IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

EUGENIO POSTORIVO, for himself and derivatively on behalf of KEE ACTION HOLDINGS, INC., a Delaware corporation, et al. Plaintiffs, v. AG PAINTBALL HOLDINGS, INC., a Delaware corporation, et al., Defendants.	)	Consolidated Civil Action No. 2991-VCP
KEE ACTION SPORTS HOLDINGS, INC., et al., Plaintiffs, v. EUGENIO POSTORIVO, et al., Defendants.	)	Civil Action No. 3111-VCP Transferred Pursuant to 10 *Del. C.* § 1902

MEMORANDUM OPINION

Submitted: November 2, 2007
Decided: February 29, 2008

Elizabeth A. Wilburn, Esquire, BLANK ROME LLP, Wilmington, Delaware; James M. Andrews, Esquire, David A. Dorey, Esquire, BLANK ROME LLP, Cherry Hill, New Jersey, *Attorneys for Postorivo Parties*

R. Montgomery Donaldson, Esquire, James G. McMillan, III, Esquire, Lisa Zwally Brown, Esquire, MONTGOMERY, McCRACKEN, WALKER & RHOADS, LLP, Wilmington, Delaware; Richard L. Scheff, Esquire, Craig E. Ziegler, Esquire, MONTGOMERY, McCRACKEN, WALKER & RHOADS, LLP, Philadelphia, Pennsylvania, *Attorneys for AG Paintball Holdings, Inc., KEE Action Sports Holdings, Inc., KEE Action Sports, LLC, KEE Action Sports I, LLC, KEE Action Sports 1 UK Limited, Brent Leffel and Raymond E. Dombrowski, Jr.*

PARSONS, Vice Chancellor.

This action concerns disputes arising out of an asset purchase agreement. Plaintiffs sold substantially all of their assets in a predecessor company involved in the paintball business to Defendants in an asset purchase agreement (the "APA" or "Agreement"). Plaintiffs also retained certain excluded assets and liabilities. Defendants employed the assets to continue to operate the same business in a successor company. Soon after the execution of the Agreement, significant disputes arose regarding, among other things, Plaintiffs' representations, warranties, and covenants under the APA. When efforts to resolve the disputes failed, Defendants filed a contract indemnity action against Plaintiffs in the Superior Court. Subsequently, Plaintiffs commenced this action in the Court of Chancery asserting direct and derivative claims for fraud, waste, breach of fiduciary duty, conversion, breach of contract, and declaratory and injunctive relief. On June 30, 2007, with the parties' consent, I consolidated the indemnity action with this action.

The consolidated action is presently before me on Defendants' motion to dismiss. Defendants moved to dismiss all derivative claims Plaintiff Eugenio Postorivo purports to bring on behalf of the successor company and all direct claims brought by the successor company. The parties focused most of their arguments on Defendants' motion to dismiss the derivative claims. Defendants seek dismissal of these claims on three grounds: (1) Postorivo's lack of standing; (2) his inadequacy as a derivative plaintiff; and (3) his failure to adequately plead demand futility.

I conclude that Postorivo has not adequately pled demand futility. Specifically, as to Postorivo's derivative claims challenging board action, he has failed the *Aronson v.*

Lewis test for demand excusal; and as to his derivative claims that do not challenge board action, Postorivo has not met the *Rales v. Blasband* standard. I also hold that Postorivo has no standing to pursue derivative claims on behalf of the successor company after the APA.[1] For the reasons stated, I deny as moot Defendants' motion to dismiss any direct claims brought by the successor company, but grant their motion to dismiss the derivative claims brought on behalf of that company.

I. FACTS[2]

National Paintball Supply, Inc. ("NPS") is a corporation founded and wholly-owned by Eugenio Postorivo. NPS was in the business of selling equipment and supplies, including guns, paintballs, protective goggles, clothing, and other gear related to the paintball gaming industry. In the APA, initially signed September 29, 2006, amended, and subsequently closed on or about November 17, 2006, Postorivo sold substantially all of the assets of NPS to AJ Intermediate Holdings, Inc. ("AJI"). AJI formed a new company, KEE Action Sports Holdings, Inc.,[3] to receive these assets and combine them with assets from another company, Pursuit Marketing, Inc. ("PMI"). PMI was a competitor of NPS.

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1 Based on these holdings, I do not need to address the adequacy of Postorivo to serve as a derivative plaintiff.

2 Unless otherwise indicated, the facts recited in this memorandum opinion are drawn from the allegations in the first amended verified complaint.

3 For simplicity, when referring to KEE Action Sports Holdings, Inc., KEE Action LLC, or AJ Intermediate Holdings, Inc., separately or collectively, I will use the designation "KEE Action."

On or about March 28, 2007, KEE Action sent an Indemnification Claims Notice (the "Indemnity Notice") to Postorivo which purported to put Postorivo on notice under the APA of Defendants' claims that Postorivo had, among other things: (a) excessively valued certain NPS inventory, (b) failed to disclose certain "liabilities," and (c) transferred to the purchasers certain intellectual property alleged to infringe upon certain patents, in violation of various representations and warranties made under the APA. More specifically, with respect to the inventory, Defendants alleged significant discrepancies between the "book value" of the inventory underlying the asset valuation of the APA and the "fair market value" asserted by Defendants post-closing. For example, Plaintiffs listed the book value of the NPS Guns as $1,209,442, and of the Empire Trucks as $281,136, while Defendants alleged the fair market value of both types of inventory was $0.

Postorivo and NPS responded in writing to the Indemnity Notice on April 17 and May 4, 2007, and denied the claims asserted in it. The response noted that KEE Action had provided no supporting data to justify the figures it supplied for each subcategory of inventory claimed. Furthermore, Postorivo and NPS observed that not only had the pre-asset sale inventory been confirmed by NPS personnel, but also the buyers had conducted their own due diligence with respect to that same inventory without issue.

Also on May 4, KEE Action commenced the Superior Court action. Simultaneously with the filing of the Superior Court Complaint, KEE Action terminated Postorivo from its board of directors. The next day, on May 5, KEE Action terminated Postorivo's employment (purportedly for cause) in what Postorivo contends was a

violation of his employment agreement. Then, on May 14, 2007, KEE Action canceled all shares issued to Postorivo under the APA, both the junior preferred shares and the common shares, leaving Postorivo with no ownership interest in KEE Action.

II. PROCEDURAL HISTORY

Plaintiff Postorivo filed this action on May 29, 2007, directly and derivatively on behalf of KEE Action, together with co-Plaintiff PBS (formerly known as NPS) and other entities affiliated with Postorivo (the "Chancery Action") seeking declaratory and equitable relief and damages. The named defendants are Brent Leffel and Raymond Dombrowski ("Director Defendants"), along with KEE Action, Inc., AG Paintball Holdings, Inc., KEE Action Sports, LLC, and other affiliated entities (collectively with the Director Defendants, the "Defendants"). The asserted claims arise out of Defendants' conduct towards Postorivo in conjunction with his sale of substantially all of the assets of NPS to Defendants pursuant to the APA and related transactions.

On July 2, 2007, Defendants moved to dismiss the first amended verified complaint (the "Complaint") pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief can be granted and Rule 23.1 for failure to comply with the pleading and demand requirements for a derivative action under Delaware law. In briefing that motion, Defendants sought to dismiss all derivative claims brought on behalf of KEE Action and all direct claims purportedly brought by KEE Action. Plaintiffs later confirmed that their Complaint did not assert any direct claims in the name of KEE

Action, thereby clarifying the situation and obviating the need for further proceedings on that portion of Defendants' motion.[4]

The Complaint contains thirteen counts. The parties dispute, however, which claims are derivative in nature (brought on behalf of KEE Action) and which ones are direct (brought by Postorivo). Postorivo contends that Count I, breach of fiduciary duty, and Count IV, waste of corporate assets, are the only derivative claims.[5] KEE Action responds that Count V (claim against KEE Action for aiding and abetting breaches of fiduciary duty and waste), Count VI (claim against KEE Action for conspiracy in breaches of fiduciary duties), Count IX (claim against all Defendants for declaratory judgment that, *inter alia*, Defendants have breached their fiduciary duties or committed waste), and Count X (claim against all Defendants to preliminarily enjoin, *inter alia*, waste and breaches of fiduciary duty) necessarily are at least partially derivative as well.[6] Therefore, Defendants seek dismissal of Counts I and IV in their entirety, and Counts V, VI, IX, and X to the extent they are derivative. For purposes of the analysis below, I

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4 Based on Plaintiffs' clarification, I stated at argument that the Court now "construe[s] the first amended complaint as not including KEE Action Sports Holdings, Inc. as a plaintiff, except to the extent that Mr. Postorivo is suing -- purporting to sue derivatively on their behalf." Tr. of Arg. on Defs.' Mot. to Dismiss held on Nov. 2, 2007 ("Tr.") at 5-6. As discussed in Part V, *infra*, I deny as moot Defendants' motion to dismiss any direct claims brought by KEE Action based on Plaintiffs' assurance that the Complaint asserts no such claims.

5 Pls.' Ans. Br. ("PAB") at 3.

6 Defs.' Reply Br. at 3.

focus on Counts I and IV, but the relief granted applies to all claims to the extent they are derivative.

After extensive briefing, the Court heard argument on Defendants' motion to dismiss on November 2, 2007. This is the Court's ruling on that motion.

III. THE PARTIES' CONTENTIONS

KEE Action argues that because Postorivo did not make a demand on its board of directors before filing suit and because demand was not excused, Postorivo's derivative claims should be dismissed. Regarding demand futility, KEE Action asserts that Postorivo failed to meet the heightened pleading requirements of Rule 23.1, advancing only generalized, circular arguments, and *per se* condemnations, instead of alleging the required particularized facts and undertaking a director-by-director analysis.[7] According to KEE Action, the Complaint contains no particularized allegations that could support a reasonable doubt (1) regarding the disinterestedness and independence of a majority of the KEE Action directors as to the challenged conduct or (2) that any given transaction approved by the board was otherwise the product of a valid exercise of business judgment. KEE Action therefore contends Postorivo's failure to make a demand cannot be excused and urges this Court to dismiss his derivative claims.

[7] KEE Action suggests that Postorivo's failure to use the tools available to him when he was a director, president, and shareholder of KEE Action, such as 8 *Del. C.* § 220, compounds his failure to meet the heightened pleading requirements of Rule 23.1.

Postorivo acknowledges he made no demand on KEE Action's board. He argues, however, that demand was futile.[8] According to Postorivo, the inventory write-down, which he characterizes as a "firesale," and his subsequent ouster from the business of KEE Action are not separate transactions. Rather, these events are "part and parcel of one continuous series of acts"; they are "inextricably intertwined" transactions designed to divest Postorivo of his role and stake in the company.[9] Thus, Postorivo argues, the sum total of the allegations in the Complaint raises a reasonable doubt that: (1) the challenged transactions are within the bounds of the business judgment rule, thereby excusing demand under *Aronson*'s second prong;[10] (2) KEE Action's board would have properly exercised its business judgment in responding to a demand, presumably excusing demand under *Rales*; and (3) a majority of the directors would have been disinterested, presumably excusing demand under *Rales* and possibly *Aronson*.[11]

KEE Action also challenges Postorivo's standing to assert a derivative claim because Postorivo is no longer a shareholder. The parties' arguments on that issue are set forth in the relevant section of the Analysis, specifically Part IV.C, *infra*.

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8 Postorivo raised several arguments in his brief and at argument regarding demand futility. His counsel waffled, however, on whether Postorivo was asserting futility under the *Aronson* or *Rales* standard or both. In response, KEE Action addresses both possibilities. Similarly, this memorandum opinion analyzes demand futility under both approaches.

9 Tr. at 33.

10 *Id.* at 22.

11 *Id.* at 35.

IV. ANALYSIS

When considering a motion to dismiss under Rule 23.1, this Court affords plaintiffs all reasonable inferences that logically flow from the particularized facts alleged in the complaint. Conclusory allegations of fact or law, however, are not considered as expressly pleaded facts or factual inferences.[12] Moreover, the court "'need not blindly accept as true all allegations, nor must it draw all inferences from them in plaintiffs' favor unless they are reasonable inferences.'"[13]

A. Requirement of Demand under Rule 23.1

As a general principle, the board of directors, not the shareholders, manages the business and affairs of a Delaware corporation.[14] Shareholders, however, can seek redress in derivative actions for torpid or unfaithful management.[15] Because a derivative action, by its very nature, impinges on the managerial freedom of directors, Chancery Rule 23.1 operates as a threshold to insure that plaintiffs exhaust intracorporate remedies and protect against strike suits.

"To preserve the board's authority over ordinary business decisions, a plaintiff who initiates a derivative action must before the commencement of the action either demand that the corporate board take up the litigation itself, or, in the alternative,

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12 *White v. Panic*, 783 A.2d 543, 549 (Del. 2001) (quoting *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000)).

13 *Id.* (quoting *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988)).

14 8 *Del. C.* § 141(a).

15 *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

demonstrate in a complaint why such a demand would be futile."[16] Successful derivative plaintiffs "must focus intensely upon individual director's conflicts of interest or particular transactions that are beyond the bounds of business judgment. The appropriate analysis focuses upon each particular action, or failure to act, challenged by a plaintiff."[17] Delaware law recognizes a simple, fundamental truth of institutional competency: "the value of assets bought and sold in the marketplace . . . is a matter best determined by the good faith business judgments of disinterested and independent directors, men and women with business acumen appointed by the shareholders precisely for their skill at making such evaluations."[18] The Delaware courts generally will not substitute the judgment of a judge for that of the board. Rather, a judge ensures that the board made the business judgment with a disinterested and independent mindset. Therefore, the courts avoid questioning the merits of a director's decision, but examine instead allegations questioning the motivations fueling the decision.[19]

A plaintiff who asserts demand futility must meet the requirement under Rule 23.1 of pleading with factual particularity, which substantially differs from the permissive notice pleading under Chancery Rule 8(a). Vague or conclusory allegations do not

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16 *In re infoUSA, Inc. S'holders Litig.*, 2007 WL 2419611, at *12 (Del. Ch. Aug. 13, 2007).

17 *Id.* at *11.

18 *Id.* at *12.

19 *Id.*

suffice, rather the pleader must set forth particularized factual statements that are essential to the claim.[20]

Because Postorivo did not make a demand on KEE Action's board of directors, he must demonstrate that demand is excused to maintain his derivative claims in the face of Defendants' motion to dismiss. Therefore, I must determine whether the Complaint alleges, with particularity, sufficient facts to support a conclusion that demand was futile.

B. Demand Futility

Turning to demand under Rule 23.1, this Court recognizes two tests for demand futility: commonly known as the *Aronson* test and the *Rales* test. Both tests spring from the concept that a court should not intervene in a board's decision to refuse a shareholder demand, unless the shareholder raises the troubling inference that the board's refusal would not be a good faith exercise of business judgment. Raising an inference that a board would refuse a demand is not sufficient. As Chancellor Chandler stated in *infoUSA*:

> A board may in good faith refuse a shareholder demand to begin litigation even if there is a substantial basis to conclude that the lawsuit would eventually be successful on the merits. It is within the bounds of business judgment to conclude that a lawsuit, even if legitimate, would be excessively costly to the corporation or harm its long-term strategic interests.[21]

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20 *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

21 2007 WL 2419611, at *13.

Therefore, it is not enough to allege the board would refuse a demand, rather the allegations must create a reasonable doubt regarding whether the refusal of the demand, itself, would be a good faith exercise of business judgment.

When a plaintiff challenges a board action, the Court employs the *Aronson* test. Under *Aronson*, demand is excused if a reasonable doubt is created that: (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[22] On the other hand, when the conduct a plaintiff complains of does not involve board action, the Court cannot examine the business judgment of an action not taken and the inquiry narrows to that prescribed in *Rales*. Under *Rales*, a plaintiff shows demand futility by establishing "a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to demand."[23] Both tests demonstrate "a Court's unwillingness to set aside the prerogatives of a board of directors unless the derivative plaintiff has shown some reason to doubt that the board will exercise its discretion impartially and in good faith."[24]

While Postorivo advocates viewing the complained of events as one continuous series of acts, I find it useful to analyze the Complaint as presenting two separate derivative claims – one claim that does not challenge a board action and a second claim

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22 *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984); *see Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000).

23 *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

24 *infoUSA*, 2007 WL 2419611, at *14.

that does. I examine the claims in the temporal order in which their underlying facts occurred. First, Postorivo challenges a write-down of inventory to liquidation firesale prices, contending that it wasted corporate assets totaling $10 million. The write-down, likely effected by Dombrowski, perhaps with the active involvement of Leffel, did not involve board participation (other than possibly acquiescence). Because this claim does not challenge board action, it is properly analyzed under *Rales*. Postorivo also asserts, however, that the board acquiesced to the write-down and ousted Postorivo from the business, and that those actions are inextricably intertwined. Because in that sense Postorivo arguably is challenging board action, I also examine the write-down under *Aronson*. Second, Plaintiffs challenge the board's removal of Postorivo as a director, the removal of Postorivo as president, and the cancellation of his junior preferred and common stock. According to Postorivo, the board's actions deprived KEE Action of his experience, reputation, and industry contacts, thereby wasting corporate assets and constituting a breach of the directors' fiduciary duties. Because this claim challenges board action, *Aronson*'s two prong test applies.

1. The inventory write-down

Dombrowski, either independently or in conjunction with one or more Defendants, wrote down the value of the business's assets to "liquidation firesale prices." Postorivo, in a derivative capacity, challenges the write-down as a waste of corporate assets.

Postorivo appears to argue demand futility for the write-down claim under both *Aronson* and *Rales*. KEE argues that, while *Rales* is the appropriate test for this derivative claim, Postorivo is not excused from demand under either analysis. I first

examine the write-down claim under *Rales*, which I consider the correct test. Extending the benefit of the doubt to Postorivo, I also examine that claim under *Aronson*. In each instance, I conclude Postorivo failed to plead sufficient facts to meet his burden under Rule 23.1.

a. The *Rales* analysis

Although Postorivo's claim stems from an alleged "liquidation firesale," the Complaint does not allege a single inventory sale, date, price, or transacting party, or any involvement of the board (other than acquiescence). Because Postorivo's write-down claim does not challenge a board action, *Rales* governs the demand futility analysis. This Court must determine whether or not the particularized factual allegations of the Complaint create a reasonable doubt that, as of the time it was filed, "the board of directors could have properly exercised its independent and disinterested business judgment in responding to demand."[25]

Postorivo's Complaint avers few, if any, particularized facts relating to that issue. In addition to the Director Defendants, the Complaint only mentions four other directors by name: Dan Bonhoff, David Freeman, Sean Murphy, and David Roberts.[26] As to these four directors, the Complaint alleges no particularized facts indicating misconduct, bias,

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[25] *Rales*, 634 A.2d at 934.

[26] While six directors would constitute a majority of the board, the Complaint simply mentions the names of these four without any further factual allegation of a disabling condition. Compl. ¶ 121.

disinterestedness, or lack of independence on the part of any of them. Instead, the Complaint conclusorily states:

> Any efforts to cause the directors of KEE Action, Inc. to bring the claims asserted in this action on behalf of KEE Action[,] Inc[.] is inevitably futile and is excused because Dombrowski, Leffel, Dan Bonhoff, David Freeman, Sean Murphy, and David Roberts, who constitute a majority of KEE Action[,] Inc.'s directors, are incapable of disinterestedly considering a demand to initiate an action on behalf of KEE Action, Inc. against KEE Action, Inc., Dombrowski and Leffel.[27]

This allegation merely states the standard. Thus, Postorivo's Complaint alleges nothing close to the fact-intensive, director-by-director analysis required to meet the pleading standard for demand futility.

The only other allegation in the Complaint specifically addressing the directors and demand futility asserts:

> Indeed, the particularized facts described above, which are incorporated by reference herein, raise a reasonable doubt both as to Director Defendants' disinterest and independence and as to whether their challenged actions were the product of a valid exercise of business judgment. Based upon the manner in which the business has been operated since the acquisition of assets, it is believed that the remaining directors are relying upon input and information provided by Dombrowski and Leffel as support for their actions, and they have not independently assessed the information or formed their own judgment concerning their actions, effectively rendering their conduct beholden to the actions of Dombrowski and Leffel.[28]

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27 *Id.*

28 *Id.* ¶ 122.

Postorivo argues this allegation supports a finding of demand futility, because the nondefendant directors were beholden to the Director Defendants, who were interested in the challenged actions.[29] Once again, however, Plaintiffs' allegation is conclusory and devoid of particularized facts to support that conclusion. Moreover, as to the four nondefendant directors, the Complaint fails to provide any pertinent facts on a director-by-director basis.

Rather than stating particularized factual allegations that raise a reasonable doubt that the board of directors could have exercised independent and disinterested business judgment in responding to a demand, the Complaint contains only vague accusations and restatements of the demand futility standards. Rule 23.1 requires more. Therefore, I find no reason to doubt that at the time the Complaint was filed the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.

b. The *Aronson* analysis

Postorivo's write-down claim does not appear to challenge a board action. If this claim did challenge a board action, however, Postorivo could not show demand futility

[29] I need not analyze the allegations specifically concerning the Director Defendants, Dombrowski and Leffel, because they do not constitute a majority of the board. Thus, even if the Complaint raises a reasonable doubt regarding the Director Defendants' ability to consider a demand, that alone would not establish demand futility. I therefore assume, without deciding, that Dombrowski and Leffel have a disabling interest.

under *Aronson* either.[30] Under *Aronson* demand is excused if a reasonable doubt is created that: (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[31]

To establish demand futility under *Aronson*'s first prong, a complaint must raise a reasonable doubt regarding the directors' disinterest and independence.[32] A plaintiff can establish that a specific director is interested by making allegations that, for example, the director will personally benefit from the challenged action or suffer as a result of the lawsuit. A plaintiff can establish that a specific director is not independent by alleging facts that suggest the director is dominated by a close personal or familial relationship or that the director is beholden to an interested director. This is necessarily a detailed, fact-intensive, director-by-director analysis.[33]

As to the *Aronson* analysis, I note preliminarily that Postorivo makes similar arguments for demand futility concerning the write-down, his ouster, and both claims in the aggregate. To avoid repetition, I discuss those arguments primarily in this section.

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30 Postorivo asserts that demand was futile because "the rest of the Board fully acquiesced in the Director Defendant's conduct as evidenced by the execution of the written consent removing Postorivo as director of KEE [A]ction, LLC." PAB at 31 n.1. According to Postorivo, the "sum total of all of these allegations," the acquiescence to Director Defendants' asset write-down and the affirmative actions taken by the board to deprive Postorivo of his role and stake in the company, excuse demand. Tr. at 35.

31 *Aronson*, 473 A.2d at 814.

32 *In re infoUSA, Inc. S'holders Litig.*, 2007 WL 2419611, at *13 (Del. Ch. Aug. 13, 2007).

33 *Id.*

Postorvio's Complaint fails to engage in the factually intensive, director-by-director analysis required by the first prong of *Aronson*. Rather, the Complaint often restates the standard for demand futility, making generalized allegations regarding most if not all directors, without any particularized factual support. Indeed, I already quoted and discussed in the preceding section the only allegations directly relevant to this inquiry. Thus, for the same reasons discussed in the *Rales* analysis, for purposes of the first prong of *Aronson*, the Complaint does not raise a reasonable doubt that a majority of KEE Action's directors are disinterested and independent.

To establish demand futility under *Aronson*'s second prong, a complaint must raise a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment. This is a high standard to satisfy. As Chancellor Chandler observed in *infoUSA*, "[a] plaintiff who seeks to excuse demand through the second prong of *Aronson* . . . faces a task closely akin to proving that the underlying transaction *could not have been* a good faith exercise of business judgment."[34]

According to the Complaint, Defendants deflated the value of the acquired business by excessively writing down inventory "to the point of liquidation firesale prices" and by conducting the "business in a way that was inconsistent with NPS's past business practices."[35] On its face, the fact that KEE Action may run the business differently than its predecessor NPS provides no basis to doubt that KEE Action's board

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[34] *Id.* at *1.

[35] Compl. ¶ 84.

acted in the proper exercise of their business judgment. Postorivo, however, provides little or no further support for his charge of egregious conduct.

Regarding the motivation for the write-down, the Complaint alleges: "In fact, it is further believed that the Defendants' course of action was dictated, not by profit motive, but instead by a desire to show to their lenders an artificially formulated balance sheet that would present a skewed financial picture of the company after the merger of assets."[36] The Complaint further alleges that all of Defendants' actions were part of a scheme to remove Postorivo from the business and the industry and to take assets without paying for them.[37] In both cases, the allegations are conclusory and lack a foundation of particularized facts which could cause a factfinder reasonably to doubt the board acted within the scope of the business judgment presumption.

The Complaint also alleges that "Dombrowski either independently, or in conjunction with one or more Defendants, intentionally dumped, at less than fair market value, much of the NPS inventory in order to meet certain compensation benchmarks contained in his employment agreement . . . ."[38] Because Postorivo failed to allege particularized facts to explain how the alleged misconduct benefited Dombrowski, the Court cannot ascribe much weight to this accusation. Additionally, the Complaint does

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36 *Id.*

37 *Id.* ¶¶ 86-87.

38 *Id.* ¶ 89. The language used in this allegation implies that an improper sale of inventory may have occurred. No specific averments in the Complaint support an inference to that effect. Indeed, the Complaint as a whole and the documents it incorporates suggest the contrary.

not allege with particularity that any other director was involved in the scheme, had an economic interest in it, or would be anything other than fully motivated to protect the rights of KEE Action, if such a scheme were apparent.

The Indemnity Notice attached as an exhibit to the Complaint states several reasons for the inventory write-down and bolsters the conclusion that there is no reason to doubt that any transactions approved by the board and related to Plaintiffs' write-down claim were the product of a valid exercise of business judgment. Regarding the types of inventory Plaintiffs mention, the Notice states: "The groups of inventory described below have been found to be obsolete, slow-moving, defective and in some instances, non-existent."[39] The Indemnity Notice amplifies this general statement, identifying specific assets with specific problems. For example, KEE Action reportedly wrote down the NPS gun inventory because the guns were old, of poor quality, and had high failure rates; and the empire trucks inventory because it did not exist.[40] These statements reflect an orderly and thorough process, inconsistent with Plaintiffs' charges of waste. For all these reasons, the second part of *Aronson* does not excuse Postorivo from making a demand related to the write-down claim.

Lastly, on the issue of demand futility generally, Postorivo asserts that if the Court concludes the Complaint states a claim for waste or breach of fiduciary duty, then the Court also must find, at the pleading stage, reasonable doubt that the board properly

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[39] Compl. Ex. D, the Indemnity Notice, at 4.

[40] Indemnity Notice at 4-5.

exercised its business judgment. This argument is not persuasive. The plaintiffs in *infoUSA*, like Plaintiffs here, argued that "where a complaint states a claim for waste, demand is necessarily excused."[41] Even well-pled allegations of waste, however, do not automatically excuse the requirement to make demand; a derivative plaintiff still must satisfy the requirements of the *Aronson* or *Rales* test, whichever is applicable.[42]

2. The Ouster of Postorivo

KEE Action's board removed Postorivo as a director, removed Postorivo as president, and shortly thereafter canceled Postorivo's junior preferred and common

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41 *infoUSA*, 2007 WL 2419611, at *14.

42 Additionally, as support for the *per se* rule, Postorivo cites *Orloff v. Schulman*, 2005 WL 3272355 (Del. Ch.). Chancellor Chandler, in *infoUSA*, addresses *Orloff*, and observes that the standard to establish a claim of waste of corporate assets is whether the consideration received by the corporation was "'so inadequate that no person of ordinary sound business judgment would deem it worth that which the corporation paid.'" *infoUSA*, 2007 WL 2419611, at *15 (quoting *Orloff*, 2005 WL 3272355, at *11). While this is not an impossible test to meet, "merely poor, misguided, or loss-making transactions are insufficient for a finding of waste." *Orloff*, 2005 WL 3272355, at *11. Postorivo relies on *Orloff v. Schulman*, and three other cases (*See* PAB at 32-34) which are factually distinct from the situation in this case. Each of the cases Postorivo relies on involved particularized allegations relating to specific transactions involving substantial waste which the board had affirmatively approved. Here, as previously mentioned, the Complaint does not allege a specific transaction that involved substantial waste; rather it only alleged a paper loss. Further, the Complaint's write-down waste claim did not allege board action. Moreover, the parties in this consolidated action vigorously dispute whether there was any "loss" at all, and that issue will be litigated in the context of Postorivo's direct claims. Postorivo's interest as to those claims is directly adverse to KEE Action. Unlike the situation in *Orloff v. Schulman* and the other cases cited by Postorivo the facts alleged here as to the write-down do not support a clear inference of waste, let alone an inability of the KEE Action board to make a good faith assessment of a demand.

stock.[43] Postorivo, in a derivative capacity, challenges these board actions as breaches of fiduciary duty. Because this derivative claim challenges a board action, the Court will employ the *Aronson* test to determine whether demand is excused.

As discussed in Part IV.B.1.b, *supra*, the parties make virtually the same arguments regarding demand futility under *Aronson* concerning Postorivo's ouster as they did concerning the write-down. For purposes of my analysis, any differences in Postorivo's arguments regarding his ouster are immaterial. Consequently, for the reasons previously stated, I find the Complaint does not raise a reasonable doubt that a majority of KEE Action's directors were disinterested and independent regarding Postorivo's ouster. Accordingly, demand was not excused under *Aronson*'s first prong.

As to *Aronson*'s second prong, Postorivo slightly varies his argument. For example, when addressing the claims in the aggregate, Postorivo argues based on the sum total of the allegations made in the Complaint, that no board of directors, exercising their business judgment in good faith, could have approved or stood idly by while Dombrowski and Leffel behaved as they did. Further, when solely addressing the ouster claim, Postorivo asserts that both parties intended for Postorivo to participate as an integral member in the new company, serving as president and a director, with an ownership stake in both common and junior preferred shares. He claims his experience,

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[43] Compl. ¶ 112 ("[O]n May 14, 2007 . . . KEE Action, Inc. purported to cancel and forfeit all shares issued to Postorivo under the APA, both the Junior Preferred Shares and the Common Shares, leaving him with no ownership interest in KEE Action, Inc. whatsoever."). *See* Compl. Ex. I, Notice of Transfer of Shares Pursuant to Pledge Agreement and Cancellation of Shares Pursuant to Restricted Stock Agreement.

reputation, and industry contacts created added value for KEE Action. Therefore, when the board acted to remove Postorivo as a director and president and to divest him of his stake in the business, the board's decisions could not have been the product of a valid exercise of business judgment.

I reject this argument for demand excusal. Indeed, Chancellor Chandler, in *infoUSA*, rejected similarly circular reasoning. In *infoUSA*, the Chancellor noted that the plaintiffs, attempting to compensate for the weakness of their particular allegations appealed to a collective unwholesomeness. Plaintiffs argued that demand was futile because no board, in the exercise of its business judgment, ever could have approved the challenged transactions. The Chancellor responded that such circular reasoning has been roundly rejected by this Court and if accepted would eviscerate the business judgment rule of any purpose.[44] The same reasoning applies to this case. Postorivo's arguments are circular and the Complaint did not plead sufficient facts to support a finding of demand futility under the second part of *Aronson*.

Therefore, neither the first nor the second part of *Aronson* excuses Postorivo from making a demand related to his derivative claims based on his ouster and other alleged breaches of fiduciary duty.

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[44] *infoUSA*, 2007 WL 2419611, at *2.

C. Standing

As a separate and independent ground for their motion to dismiss, Defendants also challenge Postorivo's standing to pursue a derivative claim on behalf of KEE Action. I believe that defense has merit, as well.

Once a plaintiff ceases to be a stockholder, whether by reason of a merger or otherwise, he or she loses standing to bring a derivative suit.[45] Postorivo ceased to be a stockholder of KEE Action on May 14, 2007, when his shares were canceled and forfeited. That was two weeks before he filed this action. Under Delaware law, however, at least two exceptions exist to the general standing rule as applied to mergers: (1) if the merger itself is the subject of a claim of fraud; and (2) if the merger is in reality merely a reorganization which does not affect plaintiff's ownership in the business enterprise.[46]

Postorivo argues this case falls squarely within the first exception. According to Postorivo, KEE Action exercised its rights under a pledge agreement based on the wasteful firesale of NPS's inventory and merely to deprive Postorivo of his standing to bring a derivative action. Thus, he contends that action was fraudulent in and of itself, and the Court must apply the exception under *Lewis* and recognize his standing. In response, KEE Action questions Plaintiffs' reliance on *Lewis*. According to KEE Action,

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[45] *See Lewis v. Anderson*, 477 A.2d 1040, 1046 (Del. 1984) (holding in the context of a corporate merger that "a derivative shareholder must not only be a stockholder at the time of the alleged wrong and at time of commencement of suit but . . . must also maintain shareholder status through the litigation.").

[46] *Id.* at 1046.

Lewis and the cases it cites deal exclusively with the narrow question of the effect of a merger on standing to bring a derivative suit relative to 8 *Del. C.* §§ 327 and 259(a) and Rule 23.1. In contrast, KEE Action argues, this case does not involve a merger transaction, but rather the alleged deprivation of shares under a contractual forfeiture provision in a pledge agreement. Moreover, KEE Action contends the claims arising from that deprivation are not derivative, but direct in nature because they do not involve injury to KEE Action (they involve injury to Postorivo) or fiduciary duties owed to KEE Action (as opposed to an alleged contractual obligation).

As merely a former stockholder, Postorivo presumptively lacks standing to be a derivative plaintiff. If he believes KEE Action's board wrongly deprived him of his shares, he may assert direct claims to right the alleged wrong, which he has done.[47]

I find unpersuasive Postorivo's argument that this case falls within the first exception articulated in *Lewis*. The courts previously have applied that exception only in the merger context. Postorivo's situation involves the deprivation of shares under a contractual forfeiture provision; thus, it is factually distinguishable. Postorivo further asserts the exception targets transactions that are themselves the subject of a claim of fraud in that they were perpetrated merely to deprive shareholders of standing to bring a derivative action. The allegations in the Complaint, however, do not support a reasonable

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[47] *See Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1188 (Del. 1988) ("Standing to pursue a derivative claim for injury to the corporate entity should not be confused with the right of a former shareholder claimant to assert a timely filed private cause of action premised upon a claim of unfair dealing, illegality, or fraud.").

inference that KEE Action's board canceled Postorivo's shares merely to deprive him of standing to pursue a derivative action. The Complaint and related documents evidence a genuine dispute among the parties in which Postorivo and KEE Action view the facts quite differently. Postorivo can, and is, seeking to establish his version of the facts through a direct claim against KEE Action involving the same facts that would be involved in a derivative action. Presumably, KEE Action's board recognized the possibility that Postorivo would challenge the disputed transactions in that way. Such a claim would go forward whether or not Postorivo also attempted to assert a derivative claim. In these circumstances and in the absence of any nonconclusory factual allegations to the contrary, I find no reasonable basis in the Complaint to infer that KEE Action's board canceled Postorivo's junior preferred and common shares merely to deprive him of the opportunity to bring a derivative suit.

Therefore, because Postorivo owns no stock in KEE Action and fails to qualify under the exceptions outlined in *Lewis*, assuming they would apply here, I hold Postorivo has no standing to bring a derivative suit on behalf of KEE Action.[48]

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[48] Postorivo also argues that if he is not allowed to pursue this claim, KEE Action will never recoup the $10 million it allegedly lost. Tr. at 35. I find no merit to this argument. It might be more convincing if the Complaint alleged an actual sale of inventory at less than fair market value. The Complaint alleges only a write-down, however, and a dispute exists as to whether or not KEE Action's accounting treatment is correct. Postorivo attributes the reduction in value to Defendants; and Defendants contend it reflects Postorivo's wrongdoing. Further, Defendants have taken actions and are pursuing claims based on the APA and related agreements, *e.g.*, the indemnity action, regarding this dispute. Consequently, KEE Action and its shareholders are not without a remedy if Postorivo is denied standing to bring a derivative claim on their behalf.

V. CONCLUSION

For the reasons stated, I deny as moot Defendants' motion to dismiss any aspects of the Complaint that suggest KEE Action is directly asserting a claim in this action. The motion to dismiss is granted, however, as to all derivative claims brought on behalf of KEE Action. I therefore dismiss Counts I and IV in their entirety and the derivative portion of all other counts that include a claim that is derivative in nature.

IT IS SO ORDERED.