IN THE COURT OF CHANCERY FOR THE STATE OF DELAWARE

LOUIS D. PAOLINO, Jr., Plaintiff,	:	
vs.	:	No. 4462-VCL
MACE SECURITY INTERNATIONAL, INC., Defendant.	:	

PLAINTIFF LOUIS D. PAOLINO, JR.'S
ANSWERING BRIEF IN OPPOSITION TO
DEFENDANT MACE SECURITY INTERNATIONAL, INC.'S
MOTION TO DISMISS

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INTRODUCTION

Louis D. Paolino, Jr. ("Mr. Paolino"), by and through his undersigned counsel, hereby files this Answering Brief in Opposition to the Defendant's Motion to Dismiss.

Mr. Paolino is a currently engaged in litigation with the Defendant where he is defending against claims being asserted by the Defendant by reason of the fact Mr. Paolino was the Chief Executive Officer and Chairman of the Board of Directors for the Defendant. The Defendant is seeking damages from Mr. Paolino in the amount of $1,000,000.00 for his alleged actions or omissions as CEO and Chairman. (Am. Compl., Ex. G at p. 5). Mr. Paolino has incurred, and continues to incur expenses, liability and loss, including attorneys' fees and costs in defending the aforementioned allegations. (Am. Compl. ¶ 17). Mr. Paolino filed the Amended Complaint in this matter on May 12, 2009 to compel the Defendant to fulfill its obligations pursuant to its own bylaws. Defendant then filed a Motion to Dismiss the Amended Complaint and an Opening Brief in Support thereof. This is Mr. Paolino's Answering Brief in Opposition to Defendant's Motion to Dismiss.

COUNTER-STATEMENT OF FACTS

Mr. Paolino served approximately nine (9) years as the Chief Executive Officer ("CEO") and Chairman of the Board of Directors ("Chairman") of Defendant, Mace Security International, Inc. ("Mace") a Delaware corporation, from his appointment in 1999 until he was wrongfully discharged on May 20, 2008. (Am. Compl. ¶ 5) Mr. Paolino's Employment Contract with the Defendant was to continue in full force and effect until August 2009. (*Id.*) Section 7 of the Employment Contract specifies that, in the event of early termination, Paolino is to receive severance payment plus accrued salary with an approximate value of $3,918,120.00. (Am. Compl. ¶ 5, Ex. A at p. 9)

D. The Claims Asserted by the Parties Against Each Other in the Underlying Action

On June 6, 2008, Mr. Paolino filed a Demand for Arbitration titled *Louis D. Paolino, Jr. v. Mace Security International, Inc.* with the American Arbitration Association against Defendant to recover damages caused by Defendant's breach of the Employment Contract (the "Underlying Action"). (Am. Compl. ¶ 6, Ex. B) On July 11, 2008, Defendant filed an Answer and Counterclaim to Mr. Paolino's Demand for Arbitration. (Am. Compl. ¶ 7, Ex. C) Defendant's counterclaims allege that during Mr. Paolino's tenure as Defendant's CEO and Chairman, he:

1. breached contractual, statutory, and common law duties as a director owed to Defendant, its Board of Directors and its shareholders by:

   i. refusing, as CEO, to follow the direction of Defendant's Board of Directors;

   ii. refusing to properly inform and/or seek approval of Defendant's Board of Directors for actions taken, as CEO, or under CEO's direction;

iii. refusing to comply with Defendant's corporate governance principals and bylaws;

iv. refusing to reduce corporate overhead and expenses as directed by Defendant's Board of Directors;

v. inappropriately interfering with the Defendant's Board of Directors' investigation of matters involving Defendant's operations; and

2. breached contractual, fiduciary and statutory obligations owed as a director to the Defendant, its Board of Directors and its shareholders by engaging in a course of misconduct, malfeasance and self-dealing, including Mr. Paolino's:

i. willful refusal as CEO to manage the Defendant;

ii. abandonment of his oversight and supervisory responsibilities as the Defendant's CEO;

iii. misappropriation of the Defendant's property;

iv. conducting personal activities and business on the Defendant's time and expense; and,

v. the placement of relatives, personal friends, and personal business associates on the Defendant's payroll.

(Am. Compl. ¶ 8, Ex. C)

In sum, the Counterclaims against which Mr. Paolino is forced to defend allege 1) breach of contract by failing "faithfully to adhere to, execute and fulfill all directions and policies established by the Board of Directors;" 2) breach of the "covenant of good faith and fair dealing in the exercise of his fiduciary, supervisory and oversight responsibilities as the Chief Executor (sic) Officer and Chairman of the Board of Directors of Mace;" 3)

breach of "statutory . . . duties owed to Mace, its Board of Directors and its Shareholders;" and 4) breach of "fiduciary . . . obligations owed to Mace, its Board of Directors and its Shareholders . . . ." (Am. Compl. Ex. C) Mr. Paolino denies each and every allegation of the Defendant's Counterclaims, all of which arise by reason of the fact that he was an officer and director of the Defendant. Defendant demands damages in the amount of $1,000,000.00[1].

E. Mr. Paolino Demands Indemnification

Mr. Paolino has incurred, and continues to incur, ongoing attorneys' fees, costs and expenses due to the Defendant's Counterclaims asserted against him. (Am. Compl. ¶ 9) Mr. Paolino sent letters to the Defendant demanding that the Defendant perform its indemnification obligations in accordance with Defendant's Bylaws. (Am. Compl. ¶ 10, Ex. D) To date, Defendant has failed and refused to honor its indemnification obligations pursuant to the Defendant's Bylaws and, in fact, by letter from its general counsel dated March 11, 2009 denied Mr. Paolino's request for indemnification. (Am. Compl. ¶ 11, Ex. E) On March 26, 2009, Mr. Paolino's counsel sent another letter to Defendant demanding indemnification and advancement and including an undertaking on behalf of Mr. Paolino to repay any amounts advanced to him in the event he was found not to be entitled to indemnification. (Am. Compl. ¶ 12, Ex. F) No response was received.

F. Defendant's Bylaws Entitle Mr. Paolino to Indemnification and Advancement

Article 6 of the Defendant's Amended and Restated Bylaws dated October 16, 2007 (hereinafter "Bylaws") provides for the indemnification of directors and officers.

[1] Although no formal denial was filed, the procedural rules of the American Arbitration Association provide that a lack of response constitutes a denial.

(Am. Compl. ¶ 13, Ex. G at 8-9) Specifically, Article 6, Section 6.01 of the Defendant's Bylaws requires the Defendant to indemnify directors and officers against all expenses, liability and loss resulting from their involvement in any legal proceeding, as follows:

> Indemnification. Each person who was or is made a party or is threatened to be made a party or is involved in any action, suit or proceeding, whether civil, criminal, administrative, or investigative (hereinafter a "proceeding"), by reason of the fact that he or she, or a person of whom he or she is a legal representative, is or was a director or officer, of the Corporation or is or was serving at the request of the Corporation as a director or officer (or person performing similar functions), employee or agent of another corporation or of a partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, whether the basis of such proceeding is alleged action in an official capacity as a director, officer, employee or agent, shall be indemnified and held harmless by the Corporation to the fullest extent authorized by the Delaware General Corporation Law, as the same exists or may hereafter be amended (but, in the case of any such amendment, only to the extent that such amendment permits the Corporation to provide broader indemnification rights than said law permitted the Corporation to provide prior to such amendment), against all expense, liability, and loss (including attorney's fees, judgments, fines, ERISA excise taxes or penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered by such person in connection therewith and such indemnification shall continue as to a person who ceased to be a director, officer, employee or agent and shall inure to the benefit of his or her heirs, executors and administrators: provided, however, that except as provided in paragraph (b) hereof, 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.

(Am. Compl. ¶ 14, Ex. G at 8-9)

Section 6.01 of the Defendant's Bylaws imposes a mandatory obligation upon the Defendant to indemnify directors and officers against "all expenses, liability and loss

(including attorney's fees, judgments, fines, ERISA excise taxes or penalties and amounts to be paid in settlement) reasonably incurred or suffered by such person" if they are involved in any legal proceedings "by reason of the fact that he or she . . . was a director or officer . . . whether the basis of such proceeding is alleged action in an official capacity as a director [or] officer… or any other capacity while serving as a director [or] officer." (Am. Compl. ¶ 14, Ex. G at 8-9)

Section 6.02 of Defendant's Bylaws also entitles Mr. Paolino to advancement of "expenses incurred in defending" litigation such as the Underlying Action and provides, in relevant part:

> Subject to the tender to the Corporation of any undertaking then required under the Delaware Corporate Law with respect to the repayment of amounts of any amounts advanced, any such expenses, including without limitation attorneys' fees, expert fees and all costs of litigation, shall be automatically and promptly upon tender by the director, officer, or employee, as applicable, of a demand therefore.

(Am. Compl. ¶ 19, Ex. G at 10).

Because Mr. Paolino has incurred expenses arising from defense of the Counterclaims initiated by the Defendant by reason of the fact that he was the CEO and Chairman of the Defendant, he is entitled to indemnification and advancement. Defendant's Motion to Dismiss should be denied.

ARGUMENT

I. LEGAL STANDARDS GOVERNING THE MOTION TO DISMISS

A complaint will not be dismissed for failure to state a claim unless it appears to a certainty that under no set of facts which could be proved to support the claim asserted would the plaintiff be entitled to relief.[2] All well-pleaded allegations must be accepted as true[3] and are to be construed in the light most favorable to plaintiff.[4] In addition, all inferences must be accepted which favor the sufficiency of the complaint.[5] Defendant's Motion fails to show that there is "no set of facts" upon which Mr. Paolino is entitled to relief; to the contrary, Mr. Paolino is entitled to indemnification and advancement.

II. PLAINTIFF'S MOTION MUST BE DENIED BECAUSE MR. PAOLINO IS ENTITLED TO INDEMNIFICATION

A. The Counterclaims In The Underlying Action Are A "Part Thereof" Which Were Initiated And Authorized By Defendant's Board of Directors

Defendant argues that the "plain language" of Section 6.01 of the Defendant's By-Laws precludes indemnification because of the following language:

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

(Am.Compl. Ex. G, p 9)

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[2] *Morgan v. Wells*, 80 A.2d 504, 505 (Del.Ch. 1951).
[3] *Danby v. Osteopathic Hosp. Ass'n.*, 101 A.2d 308, 315 (Del. Ch. 1953) *aff'd* 104 A.2d 903 (Del. 1953).
[4] *Morgan*, 80 A.2d at 506.
[5] *Delaware State Troopers Lodge No. 6 v. O'Rourke*, 403 A.2d 1109, 1110 (Del. Ch. 1979).

Defendant correctly recognizes that Mr. Paolino is not seeking indemnification for the affirmative claims he initiated in the Underlying Action. Defendant also correctly reads the Amended Complaint as seeking indemnification and advancement only for expenses incurred in defending the Counterclaims initiated by Defendant against Mr. Paolino.

However, Defendant's reading of Section 6.01 is far more restrictive than logic will permit. First, Defendant ignores the fact that it, not Mr. Paolino, initiated the Counterclaims that Mr. Paolino is now defending. Accordingly, this portion of the provision is inapplicable here.[6] Next, Defendant suggests that the drafters wrote this portion of Section 6.01 to preclude any person from indemnification for the entirety of any litigation initiated without the authorization of the Board of Directors. If that were indeed the intent, it could have been expressed much more clearly, and in far fewer words.

Mr. Paolino respectfully suggests that the language at issue in Section 6.01 is either inapplicable to him because Defendant initiated the part of the proceeding at issue, or, in the alternative, that this language *mandates* indemnification for Mr. Paolino's defense of the Counterclaims in the Underlying Action because the Counterclaims are a "part thereof"[7] which were authorized by the Board of Directors.[8] As stated above Mr.

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[6] "Technically, of course, (counterclaims) represent separate causes of action." *Zaman v. Amedeo*, 2008 WL 2168397 (Del. Ch. May 23, 2008) (quoting *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 824 (Del.. 1992))

[7] *Id.*

[8] Defendant, as a public company, is governed by its Board of Directors. Defendant acts by and through its Board of Directors and its actions must be authorized by its Board of Directors. Therefore, it is a fallacy for Defendant to argue that the Counterclaims asserted against Mr. Paolino are not authorized by the Board of Directors.

Paolino seeks indemnification and advancement only for defense of the Counterclaims which are the "part thereof" initiated and authorized by the Board of Directors.

Defendant next argues that Mr. Paolino's defense of the Counterclaims does not qualify for indemnification because that defense is no different than prosecuting his own affirmative claims. Defendant relies on *Citadel Holding Corp. v. Roven*[9] and *Zaman v. Amedeo Holdings*[10] for the proposition that there is no "substantive difference" between Mr. Paolino's defense of the "compulsory" Counterclaims and his prosecution of his affirmative claims. This conclusion is faulty because the premises upon which it rests do not support it.

Roven and *Zaman* dealt with an entirely different question: whether the costs incurred by a director or officer in prosecuting affirmative defenses and a counterclaim brought in response to litigation brought by the corporation qualified as costs incurred in "defending" within the meaning and scope of bylaws limiting *advancement* for defense of claims. Defendant's attempts to twist the rationale of those decisions to deny indemnification go far beyond what is logical and apparent: a counterclaim defendant is required to defend against the allegations of the counterclaim.

If this Court follows the Delaware Supreme Court's decision in *Roven*, then it should find that the Counterclaims here are not "compulsory" as they were in *Roven*. In *Roven*, indemnification was sought by a former director for claims arising out of an action in federal court. The counterclaims there were covered by Fed. R. Civ. P. 13 (a) and (b) which bar all claims arising from the same transaction as the original complaint

[9] 603 A.2d 818.
[10] 2008 WL 2168397.

that are not asserted in the same action.[11] In the Underlying Action, there is no such requirement. There is no provision of the American Arbitration Association ("AAA") rules requiring "all cases and controversies" be asserted in the arbitration.

By way of illustration, Mr. Paolino has also asserted against Defendant claims of retaliatory discharge in violation of 18 U.S.C. §1514A (a), the whistleblower provision of the Sarbanes Oxley Act. Those claims were lodged in the U.S. Department of Labor, not in the Underlying Action. These claims were not barred when Mr. Paolino chose not to assert them in the Underlying action. Unlike *Roven*, the Defendant here could have initiated its Counterclaims against Mr. Paolino in various forums; it was not compelled to bring them in the Underlying Action or forever abandon them.

That the Defendant chose to assert these particular Counterclaims at all was its own decision, as the Counterclaims are not "compulsory" here and were not required to state a defense against Mr. Paolino's affirmative claims:

> The term compulsory only means that the defendant must bring forward his offensive claim in the pending action or forsake it.[12] Nothing about the 'use it or lose it' nature of a 'compulsory' counterclaim actually compels a defendant to assert the counterclaim. A corporate official remains free to defend the claims against him by playing defense only without asserting a 'separate cause of action.'[13]

Because the Defendant did not risk "losing" the Counterclaims by not initiating them in the Underlying Action, it was free to defend against Mr. Paolino's claims by simply relying on its affirmative defenses without initiating a separate cause of action.

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[11] *Roven,* 603 A.2d at 824.
[12] *Zaman,* WL 2168397 at * 34 citing 6 CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1409 (2008).
[13] *Id.* at *34 quoting *Roven,* 603 A.2d at 824 (noting that counterclaims are "separate causes of action")

As stated above, the analyses employed in *Roven* and *Zaman* to determine whether costs incurred by a director for asserting affirmative defenses and prosecuting counterclaims are eligible for advancement should not apply here, where the only question is whether the director's defense of counterclaims is, in fact, "defense" for the purpose of determining entitlement to indemnification, and where the Counterclaims were not "compulsory" in any sense of the term.

In addition, the claims filed by Mr. Paolino and the Counterclaims are not identical in nature and do not cover the same ground. Mr. Paolino's claim arises solely under the Employment Contract. Conversely, the Counterclaims arise from Mr. Paolino's alleged breach of the "covenant of good faith and fair dealing in the exercise of his fiduciary, supervisory and oversight responsibilities as the Chief Executor (sic) Officer and Chairman of the Board of Directors of Mace;" breach of "statutory . . . duties owed to Mace, its Board of Directors and its Shareholders;" and breach of "fiduciary . . . obligations owed to Mace, its Board of Directors and its Shareholders . . . ." as well as breach of the Employment Contract. (Am. Compl., Ex. C) Of course, the Defendant would prefer the Court see this as a pure breach of contract claim between an employer and an employee, thus vitiating Defendant's indemnification obligation under its Bylaws. It is not so.

Defendant next cites as authority the case of *Still v. Regulus Group, LLC*[14] for the proposition that "a company can decline indemnification in all parts of a proceeding where a former officer or director is the initiating party. . . ." (Op.Brief. at 10) Mr. Paolino does not quarrel with that broad generalization, but refers this Court to the much

[14] 2002 WL 1060013 (E.D. Pa. May 29, 2002)

narrower holding of the *Still* case. *Still* denied indemnification where the express language of the Bylaws restricted indemnification to only those persons who were "named defendants."[15] Because Mr. Still was the plaintiff and counterclaim defendant in the action there at issue, he was not a "named defendant" and therefore not among the class of persons eligible for indemnification.[16] Had Defendant's Bylaws the same language, *Still* might control. It does not. Mr. Paolino is entitled to indemnification for costs incurred in defending the part of the proceeding that was initiated and authorized by the Board of Directors, i.e., the Counterclaims.

Had Mr. Paolino been sued directly by the Defendant in any forum, and been forced to defend against the exact same claims that Defendant has made in its Counterclaims, Mr. Paolino would be entitled to indemnification and advancement. It would not be equitable to bar Mr. Paolino from indemnification for defense of the Counterclaims initiated by the Defendant and authorized by the Defendant's Board of Directors simply because the Defendant chose to file them in the Underlying Action and label them as "breach of contract" claims in an attempt to avoid its indemnification obligations.

B. Mr. Paolino Is Entitled To Indemnification For Those Portions Of The Counterclaims Based On Fiduciary Duty And Loyalty Because They Arise "By Reason of the Fact" That He Served as CEO and Chairman of the Board

Defendant argues that Mr. Paolino is not entitled to indemnification or advancement because the Counterclaims do not arise "by reason of the fact" that Mr. Paolino was an officer or director of Defendant, an interesting claim in light of the express language of the Counterclaims.

[15] 2002 WL 1060013 at *2.
[16] *Id.* at *2.

"When this Court has construed the 'by reason of the fact' requirement of 8 *Del. C.* § 145 in the indemnification context, it has done so broadly and in favor of indemnification."[17] "By reason of the fact" is not, however, construed so broadly as to encompass all claims brought against an officer or director.[18] Where, as here, the dispute between the corporation and its director includes claims that the director breached an employment contract, the court will review those 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 position with the company.[19] In determining whether one is a party "by reason of the fact" Delaware courts have looked to whether the party's "use of corporate powers entrusted to him was critical to, and instrumental in, the carrying out of the scheme in which he participated . . . ."[20] Where separate claims brought in one action can be sensibly segregated for purposes of analyzing whether indemnity is owed, the court may do so.[21] The court may also examine the claims and determine whether a corporation is accurately portraying its claims rather than cleverly choosing to cast allegations of fiduciary breach as contract claims to avoid its duty of indemnification.[22]

In *Cochran v. Stifel Fin. Corp.,* the plaintiff sought indemnification for defense of a criminal proceeding and for defense of an arbitration proceeding filed by the

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[17] *Weaver v. Zenimax Media, Inc.*, 2004 WL 243163 at *3 (Del.Ch.) (quoting *Perconti v. Thornton Oil Corp.*, 2002 WL 982419, at *4 (Del.Ch.) and citing *Merritt–Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 140-41 (Del.Super. 1974)).
[18] *Weaver*, 2004 WL 243163 at *3.
[19] *Id.* (quoting *Cochran v. Stifel Fin. Corp.*, 2000 WL 1847676 at *5 (Del. Ch. Dec. 13, 2000) *aff'd in part sub nom Stifel Fin. Corp. v. Cochran*, 809 A.2d 555 (Del. 2002)).
[20] *Perconti*, 2002 WL 982419 at *4.
[21] *Cochran*, 2000 WL 1847676 at *4 fn 10 (citing *Wolfson*, 321 A.2d at 141).
[22] *See Wolfson*, 321 A.2d 138, *Weaver*, 2004 WL 243163, *Perconti*, 2002 WL 982419, *Cochran*, 2000 WL 1847676.

corporation that he had served as a director.[23] The court reviewed the nature of the claims at issue and determined that those brought "by reason of the fact" the plaintiff had been serving as a corporate executive were appropriate for indemnification while those arising from a dispute about compliance with an arms-length transaction the executive entered as an individual were not.[24] The Court here can make the same determination on the facts presented.

In *Perconti v. Thornton Oil Corp.*, a former director sought indemnification for costs incurred in defending a criminal action in which he was accused of embezzling from the corporation, and of trading in commodities markets in excess of his authority in an effort to increase his annual bonus, as well as other, related offenses.[25] The corporation asserted that indemnification was precluded because the director's actions were for personal gain and not for corporate purpose and were therefore not "by reason of the fact" that he was a director.[26] The court analyzed the phrase "by reason of the fact" and the legislative intent and determined that it conveyed the concept of a causal connection or nexus between the claims alleged and the corporate function or corporate capacity of the director.[27] On this basis, the court found that "(i)f the conduct resulting in the (claims) was done in his capacity as a corporate officer, without regard to what his motivation may have been, then the resulting (claims were) 'by reason of the fact that' (the director) was a corporate officer."[28] By the express language of its own Counterclaims, Defendant states that the basis of its entitlement to damages are the acts

[23] 2000 WL 1847676 at *1-2.
[24] *Id.* at *5-6, 9.
[25] 2002 WL 982419 at *1.
[26] *Id.* at *2.
[27] *Perconti,* 2002 WL 982419 at *4.
[28] *Id.*

and omissions (including "fiduciary" and "statutory" breaches) Mr. Paolino is alleged to have committed "in the exercise of his fiduciary, supervisory and oversight responsibilities as the Chief Executor (sic) Officer and Chairman of the Board of Directors of Mace" and so Mr. Paolino is entitled to indemnification. (Am.Compl., Ex. C at pp. 3-4).

In *Reddy v. Electronic Data Systems Corporation*,[29] plaintiff Reddy sought indemnification for defense of claims brought against him by his former employer EDS alleging negligence, gross negligence, common law fraud and breaches of the employment contract between the parties.[30] When determining whether the claims arose "by reason of the fact" of Reddy's position, the court examined the acts and omissions complained of and found in favor of Reddy because "all the misconduct alleged by EDS involves actions Reddy took on the job in the course of performing his day-to-day managerial duties."[31] In so finding, the court rejected the corporation's argument that its claims were based solely on the employment agreement and refused to allow the corporation to "escape its duties on this hyper-technical ground . . . ." The court observed:

> Under this rubric a corporation could sue a faithless officer or employee only under her employment contract. In defending an advancement suit, a corporation would then argue that the employee's improper on the job acts were simply breaches of an implied covenant to serve the corporation faithfully and honestly and that the contractual claims against her did not implicate her right to advancement.[32]

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[29] *Supra*, 2002 WL 1358761.
[30] *Id.* at *2.
[31] *Id.* at *6.
[32] *Reddy*, 2002 WL 1358761 at * 8.

Just as in *Reddy*, the Defendant's Counterclaims here include allegations that Mr. Paolino "was obligated to abide by the covenant of good faith and fair dealing in the exercise of his fiduciary, supervisory and oversight responsibilities as the Chief Executor(sic) Officer and Chairman of the Board of Directors of Mace." (Am. Compl., Ex. C at p. 3). Just as in *Reddy*, the court here should look beyond the form of Defendant's pleading and determine that the actions and omissions alleged are "by reason of the fact." The *Reddy* court stated:

> I also reject EDS's alternative argument, which rests largely on pleading formalism. Because EDS did not specifically allege that Reddy had committed a breach of fiduciary duty, it claims that the EDS action is not a proper subject of advancement. But, the negligence, gross negligence, common law fraud and contract claims brought against Reddy all could be seen as fiduciary allegations, involving as they do the charge that a senior managerial employee failed to live up to his duties of loyalty and care to the corporation. Most critically, all of the misconduct alleged by EDS involves actions Reddy took on the job in the course of performing his day-to-day managerial duties.[33]

Defendant here is trying to make the same argument which failed EDS, but with less force as it has actually included in its Counterclaims express claims for breach of fiduciary and statutory duties. Defendant cannot change the nature of its claims simply by changing the title.

In *Weaver v. Zenimax*,[34] plaintiff filed an action claiming entitlement to severance benefits after he left the defendant's employ. Defendant filed a two-count counterclaim. The first count alleged breach of fiduciary duties for failing properly to manage projects

[33] *Id.* at 6.
[34] *Supra*, 2004 WL 243163.

for which he was responsible, for making misrepresentations to management about those projects, and alleged that his mismanagement resulted in waste of corporate assets. The second count alleged plaintiff breached his employment agreement with defendant by taking more vacation time than he was allowed and for receiving travel reimbursement for personal travel expenses.[35] As in *Reddy, Cochran* and *Perconti*, the court examined the nature of the claims at issue and enforced indemnification for claims that arose "by reason of the fact" while rejecting those claims that were not rooted in the plaintiff's misuse of entrusted corporate powers. The *Weaver* court also echoed *Reddy's* sensitivity to attempts to elevate form over function in pleading practice:

> I acknowledge and concur in the principle set forth in *Reddy* that this Court's decisions in advancement cases should not 'turn on whether the complaint in the underlying action is pled with particularity or generally.' (citation omitted) . . . It is not the nature of the pleading in the underlying action that controls; it is that Zenimax alleges separate and distinct claims – one of which qualifies for advancement and one of which does not.[36]

Reddy, *Cochran, Weaver* and *Perconti* all recognized, and rejected, the argument that Defendant relies on here: that simply by calling its claims "breach of contract" rather than "breach of fiduciary duty" a corporation may avoid its obligations to indemnify its directors or officers. Accordingly, Defendant's reliance on *Cochran v. Stifel* and *Weaver v. Zenimax* to argue that its Counterclaim is based on a mere "arms-length relationship between employer and employee" is misplaced. (Op. Brief at 14). In its review of those cases Defendant fails to recognize the court in each instance enforced the corporate indemnification obligation with respect to those portions of the claims that were brought

[35] *Id.* at *1.
[36] *Id.*, at *4 fn 28.

"by reason of the fact" Mr. Paolino only seeks indemnification and advancement for his defense of those Counterclaims initiated and authorized by Defendant which arise "by reason of the fact" that he was a director and officer of Defendant.

Equity should not permit Defendant to assert in arbitration that it is entitled to $1,000,000.00 because Mr. Paolino has breached fiduciary duties and then turn around and argue to this Court that it has asserted no such thing, despite the plain and express language in its pleading. Certainly, there are facts under which Mr. Paolino may be entitled to indemnification and advancement and so this Motion must be denied.

III. MR. PAOLINO IS ENTITLED TO ADVANCEMENT

B. Because Mr. Paolino Is Entitled To Indemnification, And Because He Has Complied with Section 6.02 Of Defendant's Bylaws, He Is Entitled to Advancement

As stated in Section 6.02 of the Defendant's Bylaws:

> Subject to the tender to the Corporation of any undertaking then required under the Delaware Corporate Law with respect to the repayment amounts of any amounts advanced, any such expenses, including, without limitation attorneys' fees, expert fees and all costs of litigation, *shall be automatically and promptly* upon tender by the director, officer, or employee, as applicable, of a demand therefore.

(Am. Compl. Ex. G at p. 10).

As set forth in the Amended Complaint, Mr. Paolino's undertaking was provided by letter March 26, 2009. (Am.Compl. Ex. F). Section 6.03 of the Defendant's Bylaws provides:

> Procedure. If a claim under this Article 6 is not paid in full by the Corporation within thirty days after a written claim has been received by the Corporation, the claimant may at any time thereafter bring suit against the Corporation to recover the unpaid amount of the claim . . .

(Am. Compl. Ex. G at p. 10).

More than thirty days elapsed after the undertaking was sent without a response, and without advancement, prior to the filing of the Amended Complaint. Mr. Paolino is entitled to advancement of sums for defense of the Counterclaims that arise "by reason of the fact" of his position as CEO and Chairman.

Defendant again attempts to argue that because its "compulsory" Counterclaims "directly respond to and negate" Mr. Paolino's affirmative claims, his defense of them is indistinguishable from his prosecution of his affirmative claims. As set forth above, the Counterclaims are not compulsory, and the procedural rules that Defendant relies upon here (Del. Ch. R. Civ. P. 13(s) and Fed. R. Civ. P. 13(a)(1)(A)) do not govern the Underlying Action.

B. Mr. Paolino Is Entitled To Advancement Because He is "Defending" Against Defendant's Counterclaims

Defendant asserts that Mr. Paolino is not entitled to advancement for expenses incurred in defending against Defendant's Counterclaims because Section 6.02 limits advancement to "expenses incurred in defending" a proceeding or part thereof. (Op. Brief at 15-16) It reaches this counter-intuitive conclusion by first positing that its Counterclaims are actually defensive rather than affirmative, and then asserting that Mr. Paolino's defense of the "defensive" Counterclaims must therefore be "not defensive." This pretzel logic ignores the simple construct: by filing the Counterclaims in the Underlying Action, Defendant became a "counterclaim plaintiff," with a burden of proof that must be met to sustain the Counterclaims. Mr. Paolino became a "counterclaim defendant" and must defend against the Counterclaims.

Plaintiff's reliance on *Zaman* and *Roven* is misplaced and does little more than further confuse the issue. *Roven* and *Zaman* addressed the same question: whether the costs incurred by a director or officer in prosecuting affirmative defenses and a counterclaim brought in response to the corporation's lawsuit against him constituted "defending" within the meaning and scope of bylaws limiting advancement to defense of claims. (Op. Brief at 16) The question here is whether this former director's defense of Counterclaims initiated by the corporation alleging breach of fiduciary duty constitutes "defending" a proceeding or part thereof, as stated in Defendant's Bylaws. Again, Defendant tries to argue that because its Counterclaims are compulsory, Mr. Paolino is actually advancing his own affirmative claims when he defends against the Counterclaims. (*Id.* at 16-17) As shown above, the Counterclaims are not compulsory in the Underlying Action, and Mr. Paolino is defending far more than just a breach of contract action. If Defendant prevails on its Counterclaims, Mr. Paolino could incur liability for money damages. It is simply illogical to assert that costs incurred in the defense of these Counterclaims are actually not expenses incurred "in defending."

Most importantly, Defendant has not met its burden with respect to the instant Motion, which should be denied.

IV. BECAUSE MR. PAOLINO IS NOT A PLAINTIFF WITH RESPECT TO THE COUNTERCLAIMS INITIATED BY THE DEFENDANT, INDEMNIFICATION AND ADVANCEMENT ARE NOT PRECLUDED

Defendant relies on *Hibbert v. Hollywood Park, Inc.*,[37] *Shearin v. E.F. Hutton Group*,[38] and *Gentile v. Singlepoint Fin., Inc.*,[39] for its argument that Mr. Paolino is not

[37] 457 A.2d 339 (Del. 1983).
[38] 652 A.2d 578 (Del. 1994).
[39] 787 A.2d 102 (Del. Ch. 2001).

entitled to indemnification or advancement because the Underlying Action will not advance the interests of the corporation or its shareholders. Defendant again ignores the fact that it initiated the Counterclaims, and for that part of the proceeding Mr. Paolino is a defendant, not a plaintiff.[40] Because Mr. Paolino is not a plaintiff with respect to the Counterclaims, the holdings of *Hibbert*, *Shearin*, and *Gentile* should not apply to bar indemnification or advancement.

V. CONCLUSION

WHEREFORE, for the foregoing reasons, Plaintiff Louis D. Paolino, Jr. respectfully requests Defendant's Motion to Dismiss be denied.

Respectfully submitted,

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Date: July 15, 2009

[40] It is worth noting that *Hibbert* permitted indemnification where a lawsuit "served to uphold the (party's) honesty and integrity as directors." 457 A.2d at 344. Certainly Mr. Paolino's suit, including as it does claims for defamation, if successful, will serve to vindicate his honesty and integrity as the CEO and Chairman of Mace. His defense of the Counterclaims will have the same affect.