IN THE COURT OF CHANCERY FOR THE STATE OF DELAWARE

LOUIS D. PAOLINO, JR.,	:	
	:	
Plaintiff,	:	
	:	
v.	:	C.A. No. 4462-VCL
	:	
MACE SECURITY INTERNATIONAL, INC.,	:	
	:	
Defendant.	:	
	:	

DEFENDANT'S REPLY BRIEF IN SUPPORT OF ITS MOTION TO DISMISS

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August 3, 2009

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INTRODUCTION

The Answering Brief filed by Plaintiff Louis D. Paolino, Jr. makes clear that this case presents a single question of contract interpretation that is ripe for decision as a matter of law. Paolino does not dispute in his Answering Brief that he initiated the Underlying Proceeding for which he now claims indemnification and advancement by filing a Demand for Arbitration seeking money damages for alleged breaches of his employment agreement. Paolino also does not dispute that he lacked the authorization of Mace's board to initiate that proceeding. Paolino thus concedes as he must that he is not entitled to indemnification or advancement for the costs of pursuing his affirmative claims. Therefore, the only question that remains is whether Paolino is entitled to indemnification and advancement for "defending" counterclaims Mace asserted to defend itself against Paolino's breach of employment contract claims. He is not.

Paolino is not entitled to indemnification for the costs of "defending" Mace's counterclaims because the plain language of Section 6.01 of the Bylaws prohibits indemnification for any costs incurred "in connection with" a "proceeding" initiated without Board authorization. Paolino is not entitled to indemnification because there is no substantive difference between advancing one's own affirmative claims and "defending" counterclaims where, as here, the counterclaims "directly respond to and negate" the affirmative claims. Additionally, he is not entitled to indemnification because the counterclaims did not arise "by reason of the fact" that Paolino was an officer or director. Instead, the Underlying Proceeding is a personal capacity suit that Paolino initiated to vindicate his personal rights in his employment contract and his personal rights in his reputation. Mace asserted the counterclaims only to defend the allegations and to obtain setoff. Because Paolino is not entitled to indemnification

or advancement, Mace requests that this Court grant Mace's Motion to Dismiss the Amended Complaint for failure to state a claim upon which relief can be granted pursuant to Rule 12(b)(6).

ARGUMENT

I. PAOLINO IS NOT ENTITLED TO INDEMNIFICATION AS A MATTER OF LAW[1]

A. The Bylaws Prohibit Indemnification Because Paolino Initiated The Underlying Proceeding Without Board Authorization

The plain language of Section 6.01 of Mace's Bylaws prohibits indemnification for any part of a proceeding initiated without Board authorization:

> the Corporation shall indemnify any such person seeking indemnification in connection with a proceeding (or part thereof) initiated by such person only if such proceeding (or part thereof) was authorized by the Board of Directors of the Corporation.

(Amended Compl. Ex. G, p. 9). In other words, any person seeking indemnification must have Board authorization to initiate a proceeding to be entitled to indemnification for any part of the proceeding the person initiated.

It is undisputed that Paolino initiated the Underlying Proceeding when he filed the Demand for Arbitration and that he did not have authorization from the Board to initiate the Underlying Proceeding. It is also undisputed that Paolino is not entitled to indemnification for the costs of advancing his affirmative claims. Answering Br. at 8. Therefore, the only question is whether Paolino is entitled to indemnification for the costs of "defending" Mace's counterclaims. Under the plain language of the Bylaws, he is not.

Paolino advances two arguments in his Answering Brief regarding why he believes he is entitled to indemnification: (1) Section 6.01 is inapplicable to him because Mace initiated the

[1] "Corporate charters and by-laws are contracts among the shareholders of a corporation, and the proper interpretation and construction of a contract is a question of law." *Levitt Corp. v. Office Depot, Inc.*, 2008 Del. Ch. LEXIS 47, at *11 (Del. Ch. Apr. 14, 2008).

counterclaims; and (2) Mace's counterclaims in the Underlying Proceeding are a "part thereof" which were initiated and authorized by the Board. Both arguments lack merit. First, it is of no consequence that Mace "initiated" the counterclaims because the counterclaims are simply a "part" of the Underlying Proceeding Paolino initiated. Paolino's position is that he is only barred from receiving indemnification for the "part" of the Underlying Proceeding he initiated—*i.e.* the affirmative claims—and therefore he must be entitled to indemnification for the "part" of the Underlying Proceeding he did not initiate—*i.e.* the counterclaims—but this creative reading has no support in the text of Section 6.01 and reads out the broad "in connection with" and "or part thereof" language. While Paolino argues that counterclaims represent separate causes of action, this principle of law has no application here because the counterclaims are "part" of the Underlying Proceeding he initiated as the affirmative claims and counterclaims arise from the same transaction or occurrence and will be resolved on the merits together in the Underlying Proceeding. Furthermore, Section 6.01 discusses indemnification in terms of proceedings, not causes of action, and Paolino does not argue to the contrary. Because Paolino initiated a "proceeding" without the authorization of the Board, he is not entitled to "indemnification in connection with [that] proceeding (or part thereof)."

Second, Paolino's argument that he is entitled to indemnification because the counterclaims "are a 'part thereof' which were [sic] authorized by the Board of Directors" is not supported by the language of Section 6.01. Even if the counterclaims could properly be characterized as such, the Underlying Proceeding was initiated by Paolino, and he is therefore not entitled to indemnification for any expenses "in connection with" that Underlying Proceeding. Section 6.01 does not state that a person is entitled to indemnification where that person initiates a proceeding and Mace later initiates a part of a proceeding. Also, Section 6.01

does not state that Board approval to initiate a proceeding is necessary only when the person seeking indemnification initiates all parts of a proceeding. If Mace had intended to provide such extremely broad indemnification rights for plaintiffs, it would have stated so clearly in its Bylaws. However, the plain language and clear intent of Section 6.01 bar indemnification for plaintiffs, such as Paolino, who lack Board authorization to initiate a proceeding.

To grant Paolino indemnification for the costs of defending the counterclaims would result in an end run around the plain language of the Bylaws. Such a result could only be reached by (1) ignoring the fact that he initiated the Underlying Proceeding and (2) classifying the counterclaims as a separate proceeding. There is no support in fact or law for either proposition. Furthermore, awarding Paolino indemnification is improper because the counterclaims would not exist but for the Underlying Proceeding he initiated. If Paolino's overly broad reading of the Bylaws had merit, he could bring any sort of claim against Mace and receive indemnification for the costs of "defending" Mace's defense, thereby rewriting the Bylaws.

Additionally, there is no substantive difference between Paolino's "defense" of the counterclaims and his prosecution of his affirmative claims. In *Zaman v. Amadeo Holdings, Inc.*, the Court of Chancery held that the individual defendants were "defending" when they asserted counterclaims that directly responded to and negated the corporation's affirmative claims. 2008 Del. Ch. LEXIS 60, at *121-*122 (Del. Ch. May 23, 2008). *See also Citadel Holding Corp. v. Roven*, 603 A.2d 818, 824 (Del. 1992) (holding that prosecuting counterclaims is defensive where the counterclaims are advanced "to defeat" the affirmative claim). Paolino's attempt to distinguish *Zaman* and *Roven* on the basis that the defendants in these cases were natural persons, not a corporation, as here, must fail because this fact is merely a distinction without a

difference. The *Zaman* and *Roven* courts did not condition their holdings that the individual defendants were "defending" by asserting the counterclaims on the fact that the individual was a natural person as opposed to a corporation. Furthermore, Paolino points to no logical distinction between an individual's "defense" of counterclaims and a corporation's "defense" of counterclaims. Therefore, the basic holding of *Zaman* and *Roven*—that prosecuting counterclaims is "defensive" when the counterclaims are compulsory because they arise out of the same transaction or occurrence as the affirmative claims and they directly respond to and negate the affirmative claims—is applicable here. Because Paolino effectively concedes that he is not entitled to indemnification for the costs of prosecuting his affirmative claims, Answering Br. at 8, and he is in fact prosecuting his affirmative claims by "defending" Mace's counterclaims, Paolino is not entitled to any indemnification whatsoever.

Paolino's argument that *Zaman* and *Roven* are inapplicable because the counterclaims at issue here are not compulsory counterclaims under the arbitrator's rules misses the point. The *Zaman* court was not interpreting procedural rules to reach its holding; rather, it was interpreting the "in defending" limitation of a bylaws provision. *See* 2008 Del. Ch. LEXIS, at *121-*122. Regarding this issue, the *Zaman* court stated:

> For these reasons, I believe that the interpretation of the "in defending" limitation most faithful to the Supreme Court's teaching in *Roven*, is that the costs of prosecuting a counterclaim should be subject to advancement if the counterclaim *would qualify* as a compulsory counterclaim[] under the traditional counterclaim test used by both Delaware and federal civil procedure . . . .

Id. (emphasis added). Notably, the court used the phrase "*would qualify*," not "do qualify," and a particular counterclaim cannot simultaneously be subject to both the Delaware Court of Chancery Rules and the Federal Rules of Civil Procedure. *Id*. Therefore, regardless of whether a particular arbitrator's rules, Delaware's procedural rules, or the Federal Rules of Civil

Procedure apply, where a claim *would qualify* as a compulsory counterclaim under Delaware and Federal Rules of Civil Procedure, and the counterclaim directly responds to and negates the affirmative claim, the assertion of the counterclaim is defensive. *Id.*

Mace's counterclaims would be compulsory under the Delaware Rules and the Federal Rules because they arise out of the same transaction or occurrence as the affirmative claims. *See* Court of Chancery R. 13(a); Fed. R. Civ. P. 13. Paolino claims that Mace breached his contract by discharging him and defamed him by announcing he was terminated for willful misconduct. (Amended Compl. ¶ 6). Mace's counterclaims defend the affirmative claims by alleging that he was rightfully discharged after he committed willful misconduct. (Amended Compl. ¶ 8(a) & (b)). Thus, the counterclaims not only arise out of the same transaction or occurrence as the affirmative claims, the counterclaims are simply the mirror image of Paolino's affirmative claims. Therefore, Mace is "defending" by asserting its counterclaims, Paolino is advancing his affirmative claims by "defending" against Mace's defense, and Paolino is not entitled to indemnification for any costs whatsoever.

B. Paolino Is Not Entitled To Indemnification Because The Counterclaims Do Not Arise "By Reason Of The Fact" That He Was An Officer Or Director

Section 6.01 of Mace's Bylaws only provides indemnification to those who participate in a proceeding "by reason of the fact that he or she . . . is or was a director or officer [] of the Corporation." (Amended Compl. Ex. G, p. 8). "By reason of' claims are essentially claims that challenge conduct by the party seeking indemnity in his official corporate capacity." *Cochran v. Stifel Fin. Corp.*, 2000 WL 1847676, at *1 (Del. Ch. Dec. 13, 2000), *aff'd* 809 A.2d 555, 562 (Del. 2002). As Paolino concedes, "the court will review . . . claims to determine whether they are merely 'examples of a dispute between an employer . . . and an employee' rather than arising 'by reason of the fact' of the director's [or officer's] position with the company." Answering Br.

at 13 (quoting *Weaver v. Zenimax Media, Inc*., 2004 WL 243163, at *3 (Del. Ch. Jan. 30, 2004)). Because Paolino simply failed to perform the basic functions of his job, this dispute is merely a dispute between an employer and an employee for which indemnification is improper.

Careful analysis of the interests underlying the claims and the counterclaims confirms that this is a personal capacity suit, not an official capacity suit, and thus Paolino is not entitled to indemnification for any costs. *See Stifel Fin. Corp.*, 809 A.2d at 562 (holding that a former employee's claim for breach of his employment contract did not arise "by reason of the fact" that he was an officer or director). The "assertion of plaintiff's personal rights (*i.e. defamation, breach of contract*)" advances no interest of the corporation and therefore does not give rise to a claim for indemnification. *See Shearin v. E.F. Hutton Group*, 652 A.2d 578, 594 (Del. Ch. 1994) (emphasis added); *see also Stifel Fin. Corp.*, 809 A.2d at 562 (applying *Shearin* to deny claim for indemnification). Paolino's breach of contract and defamation claims seek to vindicate his personal performance by alleging that Mace wrongfully terminated his employment contract for willful misconduct and defamed him by publicly announcing it. Mace's counterclaims directly respond to and negate that claim by showing that Mace properly terminated him for willful misconduct pursuant to Paragraph 7(a)(iv) of the employment contract because he failed to perform his basic duties under the contract by, inter alia, conducting personal activities at Mace's time and expense, misappropriating Mace's property, and refusing to manage Mace as CEO. (Am. Comp. ¶ 8(b)). Therefore, the Underlying Proceeding is an employment dispute for which indemnification is not proper.

Paolino makes much of the fact that Mace alleges in the counterclaims that Paolino breached statutory and fiduciary duties, but these allegations do not change the basic character of the Underlying Proceeding—an employment dispute—because the statutory and fiduciary duty

allegations support Mace's key claim that it had a proper basis for terminating Paolino's employment contract for willful misconduct. Mace contends that Paolino knowingly breached his statutory and fiduciary duties, the breaches constituted willful misconduct, the willful misconduct provided a proper basis for termination of the employment contract, and that Paolino was not defamed because the allegations of willful misconduct are true. If the arbitrators conclude that all of these arguments have merit, then Paolino's claims will necessarily fail.

Moreover, Mace's request for money damages for its counterclaims does not transform Paolino's employment claims into claims arising "by reason of the fact" that he was an officer or director. *See Cochran*, 2000 WL 1847676, at *6 ("When the corporation brings a claim and proves its entitlement to relief because the officer has breached his individual obligations, it is problematic to conclude that the suit has been rendered an 'official capacity' suit subject to indemnification. . . ."). If Paolino prevails on one or both of his claims but Mace nevertheless prevails on at least one of its counterclaims,[2] Mace could assert its damages award as a setoff against any damages Paolino might be awarded. Therefore, Mace's counterclaims are merely defenses to an employment dispute that Paolino initiated and do not arise "by reason of the fact" that Paolino was an officer or director.

Furthermore, Paolino put the fulfillment of his statutory and fiduciary duties at issue in the breach of contract and defamation claims by claiming that he never committed willful misconduct. He should not be indemnified simply because Mace seeks to defend these allegations and to offset any liability to Paolino under the employment agreement by showing that he did not fulfill the duties. The counterclaims touch on Paolino's personal conduct in

[2] Such a result could occur, for example, if the arbitrators find that Paolino breached a contractual, statutory, or fiduciary duty and his breach caused Mace damages, but his breach did not constitute a material breach of the employment contract, his immaterial breach did not excuse Mace's obligation to perform under the employment contract, and Mace's failure to perform caused Paolino damages.

connection with his (lack of) performance and do not arise "by reason of the fact" that he was an officer or director. *See Weaver*, 2004 WL 243163, at *3. Where, as here, an employee simply fails to perform the basic functions of that employee's job properly and is terminated, that employee has been terminated as a result of a "dispute between an employer . . . and an employee," not "by reason of the fact" that the employee was a director or officer of the company. *Id*. at *5 ("Taking too much vacation time and submitting fraudulent travel expenses are examples of personal conduct by employees; they did not give rise to claims 'by reason of the fact' that [the former employee] was an officer or director.").

The cases Paolino cites for the proposition that he is entitled to indemnification "by reason of the fact" that he was an officer or director of Mace do not support his conclusion. First, in *Cochran*, unlike here, the former employee did not initiate the underlying proceeding. 2000 WL 1847676, at *2. Instead, he was charged with fraud in a criminal proceeding, the SEC initiated a civil enforcement proceeding against him, and the company initiated an arbitration proceeding against him. *Id*. Even though the former employee was clearly a defendant at every stage of every proceeding, the Court of Chancery nevertheless denied him indemnification for the employment contract claims asserted against him because the claims did not arise "by reason of the fact" that he was an officer or director. *Id*. at *6 ("When a corporate officer signs an employment contract committing to fill an office, he is acting in a personal capacity in an adversarial, arms-length transaction."). Cochran appealed and the Delaware Supreme Court affirmed this part of the Court of Chancery's holding. 809 A.2d at 562 ("We agree that the claims litigated in the arbitration action were properly characterized as personal, not directed at Cochran in his official capacity. . . ."). Far from supporting his arguments, *Cochran* severely undermines Paolino's position that he is entitled to indemnification.

Second, in *Perconti v. Thornton Oil Corp.*, 2002 WL 982419 (Del. Ch. May, 3, 2002), the Court of Chancery held that a former employee was eligible for indemnification for the costs of defending a criminal prosecution that resulted in mistrial and eventual dismissal of all charges where the employee allegedly embezzled the corporation's funds, improperly traded on behalf of the corporation, lied to conceal his offenses, and committed related offenses. *Id*. at *1 & *10. The corporation argued that the former employee was not entitled to indemnification "by reason of the fact"—that he was an officer or director because "his conduct is motivated by personal self-interest and greed." *Id*. at *4. The Court of Chancery rejected this argument for two reasons. *Id*. First, the former employee was "successful" in the criminal proceeding because of the mistrial and eventual decision to drop the charges. *Id*. Second, the misconduct of which the former employee was accused—which centered on his unauthorized trading on behalf of the corporation—was "done in his capacity as a corporate officer." *Id*. Here, in contrast, quitting on the job is not analogous to unauthorized trading on behalf of the corporation. *Perconti* is distinguishable because (1) Paolino is a plaintiff, not a defendant, (2) he has not yet been "successful," and (3) he did not act in his capacity as a corporate officer when he breached his personal obligations under the employment contract.

Third, in *Reddy v. Elec. Data Sys. Corp.*, 2002 WL 1358761 (Del. Ch. June 18, 2002), the Court of Chancery held that the former employee was entitled to advancement where he allegedly manipulated the corporation's financial records to increase payments he received from escrowed funds, his conduct led to a criminal prosecution for mail fraud and wire fraud, and his employer sued him for fraud and asserted other claims based on the same conduct. *Id*. at *1-*2. Similar to *Perconti*, the corporation argued that the former employee was not entitled to advancement because he acted purely for his personal gain and not "by reason of the fact" that he

was an employee. *Id*. at *5. The Court of Chancery applied *Perconti* and rejected this argument. *Id*. at *6. Here, quitting on the job is not analogous to manipulating the corporation's financial records to obtain a larger payout. *Reddy* is distinguishable because (1) Paolino is a plaintiff here, not a defendant, (2) *Reddy* involved a claim for advancement, not indemnification, and the court relied heavily on the fact that the former employee would have to repay the advances if it were later determined that he was not entitled to indemnification, and (3) Mace's counterclaims for breaches of contractual, fiduciary, and statutory duties are defenses to Paolino's affirmative claims and do not seek recovery for the corporate treasury.

Finally, *Weaver* does not support Paolino's position and, much like *Cochran*, actually undermines his claim for indemnification. The fact that *Weaver* involved a corporation's assertion of counterclaims does not help Paolino because there the employer *conceded* that the former employee was entitled to advancement for Count I (breach of fiduciary duty). *Weaver*, 2004 WL 243163, at *2. Party concessions in unrelated cases do not carry the weight of precedent. Moreover, the *Weaver* court agreed with employer that employee was not entitled to advancement for Count II (breach of employment agreement) because the claim did not arise "by reason of the fact" of the employee's position where the employee took too much vacation time and submitted fraudulent travel expenses. *Id.* at *3 & *5.

There is no legal, equitable, or public policy reason to permit an employee to quit on the job, to bring claims against the corporation for terminating his contract, and to obtain indemnification "by reason of the fact" that he was an officer or director to rebut the corporation's defensive counterclaims.

II. PAOLINO IS NOT ENTITLED TO ADVANCEMENT

A. Paolino Is Not Entitled To Advancement Under The Plain Language Of The Bylaws

Section 6.02 of Mace's Bylaws governs advancement and limits advancement to proceedings where the claimant is entitled to indemnification:

> Advances. The right to indemnification conferred by this Article 6 shall include the right to be paid by the Corporation the expenses incurred in defending any such proceeding in advance of its final disposition, including, without limitation, attorney's fees, expert fees, and all costs of litigation.

(Amended Compl. Exhibit G, p. 9) (emphasis added). As with his claim for indemnification, Paolino concedes that he is not entitled to advancement for the affirmative claims he has asserted. The question thus becomes whether he is entitled to advancement for the counterclaims. He is not. The "right to indemnification" and the "such proceeding" language refer back to the description of an indemnifiable proceeding in Section 6.01. Because Paolino has no "right to indemnification," he has no right to "be paid by the Corporation the expenses incurred in defending any such proceeding in advance." In other words, because he has no right to indemnification, he has no right to advancement.

Paolino fails to develop an argument that the plain language of Section 6.02 entitles him to advancement. He cites to no Bylaws language in support of his claim for advancement except the procedural provisions of Sections 6.02 and 6.03 that govern the procedure for making a claim for advancement. Answering Br. at 18-19. However, these provisions do not govern substantive entitlement to advancement, and a former employee is not entitled to advancement simply by virtue of following the procedure for submitting a claim.

Next, Paolino is not "defending" the counterclaims within the meaning of Section 6.02 of the Bylaws, which limits advancement to costs incurred "in defending." Because the

counterclaims directly respond to and negate his affirmative claims, he is substantively advancing his own affirmative claims by "defending" Mace's counterclaims. *Roven*, 603 A.2d at 824; *Zaman*, 2008 Del. Ch. LEXIS 60, at *121-*122. He essentially concedes that he is not entitled to advancement for the costs of prosecuting his affirmative claims. Answering Br. at 8. However, because there is no difference between prosecuting the affirmative claims and defending the counterclaims, Paolino is not entitled to advancement of any sum. Paolino criticizes this argument as "pretzel logic" and "counter-intuitive," but Mace's argument is well-supported. Just as multiplying a negative by a negative makes a positive and putting a car in the reverse of reverse results in going forward, "defending" a "defense" results in prosecuting the affirmative claim where the counterclaim directly responds to and negates the affirmative claim. This intuitive principle was the fundamental holding of *Roven* and *Zaman*.

By way of illustration, suppose Paolino's attorney performs legal research to evaluate the strengths and weaknesses of the defamation claim. Would this research advance Paolino's affirmative claim that he was defamed, or would it advance his "defense" of Mace's counterclaims, which allege that Mace's statements were true? Paolino develops no answer to this basic question in his brief because there is no objective basis for distinguishing between the costs of prosecuting the affirmative claims and defending the counterclaims. If Paolino is awarded indemnification or advancement for the costs of "defending" the counterclaims, his attorneys could claim that the entire cost of the Underlying Proceeding was for "defending" the counterclaims. Therefore, Paolino is not entitled to advancement of any costs under the plain language of Section 6.02.

B. Paolino Is Not Entitled To Indemnification or Advancement Because He Is A Plaintiff In The Underlying Proceeding And He Initiated The Underlying Proceeding To Further His Own Interests, Not His Duties To The Corporation And Its Stockholders

Delaware law does not allow advancement to directors and officers where they seek to advance their own personal interests as a plaintiff at the expense of the corporation. *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 343 (Del. 1983); *Shearin*, 652 A.2d at 594 (holding that a plaintiff may seek indemnification "only insofar as the suit was brought as part of [his or her] duties to the corporation and its shareholders."). Defamation and breach of contract claims—*i.e.* Paolino's claims—are purely personal, advance no interest of the corporation, and therefore are not the proper subject of indemnification or advancement. *Shearin*, 652 A.2d at 594-95. *See Gentile v. Singlepoint Fin., Inc.*, 787 A.2d 102, 107 (Del. Ch. 2001).

It makes no difference that Mace initiated the counterclaims because (1) Paolino initiated the Underlying Proceeding as plaintiff, and the counterclaims are simply part of his proceeding, (2) the counterclaims directly respond to and negate the affirmative claims, and (3) there is no objective basis on which to distinguish the expenses. Paolino initiated the Underlying Proceeding to advance his own interests, to vindicate purely personal rights, and to recover for his own account, so he should be required to fund all of his own litigation efforts just like any other plaintiff alleging breach of an employment contract or defamation. *See Stifel Fin. Corp*., 809 A.2d at 562 (denying indemnification where "Cochran's decision to breach the [employment] contract was entirely a personal one, pursued for his sole benefit."). Because Paolino initiated the Underlying Proceeding, he should pay for all costs arising from the natural consequences of doing so, including the costs of "defending" Mace's defensive counterclaims that show that Mace did not breach his employment contract and did not defame him.

CONCLUSION

For the foregoing reasons, Defendant Mace respectfully requests that this Court dismiss the Amended Complaint for failure to state a claim upon which relief can be granted.

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August 3, 2009

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