevertheless, those present went forward and purported to approve the interested transactions, including the Dilutive Transactions.

The annual stockholders meeting took place three days later on September 14, 2009 and Grayson and Kittelson were elected to the IStation Board in accordance with the terms of the Voting Agreement. On September 17, 2009, Grayson sent an email to the Board advising them

[8] Had Kittelson been on the Board, the vote likely would have broken down with two in favor, two opposed and one abstaining. Collins and Blevins presumably would have voted for the transaction, Grayson and Kittelson would have voted against it, and Collins should have abstained.

that he considered the acts taken at the September 2009 Board Meeting to be invalid. Am. Comp. ¶44. Grayson requested that a new Board meeting be held to reconsider those actions. Am. Comp. ¶44. Collins unilaterally denied Grayson's request. Am. Comp. ¶45. The other Board members did not respond.

The Company is now operating as if the actions taken at the September 2009 Board Meeting are valid despite knowing that those actions are void for lack of approval by the legitimate Board of IStation. To date, defendants have refused to call a Board Meeting as requested by plaintiff to reconsider the actions taken at the September 2009 Board Meeting.

ARGUMENT

I. INTRODUCTION AND LEGAL STANDARDS

Defendants seek to dismiss Counts II (Breach of Fiduciary Duty) and III (Violation of 8 *Del. C.* § 141) of the Amended Complaint, but not Count I (Breach of Contract). Defendants seek to dismiss Count II claiming that it is redundant of Count I and that the claims are mutually exclusive. Defendants seek to dismiss Count III because they claim it is derivative and that plaintiff (i) has not made a demand on the Company's Board of Directors, and (ii) has not filed the affidavit required by Rule 23.1(b).[9]

As to Count II, there is a separate and distinct basis for a breach of fiduciary duty claim against Collins. Collins, by his actions, engaged in activities that constituted wrongful manipulation of the voting process. Claims challenging such conduct have been consistently recognized by the Delaware courts as arising from fiduciary obligations of corporate directors and officers. While Collins' actions in denying Grayson his right to appoint a second director constitute a direct breach of the contract, Collins' actions in rearranging meeting dates, presenting interested transactions for board approval in the face of a challenge to the validity of Thomas's asserted status as a director, and timing the board vote so as to have it considered only days before a stockholders meeting at which Collins knew his asserted basis for challenging Kittelson's position on the board would be unambiguously negated, constitute the types of machinations that the Delaware courts consistently recognize as breaches of fiduciary duty.

[9] In their motion to dismiss, defendants stated that they sought to dismiss "Count III and all claims purportedly brought derivatively" for failure to make demand. In their opening brief, defendants failed to identify any claim that they deemed to be derivative or seek dismissal of any claim for failure to make demand other than Count III. Accordingly, defendants have waived any right to seek dismissal of any other claims pursuant to Rule 23.1. Plaintiff contends that none of the asserted claims are derivative. However, should the Court determine that Count III or any other claims are derivative, plaintiff will promptly file the affidavit contemplated by Rule 23.1(b).

As to Count III, that claim is individual, not derivative. Claims asserting violation of the DGCL are per se individual claims. Furthermore, only Grayson had his voting rights diluted. Thus, if this Court reaches the stage where it asks "who suffered the alleged harm – the corporation or the suing stockholder individually – and would receive the benefit of the recovery or other remedy?" the clear answer is that it was Grayson individually who suffered harm by denial of his right to a board representative and effectively dilution of his voting rights and economic interest in the Company.[10]

The standard for deciding a Rule 12(b)(6) motion to dismiss is long established and well known. The Court accepts all well pled allegations as true and gives the benefit of all reasonable inferences to the non-moving party. The Rule 23.1 standard is discussed in context below.

A. Count III is Not Derivative, or if it is, Demand is Excused

1. Count III is Not Derivative.

Defendants seek solely to dismiss Count III for failure to make a demand. OB at 6, 11. The parties agree that the test for determining whether Count III is derivative is set forth in the Supreme Court's opinion in *Tooley*.[11] The Court must look at who suffered the alleged harm and who would receive the benefit of any remedy. *Id*. at 1035. In making that determination, plaintiff's characterization of the claims is irrelevant. *Id*. at 1036. As specified in the original complaint and noted in the Amended Complaint, plaintiff does not consider his claims and requests for relief to be derivative, however, Grayson recognizes that as to a small portion of the relief he seeks it is a close call whether such relief should be characterized as derivative. Plaintiff's original complaint did not allege any claims on a derivative basis. In response to defendants' original motion to dismiss, plaintiff amended his complaint out of an abundance of caution recognizing that certain of the relief he requests could be deemed derivative ("To the

[10] *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004).
[11] *Id*.

extent that plaintiff seeks disgorgement of benefits received by Collins and reimbursement of all fees and expenses incurred by the Company as a result of Collins' breaches, plaintiff asserts such claims derivatively, however no demand on the board was required as to those claims (or any other claims that may be deemed derivative) because demand is excused.") Am. Comp. ¶52.[12] A more accurate description of plaintiff's claims would be that the claims, themselves, are direct (as is explained below) but that certain of the remedies associated with those claims could be argued to be derivative.

The focus under the *Tooley* test on who was harmed and who would receive the remedy necessarily implicates the possibility that in connection with a single claim, one remedy may be permissibly pursued as an individual remedy while another remedy may have to be pursued derivatively. Plaintiff has located no case in Delaware that directly discusses this potential bifurcation of a claim which would potentially result not in dismissal of the claim itself, but rather only of a particular remedy sought in connection with that claim.[13] While the possibility for such a dichotomy is interesting, Grayson submits that the Court does not need to reach it in this instance because Count III is unambiguously individual. The core of Grayson's claims is a declaration that the persons acting at the September 11, 2009 Board Meeting did not constitute the valid board of directors. In turn, Count III asserts that implementation of the transactions

[12] While plaintiff has always believed his claims are individual, the potential repercussions of Court of Chancery Rule 15(aaa) merit a belt and suspenders approach. As the Court itself has recognized regarding the derivative/direct distinction: "Though the test may be stated simply, in practice it is not always simple to apply." *MCG Capital Corp. v. Maginn*, 2010 WL 1782271, at *7, (Del. Ch. May 5, 2010).

[13] The closest case that plaintiff could locate was *MCG Capital* wherein the Court determined that a particular count in the complaint pled both direct and derivative claims. *MCG*, 2010 WL 1782271 at *15. However, the direct v. derivative claims contained in Count V of the complaint in that action were premised upon discrete underlying factual acts. Thus, the *MCG* situation was different from the one here where the statutory violation claim is premised upon the same facts but could give rise to several different remedies, some of which are clearly direct in nature and some of which arguably could be characterized as derivative.

approved at the September 2009 Board Meeting violates §141 because such transactions lacked the requisite board approval mandated by that section of the DGCL. The statutory violation claim asserted in Count III is individual for three distinct reasons.

First, claims that require a determination of whether particular actions comply with the provisions of the Delaware General Corporation Law are individual. In *Grimes v. Donald*, the Delaware Supreme Court affirmed a determination by the Court of Chancery that a claim asserting that a CEO's employment contract violated 8 *Del. C.* §141 by abdicating functions reserved to the directors, was an individual claim.[14] As reasoned by the Court, determinations of statutory compliance do not involve issues of business judgment and therefore cannot be made by the Board of Directors. Such claims raise questions of law to be determined by the Court.[15] The business judgment of the board regarding such claims is simply not relevant. As a result the derivative suit requirements, including the demand requirement, have no relevance and claims alleging violation of the DGCL are necessarily individual.

Plaintiff has located no case where a statutory violation was alleged to be a derivative claim. Apparently, defendants could locate no such case either because in their opening brief, the cases they cite all involve claims premised on breach of fiduciary duty, not statutory violations.[16] The failure of plaintiff to identify a single case holding, or even discussing the possibility that a statutory violation claim could be derivative is the best indicator that the common sense holding in *Grimes* states an unassailable black letter law principle of Delaware corporate law. Nevertheless, plaintiff discusses below other reasons why his claims are individual drawing upon the large body of fiduciary duty case law. Grayson makes those

[14] *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996).
[15] *Grimes*, 673 A.2d at 1213.
[16] *See* OB at 11-12.

arguments in the alternative because Grayson submits that the statutory nature of the claim is determinative of the question of whether Count III is individual or derivative.

The second reason Count III is individual may be stated as follows: when a corporation prevents a stockholder from exercising his or her right to vote, the stockholder has an individual claim.[17] As explained by this Court,

> …if the owner of stock in a corporation is entitled to vote his shares (either by default rule of 8 *Del. C.* § 212(a) or otherwise), the stockholder is the holder of the right to vote (the corporation owing the duty to allow the stockholder to vote). If a corporation wrongfully prevents a stockholder from exercising his or her right to vote, the stockholder may assert individual ownership over the claim.

Agostino, 845 A.2d at 1122 n.54 (emphasis added). As indicated by the emphasized language, the source of the voting right is irrelevant. If it is impaired, it gives rise to an individual claim.

Recently, this Court characterized claims very similar to those brought by Collins here as individual. Specifically, in *MCG Capital Corp.*, this Court determined that claims alleging (i) violation of special voting rights, and (ii) improper attempts to exclude a director from participation in board deliberations as direct claims.[18] That is precisely the nature of Grayson's claims here. Thus, while Count III is not premised on fiduciary concepts, it is instructive that claims predicated on facts very similar to those alleged in Count III are deemed direct by this Court when they are asserted under a breach of fiduciary duty construct.

Similarly claims challenging manipulation of the voting process which interferes with stockholder voting rights are individual.[19] In *Blasius*, direct claims were asserted by a stockholder challenging actions by the corporate directors that prevented unaffiliated

[17] *Agostino v. Hicks*, 845 A.2d 1110 at 1122 (Del. Ch. 2004).
[18] *MCG Capital Corp.*, 2010 WL 1782271, at *13-14 (Del. Ch. May 5, 2010).
[19] *See e.g.*, *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

stockholders from effectively exercising their right to elect directors. The claims were brought directly and there was no dispute over whether such claims were derivative. In finding that the defendants had improperly interfered with stockholders' voting rights, Chancellor Allen explained that stockholders are entitled to employ the mechanisms provided by the corporation law to advance their view.[20] Such mechanisms include the right to have the board of directors comprised of "properly" elected directors who are representative of stockholders' legitimate voting interests. Claims to enforce that right are individual.

Finally, the nature of the underlying transaction at issue here demonstrates the direct nature of plaintiff's claims under the reasoning of *Gentile v. Rossette*, 906 A.2d 91 (Del. Ch. 2006). In *Gentile*, plaintiff minority shareholders filed a breach of fiduciary duty claim against the defendant corporation's former directors and its CEO/controlling stockholder. The claims challenged a self-dealing transaction in which the CEO/controlling stockholder forgave the corporation's debt to him in exchange for being issued stock whose value allegedly exceeded the value of the forgiven debt. Defendants moved to dismiss the claim as derivative and the motion was granted in the Court of Chancery. On appeal, the Delaware Supreme Court reversed.

In reversing the lower court and determining that the claim was individual, the Supreme Court recognized a two part analysis:

> The first aspect is that the corporation [sic] was caused to overpay for an asset or other benefit that it received in exchange (here, a forgiveness of debt). The second aspect is that the minority stockholders lost a significant portion of the cash value and the voting power of their minority stock interest.[21]

Here, the analysis is the same except that in the Dilutive Transactions between Collins and the Company, Collins received shares or warrants in exchange for providing credit to the

[20] *Blasius*, 564 A.2d at 663.
[21] *Gentile*, 906 A.2d at 99.

Company rather than forgiving preexisting debt. Such transactions, the Supreme Court went on to hold, are recognized under Delaware law as both derivative and direct in character. *Id*. at 99. Such dual character claims arise where:

> A stockholder having majority or effective control causes the corporation to issue "excessive" shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.[22]

The court recognized that because the means used to achieve the end in such transactions is an overpayment of shares to the controlling stockholder, the corporation is harmed and itself has a claim for the value of the overpayment. *Id*. However, the Supreme Court went on to note that the minority stockholders have a separate, direct claim arising out of that same transaction "[b]ecause the shareholders representing the 'overpayment' embody both economic value and voting power…" *Id*. at 100. As a result, "a separate harm also results: an extraction from the public shareholders, and a redistribution to the controlling shareholder, of a portion of the economic value and voting power embodied in the minority interest." *Id*. That harm, the Supreme Court held, entitles the minority shareholders "to recover the value represented by that overpayment – an entitlement that may be claimed by the [minority] shareholders directly and without regard to any claim the corporation may have." *Id*. The nature of the underlying transaction challenged here is the type of transaction recognized by the Supreme Court as individual and that is a third reason why Count III is not derivative.[23]

Thus, Count III asserts individual claims for three independent reasons. First, it asserts a violation of a provision of the DGCL. Such claims necessarily are individual because they do

[22] *Id*. at 100 citing *Turner v. Bernstein*, 1999 WL 66532 at *11 (Del. Ch. Feb. 9, 1999).
[23] *See also Gatz v. Ponsoldt*, 925 A.2d 1265, 1281 (Del. Supr. 2006) reaffirming the holding of *Gentile* and finding that claims challenging a similar transaction were direct.

not implicate issues over which a board can legitimately exercise business judgment. Second, they are individual because the primary claim and remedies sought relate directly to the impairment of Grayson's voting rights, which are individual. Third, the underlying interested transaction that is being challenged falls within the species of corporate transactions which the Delaware Supreme Court has recognized as being both derivative and direct in character.

The only reason that plaintiff's amended complaint might implicate derivative claims is because of plaintiff's request for disgorgement of any benefits received by Collins and the reimbursement to the Company by Collins of all amounts the Company incurred as a result of Collins' actions.[24] While in theory such an award of damages would seem derivative in that such amounts would be owed to the Company, in this context they are not. First, they are not because to the extent such damages flow from a statutory violation, which is the basis of Count III, such claims are *per se* individual. Second, and in a similar vein, the damage claims are really incidental to the claims alleging interference with Grayson's voting rights. Because those claims are individual, the fact that an ancillary portion of the remedy may flow to the Company should not alter the characterization of the claim itself. Third, because the underlying transaction at issue is one that falls within that species of transaction recognized as both derivative and individual, Grayson should be permitted to assert the claim on an individual basis and pursue all remedies that flow from such claim regardless of whether they are derivative or individual. Finally, that remedy, if granted, would be covered under what has been described as the "unjust enrichment exception" to the classification of derivative claims.[25] Given Collins' status as the largest stockholder at the Company, an award which required him to simply pay money back into

[24] Am. Comp. at p. 20, ¶ E.
[25] *Agostino*, 845 A.2d at 1124.

the Company would, in effect, simply return value to him. As articulated by former Vice Chancellor and now Chief Justice Steele:

> An eventual victory for plaintiff, would achieve little since the individual defendants own an overwhelming interest in [the nominal defendant corporation]. The pleaded fundamental wrong alleged underlies both the asserted individual and derivative claims. Equity's appropriate focus should be the alleged wrong, not the nature of the claim which is no more than a vehicle for reaching the remedy for the wrong. As equity will not suffer a wrong without a remedy, I must permit plaintiff's individual claims to proceed.[26]

2. To the Extent Any Claims Are Derivative, Grayson Has Adequately Pled Facts to Excuse Demand.

a. The Legal Standard

In their opening brief, defendants discuss the demand requirements as if this were a case challenging an affirmative decision by the board of directors. That is not this case. This case challenges, at its core, the unilateral decision of Collins to thwart Grayson's voting rights and prevent Kittelson's recognition as a director of the Company.[27] The complaint also challenges Collins' decisions regarding the scheduling of the annual shareholders meeting.[28] In fact, plaintiff specifically alleges that "no board action was ever requested to reschedule the meeting from March to September."[29] Thus, at its core, Grayson's complaint challenges several unilateral decisions made by Collins without involvement of the board. Under that scenario, the standard for determining whether demand is excused is the one articulated by the Delaware Supreme Court in *Rales v. Blasband*.[30] That standard is as follows:

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[26] *Agostino*, 845 A.2d at 1124 quoting *Fischer v. Fischer*, 1999 WL 1032768, at *4 (Del. Ch. Nov. 4, 1999).
[27] *See* Am. Comp. ¶¶ 29-32.
[28] *See* Am. Comp. ¶ 38.
[29] Am. Comp. ¶ 38.
[30] *Haseotes v. Bentas*, 2002 WL 31058540 (Del. Ch. Sept. 3, 2002) citing *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

> [I]t is appropriate in these situations to examine whether the board that would be addressing the demand can impartially consider the merits without being influenced by improper considerations. Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time of the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.[31]

Here, the fundamental wrongs alleged are the interference with Grayson's voting rights and the purported implementation of interested transactions without Board approval. Grayson's ancillary request for relief to recover amounts unnecessarily and wrongfully expended by the Corporation as a result of those fundamental wrongs should not change the analysis. Instead, such amounts if awarded by the Court, should be awarded as damages to the nonaffiliated stockholders so as to prevent any benefit to Collins.

Only if the Court determines that in fact the acts at the September 2009 Board Meeting were undertaken by the validly constituted board of directors do plaintiff's claims implicate a board decision. Specifically, the claims then challenge the approval of the Dilutive Transactions. Regardless of whether the Court considers this as a *Rales* situation or a more traditional situation challenging a board decision and applying the futility standard articulated in *Aronson v. Lewis*, plaintiff has alleged sufficient facts to establish that demand would have been futile because the board is not disinterested and independent.[32]

Defendants have moved to dismiss only Count III for failure to make demand. As explained above, because Count III alleges a statutory violation of the DGCL, that claim raises a

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[31] *Haseotes*, 2002 WL 31058540 at *4 quoting *Rales*, 634 A.2d at 934.

[32] *Haseotes*, 2002 WL 31058540 at *4; *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Under *Aronson*, the test for futility is: "…the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* at 814.

legal issue that can be determined only by the Court. The board of directors has no basis or standing to render a business judgment on whether or not a claim that the Company has acted in contravention of a statutory requirement should be pursued.

When determining a director's independence for purposes of analyzing whether or not demand is required, the Court should look at all surrounding circumstances. *See Beam ex. rel. Martha Stewart Living Omnimedia Inc. v. Stewart*, 845 A.2d 1040, 1049-1050 (Del. 2004); *In re The Limited, Inc. Shareholders Litig.*, 2002 WL 537692, *4 (Del. Ch. Mar. 27, 2002). In this case, the combination of Collins' complete control of the Company coupled with other relationships between Collins and the directors establish the futility of demand.

b. Collins Controls the Board of Directors

Even if the Court determines that all or part of Count III is derivative, Grayson has alleged facts to establish that demand on the board of directors is excused. Specifically, Grayson has alleged that Collins, by virtue of his status as at least a 42% stockholder coupled with his positions as Chairman and CEO of the Company controls the board. Am. Comp. ¶¶ 8, 56. Moreover, as noted above, the bylaws state that, as Chairman, Collins has the individual authority, "in his sole judgment, to remove any officer or agent of the corporation, including the CEO." OB at 9. Such broad authority and unfettered control makes demand futile.[33]

c. Goss Is Not Independent

Collins' control of the board combined with other alleged facts demonstrate the lack of independence of the other board members. Goss sold a significant portion of his Company shares to Collins in exchange for approximately $1 million. Am. Comp. ¶58. As a result, Goss was able to obtain liquidity for a large amount of his shares in a transaction that was not

[33] *See Friedman v. Beningson*, 1995 WL 716762, *5 (Del. Ch. Dec. 4, 2005) (stating that from a practical perspective, the defendant's position as holder of 36% of the outstanding stock, chairman, CEO and president is consistent with control of the board).

generally available to other stockholders. Through that transaction he also facilitated an increase in the level of Collins' ownership and his control of the Company. At the same meeting where Collins' purchase of Goss's stock was announced, Collins and Goss announced that they had terminated Grayson as CEO. *Id.* ¶58. A reasonable inference is that the two events were a *quid pro quo.*

Defendants argue that Collins' purchase of Goss' shares two years ago does not show that Goss is presently beholden to Collins. Whether a director is beholden to an allegedly controlling person is not solely dependent on the controlling person's power to affect the director in the future. "One may feel 'beholden' to someone for past acts as well."[34] The fact that Collins provided liquidity to Goss for his otherwise, substantial and illiquid investment could instill a sense of "owingness" to Collins that could last two years. See *Id.* In *In re The Limited* one director was found to be beholden to the controlling director because when he had served as university president of Ohio State two years prior, the controlling director made a $25 million donation to the university.

Grayson also alleged his understanding that Collins and Goss participate together in various political, community and charitable events. *Id.* ¶59.[35]

Defendants argue that Goss' interests were aligned with the other shareholders and that he suffered the same dilution from the dilutive transactions as the rest of the shareholders. As such, defendants say, it is not reasonable to infer that Goss would sacrifice his own reputation and vote in favor of a transaction in disregard of his duties to the company. A similar argument was made

[34] *In re The Limited, Inc.*, 2002 WL 537692, *7.

[35] If the Court believes that such allegations are insufficient, Grayson has attached as exhibit 1 various publicly available news articles or other documents that report on events, organizations or activities in which both Collins and Gross are involved. Plaintiff would request that the Court exercise its discretion to permit amendment of the complaint to include these items. Notwithstanding Rule 15 (aaa) such amendment would be appropriate in the interests of justice given that plaintiff has identified the substance of any such amendment at the same time he is filing his answering brief.

and rejected in *Haseotes v. Bentas*.[36] In *Haseotes*, two director-shareholders brought an individual and derivative action against the other two director-shareholders, all of whom were siblings. The defendants were brother and sister. The sister was also the company's CEO and was interested. The plaintiff's argued that the other defendant, the brother, lacked independence because he was beholden to his sister. Plaintiffs argued that evidence of this was the fact that the defendants always voted together on all disputes and essentially constituted a faction. Plaintiffs pointed to multiple incidents where the defendants had voted together on disputed issues. Defendants argued that the brother's substantial ownership interest in the company made his interests aligned with the shareholders and therefore, he was able to objectively consider a lawsuit against his sister. The Court disagreed and stated that despite this, the brother had "countervailing interests which could disable him from disinterestedly and objectively considering a demand."[37]

d. Defendants Concede That Blevins Is Not Independent

Defendants do not challenge and therefore concede plaintiff's assertion that Blevins lacks independence. OB at 10. Such concession is reasonable in face of Grayson's allegations that Blevins lacks independence because of his family's dependence on salaries from their employment at the Company. As alleged in the Amended Complaint, Blevins, his wife and his son are all employees of the Company. Collectively, they earn approximately $500,000 annually in salaries and compensation. Am. Comp. ¶¶ 11, 57. As such, the Blevins family financial position could be put in severe jeopardy if Blevins were to act contrary to the wishes of Collins. Such direct financial reliance demonstrates Blevins lack of independence.

[36] *Haseotes*, 2002 WL 31058540.
[37] *Id*. 2002 WL 31058540 at *6.

II. COUNT II STATES A VALID CAUSE OF ACTION FOR BREACH OF FIDUCIARY DUTY

A. Introduction and Legal Standard

Defendants seek to dismiss Count II of the amended complaint by arguing that plaintiff's claims arise solely from contractual rights contained in the Voting Agreement thereby precluding fiduciary claims. However, Delaware law recognizes that breach of contract and breach of fiduciary duty claims can arise from the same nucleus of operative facts.[38] Only when the obligations at issue arise expressly and solely from the relevant contract does the contract claim take precedence and the fiduciary duty claim get dismissed.[39] The Court must determine whether the rights claimed by the plaintiff arise from the contract or whether there are rights and obligations created not by virtue of any contractual provision but rather arise because of the fiduciary relationship between the parties.[40] In short, the relevant inquiry is not whether the fiduciary and contract claims are based on the same facts, but rather, "whether there exists an independent basis for the fiduciary duty claims apart from the contractual claims, even if both are related to the same or similar conduct. If so, the fiduciary duty claims will survive."[41]

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[38] *Schuss v. Penfield Partners, L.P.*, 2008 WL 2433842, at *10 (Del. Ch. June 13, 2008).

[39] *Id*. *See also Nemec v. Shrader*, 2009 WL 1204346, at *4 (Del. Ch. April 30, 2009) ("If the 'fiduciary claims relate to obligations that are expressly treated' by contract then this Court will review those claims as breach of contract claims and any fiduciary claims will be dismissed." (emphasis added) *citing Madison Realty Co. v. AG ISA, LLC*, 2001 WL 406268, at *6 (Del. Ch. April 17, 2001) (quoting *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, C.A. No. 13911, 11-12 (Del. Ch. Nov. 2, ,1995)); *Gale v. Bershad*, 1998 WL 118022, at *5 (Del. Ch. Mar. 4, 1998) ("The issue is whether the duty sought to be enforced arises out of the parties' contractual, as opposed to their fiduciary, relationship.").

[40] *See Gale*, 1998 WL 118022, at *5 ("To decide that issue, the Court must determine whether Gale's claimed right to a fair valuation of the Preferred arises from the Certificate provision governing the terms of the Preferred, or whether it is a right or obligation created not by virtue of any preference, and is shared equally with the common.").

[41] *PT China LLC v. PT Korea LLC*, 2010 WL 761145 at *7 (Del. Ch. Feb. 26, 2010).

B. Plaintiff's Right to be free from Interference with his Voting Rights Arises from Long Standing, Fundamental Fiduciary Law Concepts in Delaware Common Law.

The rights of common stockholders to freely exercise their franchise is the most basic and important right arising from their ownership of stock in a Delaware corporation.[42] Actions by director or officers that interfere with the franchise have consistently been recognized as violations of the impinging party's fiduciary obligations.[43] Because of the importance of voting rights, "… those in charge of the election machinery of a corporation must be held to the highest standards of providing for and conducting corporate elections."[44] Even an action taken in good faith that interferes with the franchise constitutes an "unintended violation of the duty of loyalty" and will be remedied under Delaware law.[45] Thus, there is a strong independent basis in the Delaware common law of corporate fiduciary duties for plaintiff's claims challenging the manipulation of the election process by Collins, and the Voting Agreement contains no provisions governing the mechanics of the election process such as when stockholder meetings to elect directors would be held or how vacancies would be filled.

Beyond the fundamental nature of voting rights that arise from the fiduciary relationship between stockholders and directors, plaintiff's allegations that Collins manipulated and interfered with the stockholder vote process specifically to accomplish a self interested unfair transaction also implicate rights arising solely from the fiduciary relationship between the parties. Allegations of self-dealing and actions by directors and officers intended to further their personal self interests are classic examples of claims arising from the fiduciary relationship

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[42] *Blasius* 564 A.2d at 659 ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").
[43] *See e.g. Blasius*, 564 A.2d at 663; *Schnell v. Chris-Craft Industries, Inc*., 285 A.2d 437 (Del. Ch. 1971)(finding that delay of the annual meeting for an improper purpose constitutes a breach of fiduciary duty); *Aprahamian v. HBO & Co*., 531 A.2d 1204 (Del.Ch. 1987)(same).
[44] *Blasius*, 564 A.2d at 661.
[45] *Blasius*, 564 A.2d at 663.

between the officers and directors on one hand, and the corporation and its shareholders on the other.[46]

C. The Facts and Remedies Relevant to Plaintiff's Breach of Fiduciary Duty Claim Go Beyond Those Relevant to the Contract Claim.

Delaware law also recognizes that when the facts underlying the breach of fiduciary duty claims and the remedies sought in connection with such claims are different from or go beyond those relevant to the contract claims, the fiduciary duty claims must not be dismissed.[47] The facts underlying and potential remedies available to plaintiff from the breach of fiduciary duty claims extend beyond those relevant to the contract claims. The breach of the Voting Agreement is premised strictly on the failure to recognize and include Kittelson as a director at the September 2009 Board Meeting. The denial of that right violated the Voting Agreement's requirement that Grayson be permitted to have two designees on the Company's Board. The subsequent election of Kittelson to the Board would have probably cured that breach except that the Company has now implemented and continues to operate subject to the dilutive transactions that were approved in breach of the Voting Agreement. The remedies sought under the contract are a declaration that all acts taken at the September 2009 Board Meeting are void (because the breach of contract caused those transactions to be approved in violation of 8 *Del. C.* §141) and an award of attorneys' fees and expenses under Section 19 of the Voting Agreement.[48]

The conduct and remedies relevant to plaintiff's breach of fiduciary duty claim extend beyond that. First, given the primacy of a stockholders' franchise, common stockholders have a vested and material right to be able to fairly exercise that right. In contrast, Delaware law

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[46] *See e.g. PT China*, 2010 WL L761145 at *7 (recognizing claims of usurpation of opportunities and use of corporate information and resources for personal benefit were independently grounded in the duty of loyalty and not precluded by plaintiff's breach of contract claims).
[47] *Schuss*, 2008 WL 2433842 at *10.
[48] See Am. Comp. ¶¶ 63 – 69, and p. 19 ¶D.

recognizes that preferred stockholders' rights are contractual in nature to the extent that they exceed the rights of the common stockholders.[49] That fundamental difference in the nature of the relationship between common stockholders and the corporation (which is governed by common law fiduciary concepts) and preferred stockholders and the corporation (which is fundamentally contractual in nature) distinguishes many of the cases that have dismissed breach of fiduciary duty claims because of the existence of breach of contract claims.[50] Here, all common stockholders, including Grayson, have the right to an election process the does not interfere with the right to elect a valid board of directors and in turn to have the legitimately elected board of directors deliberate and act on matters involving the corporation. Beyond just denying Grayson his contractual right to elect two directors to the Board, Collins moved meeting dates (without Board approval and in violation of the bylaws), and utilized a technical bylaw in order to manipulate the board approval process to obtain approval of self interested transactions. In doing so, he ignored the express mandate of the Board (which had approved Kittelson's appointment to the Board of Directors) and violated bylaws (which specified the month for the stockholder annual meeting). The right of stockholders to a fair voting process, compliance with corporate governance documents and board resolutions, and approval of transactions (especially interested transactions) by the properly constituted directors are all rights that are independent of

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[49] *Blue Chip Capital Fund II Limited Partnership v. Tubergen*, 906 A.2d 827, 834 n. 25 (Del. Ch. 2006) ("With respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual … where however the right asserted is not a preference as against the common stock but rather a shared right equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards."); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986).

[50] *Gale v. Bershad* and *Blue Chip*, both relied on by defendants in their opening brief, involved preferred shareholder rights. *Madison Realty* and *Grunstein* involved partnerships which are different because the fundamental relationship between the parties is subject to a partnership agreement that creates contractual rights. The only case cited by defendants that involved a common stockholder is *Nemec* ,but the claims there turned on a retirement contract and stock plan and were unrelated to voting rights or self-dealing transactions. Moreover the contract and fiduciary claims were premised on identical facts, i.e. improper redemption of the plaintiff's stock. *Id.* at *4.

the terms of the Voting Agreement and arise strictly from Collins' fiduciary obligations to the Company and its stockholders. Because there are facts underlying the fiduciary duty claims that are different from and in additional to the facts relating to the breach of contract claim, Count II should not be dismissed.

Count II should also survive because it supports different remedies than does the Count I breach of contract claim. Specifically, plaintiff seeks disgorgement of benefits by Collins and reimbursement of all costs incurred by the Company as a result of his wrongful actions.[51] These remedies have no basis in the terms of the contract. Instead, they arise strictly from Collins' status as a fiduciary.[52] Furthermore, to the extent Collins' actions were intended to and caused the implementation of an interested transaction pursuant to an unfair process, such facts relate solely to his fiduciary obligations and give rise to remedies not available under contract law.[53]

[51] Am. Comp. p. 20 ¶E.

[52] *See Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 445 (Del. 1996) (holding that breach of fiduciary duty required disgorgement of profits by fiduciary even in the absence of any harm to the beneficiary.)

[53] *See e.g. Thorpe* 676 A.2d at 445 quoting *Milbank Tweed Hadley & McCloy v. Boon,* 13 F.3d 537, 543 (2d. Cir. 1994) ("breaches of a fiduciary relationship in any context comprise a special breed of cases that often loosen normally stringent requirements of causation and damages.").

CONCLUSION

For the foregoing reasons, plaintiff respectfully requests that the Court deny defendants' motion to dismiss in its entirety.

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CERTIFICATE OF SERVICE

I hereby certify that on this 1st day of June, 2010, I caused a copy of the foregoing **Plaintiff George Grayson's Answering Brief in Opposition to Defendants' Motion to Dismiss** to be served through LexisNexis File and Serve upon the following counsel of record:

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