EFiled: Mar 15 2012 6:09PM EDT
Transaction ID 43121822
Case No. 6539-VCL

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

THEODORE V. BUERGER, PHILIP D. GUNN, and JERRY SESLOWE,	)	
Plaintiffs,	)	
v.	)	C.A. No. 6539-VCL
DENNIS APFEL, JASON APFEL, and ERIC APFEL,	)	
Defendants,	)	
and	)	
FRAGRANCENET.COM, INC., a Delaware corporation,	)	
Nominal Defendant.	)	

MEMORANDUM OPINION

Date Submitted: February 14, 2012
Date Decided: March 15, 2012

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LASTER, Vice Chancellor.

This derivative action challenges a series of related-party transactions. The defendants have moved for judgment on the pleadings, contending that laches bars the bulk of the claims. They are partly right. Laches bars the challenges to certain stock options granted in 2004 and 2005. Laches also bars a portion of the challenges to compensation received under certain employment agreements and a rent-free sublease. With respect to these claims, the doctrine applies to the extent the compensation was paid and rent-free space provided before March 18, 2008. The doctrine does not apply to the extent that compensation was paid and rent-free space provided on or after March 18, 2008. On a final set of claims, I grant the plaintiffs leave to replead, because although the complaint alleges facts sufficient to invoke the doctrine of equitable tolling, the pleading fails to identify when the plaintiffs subsequently found out about the self-dealing transactions.

I. FACTUAL BACKGROUND

Fragrancenet.com, Inc. (the "Company") sells brand-name fragrances and related products over the internet. Dennis Apfel and his sons Jason and Eric control the Company. Collectively, the Apfels own approximately 68% of the Company's outstanding stock, and they comprise the entire board of directors. Dennis serves as Chief Executive Officer, and Jason serves as President and Chief Operating Officer. Eric, a line employee, holds the titles of Vice President and Secretary.

Dennis and Jason formed the Company's predecessor in 1997. Plaintiffs Theodore V. Buerger and Philip D. Gunn invested $100,000 in the start-up and received a 30%

equity stake. Buerger currently owns 9% of the outstanding stock. Gunn currently owns 10%. Plaintiff Jerry Seslowe owns 1%.

In 1999, the Company raised $500,000 through a reverse merger with National Capital Management Corporation, a publicly listed entity. From 1999 until 2005, the Company's common stock traded on Nasdaq under the symbol "FGNT1."

In 2005, the Company effected a reverse split, delisted, and stopped sending financial statements and other information to its stockholders. The Company's common stock continues to trade in the over-the-counter market.

The complaint challenges a series of transactions between the Company and the Apfels. I discuss each transaction as part of the legal analysis. I do not discuss the claims involving JASER Realty LLC, because the defendants concede those claims are timely.

II. LEGAL ANALYSIS

"After the pleadings are closed but within such time as not to delay the trial, any party may move for judgment on the pleadings." Ct. Ch. R. 12(c). "In considering a motion for judgment on the pleadings, the Court must be satisfied that there are no material facts in dispute, and it must draw all reasonable inferences from those facts in the light most favorable to the nonmoving party." *CorVel Enter. Comp, Inc. v. Schaffer*, 2010 WL 2091212, at *1 (Del. Ch. May 19, 2010). "The Rule 12(c) standard has been described as 'almost identical' to the Rule 12(b)(6) standard and favors the plaintiff." *Petroplast Petrofisa Plasticos S.A. v. Ameron Int'l Corp.*, 2009 WL 3465984, at *7 (Del.

Ch. Oct. 28, 2009) (footnote omitted) (quoting *Acierno v. Goldstein*, 2004 WL 1488673, at *2 (Del. Ch. June 25, 2004)).

In this case, the defendants attempted to support their Rule 12(c) motion with a detailed factual affidavit and a host of documents. I have disregarded the affidavit and any documents not specifically referenced in the pleadings.

The defendants invoke the doctrine of laches. Although a laches analysis is often fact-intensive, the doctrine can be applied at the pleadings stage if "the complaint itself alleges facts that show that the complaint is filed too late." *Kahn v. Seaboard Corp.*, 625 A.2d 269, 277 (Del. Ch. 1993) (Allen, C.).

The parties agree that the presumptive limitations period for laches is three years. *See* 10 *Del. C.* § 8106; *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 860 A.2d 312, 319 (Del. 2004). The parties further agree that an additional seventy-seven days should be added to the limitations period because of a tolling agreement. The plaintiffs have not argued that the limitations period should be extended further to account for their efforts to obtain books and records pursuant to 8 *Del. C.* § 220.[1] In light of the parties' agreements, any claim that arose before March 18, 2008 is presumptively time-barred.

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[1] *See, e.g.*, *Sutherland v. Sutherland*, 2009 WL 857468, at *5 (Del. Ch. Mar. 23, 2009) ("The applicable three-year statute of limitations was tolled, however, during the pendency of the plaintiff's Section 220 action."), *clarified*, 2009 WL 1177047 (Del. Ch. Apr. 22, 2009); *Technicorp Int'l II, Inc. v. Johnston*, 2000 WL 713750, at *9 (Del. Ch. May 31, 2000) ("It is settled Delaware law that the institution of other litigation to ascertain the facts involved in the later suit will toll the statute while that litigation proceeds."); *Gotham P'rs, L.P. v. Hallwood Realty P'rs, L.P.*, 714 A.2d 96, 105 (Del. Ch. 1998) (noting that plaintiff could defeat a laches defense by showing "that it asserted its rights in a timely manner by making demand and filing [a books and records] action").

A. The Employment Agreements

In August 2003, each of the Apfels entered into an employment agreement with the Company. The directors approved the agreements in round-robin fashion. Each abstained from voting on his own agreement, which was approved by the other two. The agreements granted the Apfels base salaries of $150,000, subject to a potentially lucrative one-way ratchet. Each year, the Company would pay each of the Apfels an annual incentive bonus equal to 1% of the amount by which the Company's sales increased over the prior year, and in the ensuing year the base salaries would increase by the amount of the incentive bonus. The agreements did not place any ceiling on the escalation formula, nor did they contemplate reducing the Apfels' compensation if sales declined.

Over time, the upward-only feature produced dramatic increases in compensation. By 2010, the Apfels' salaries and bonuses equaled approximately 10% of the Company's gross profit. In 2011, the Apfels each earned roughly $1.3 million. No other Company employee receives more than $200,000.

In April 2009, the Apfels amended their employment agreements to add severance arrangements. Jason and Eric received the right to a severance payment equal to 75% of their salary during the year before termination. Jason could retire and receive the payment at fifty-seven, Eric at fifty-five. Dennis received the right to a post-termination, ten-year consulting agreement with the Company that will pay him annual compensation equal to 75% of his salary during the year before termination plus 50% of his average incentive bonus over the five years before termination. Under the agreement, Dennis will be required to spend only fifteen hours per month on Company business.

The complaint contends that the Apfels breached their fiduciary duties by adopting the employment agreements in 2003, receiving excessive compensation, and amending the agreements in 2009. The defendants agree that the challenge to the 2009 amendments is timely.

The attack on the initial adoption of the employment agreements is untimely. The agreements were approved more than four years before the March 18, 2008 tolling date.

The attack on the compensation received is untimely to a degree. According to the defendants, because the attack on the initial adoption of the agreements fails, the plaintiffs cannot challenge any of the compensation that the Apfels received. The defendants rely on *Coca-Cola Enterprises*, in which this Court dismissed a claim challenging actions that "were the foreseeable results of a contract formed" twenty years earlier. *In re Coca-Cola Enters., Inc.*, 2007 WL 3122370, at *6 (Del. Ch. Oct. 17, 2007), *aff'd sub nom. Int'l Bhd. Teamsters v. Coca-Cola Co.*, 954 A.2d 910 (Del. 2008). But *Coca-Cola Enterprises* does not perpetually immunize contractual benefits from attack. When fiduciaries have the power to terminate or modify an agreement, the decision to leave the agreement in place and continue to receive self-dealing benefits can be challenged as a breach of duty. *Teachers' Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654, 666 (Del. Ch. 2006).

Here, the Company could terminate the employment agreements on thirty days written notice, and the Apfels had the power to amend the employment agreements at their convenience. Under *Aidinoff*, the plaintiffs may challenge the fairness of the Apfels' failure to terminate or modify their employment agreements and the compensation they received during the period from March 18, 2008 through the present. Because any challenge to the initial decision to enter into the employment agreements is time-barred, the fairness analysis must take into account the contractual rights that the Apfels possess. In other words, the plaintiffs must litigate the fairness of the compensation in a world where the employment agreements validly exist and where a termination decision would have contractual consequences. *See Hokanson v. Petty*, 2008 WL 5169633, at *5-8 (Del. Ch. Dec. 10, 2008) (analyzing alleged fiduciary breach in 2007 in the context of contractual obligations under agreement entered into in 2003 as to which fiduciary challenge was time-barred). Any challenge to compensation received before March 18, 2008 is untimely.

B. The Office Lease

In addition to serving as part-time CEO of the Company, Dennis is a partner at Miller, Apfel & Curran, P.L.L.C, a law firm specializing in divorce work and family law. Since 2006, the Company has provided Dennis's firm with office space in its headquarters. There is no written lease, and the firm does not pay rent. Rather, the parties have an informal rent-for-services arrangement. It is reasonably conceivable at the pleading stage that the Company would not have much need divorce work.

Although the rent-for-services relationship began in 2006, the Company can terminate the informal arrangement at any time. Under *Aidinoff*, the plaintiffs can challenge the sublease from March 18, 2008 onward. Challenges to the sublease for the period before March 18, 2008 are barred by laches.

C. The Personal Loan To Jason

On May 8, 2007, Dennis and Eric approved a personal loan for Jason in the amount of $600,000. The loan bears interest at 7% and is due on demand. The Company disbursed the funds in June 2007. Any claim attacking the loan arose at that time.

In their brief opposing the defendants' motion for judgment on the pleadings, the plaintiffs argue for equitable tolling. Under this doctrine, the limitations period will not run on claims for wrongful self-dealing when "a plaintiff reasonably relies on the competence and good faith of a fiduciary." *Weiss v. Swanson*, 948 A.2d 433, 451 (Del. Ch. 2008). The doctrine recognizes that "[s]ince trust and good faith are the essence of [the fiduciary] relationship, it would be corrosive and contradictory for the law to punish reasonable reliance on that good faith by applying the statute of limitations woodenly or automatically to alleged self-interested violations of trust." *Seaboard*, 625 A.2d at 275. "[R]elief from the [running of the limitations period] extends only until the plaintiff is put on inquiry notice." *In re Tyson Foods, Inc.*, 919 A.2d 563, 585 (Del. Ch. 2007). Accordingly, "[a] plaintiff asserting a tolling exception must plead facts supporting the applicability of that exception." *State ex rel. Brady v. Pettinaro Enters.*, 870 A.2d 513, 525 (Del. Ch. 2005). The plaintiff bears this pleading burden because facts "relating to when plaintiff learned of the [challenged transaction] . . . ; when he had notice of facts concerning possible unfairness of the terms; and the reasonable steps he took to oversee his investment, are matters within plaintiff's knowledge." *Seaboard*, 625 A.2d at 277.

The complaint alleges that in 2005, the Company "stopped sending financial statements and other similar financial information to its shareholders." Compl. ¶ 12. The complaint also alleges that "an examination of the financial statements *recently* provided to Mr. Buerger and Mr. Gunn by [the Company] (attached hereto as Exhibit 1) revealed a number of questionable transactions." *Id.* ¶ 15 (emphasis added). After becoming concerned, Gunn and Buerger served a books and records demand and obtained documents from the Company. *Id.* ¶¶ 16-17. It is undisputed that the books and records request was served in 2010.

Based on the allegations in the complaint, it is reasonably conceivable that the plaintiffs did not learn of the loan to Jason until after the tolling date. Nevertheless, the plaintiffs have not met the pleading requirements for equitable tolling because they failed to identify the date when they learned of the loan. Without this information, the doctrine of equitable tolling cannot be applied.

Because it appears likely that equitable tolling should apply, fairness requires that the plaintiffs be granted leave to amend their complaint to cure this isolated omission. Because the defendants have filed the operative motion under Rule 12(c), Rule 15(aaa) does not limit the plaintiffs' ability to replead. Ct. Ch. R. 15(aaa) ("[A] party that wishes to respond to a *motion to dismiss under Rules 12(b)(6) or 23.1* by amending its pleading must file an amended complaint, or a motion to amend in conformity with this Rule, no later than the time such party's answering brief in response to either of the foregoing motions is due to be filed.") (emphasis added); *see Lillis v. AT&T Corp.*, 896 A.2d 871, 878 (Del. Ch. 2005) ("Although it would seem true that some of the same concerns that prompted the court to adopt Rule 15(aaa) are present [on a Rule 12(c) motion] . . . , the language of the rule makes it clear that it does not apply in this case.").

D. The Stock Options

Dennis and Jason have approved multiple rounds of stock options for Eric. In November 2004, Dennis and Jason granted Eric options to acquire 500,000 shares at an exercise price of $0.75 per share. In August 2005, after receiving a report that valued the Company's stock at $0.97 per share, Dennis and Jason lowered the strike price on Eric's options to $0.25 per share. In December 2005, Dennis and Jason granted Eric options to acquire an additional 250,000 shares at an exercise price of $0.40 per share. According to the complaint, in April 2009, Dennis and Jason granted Eric options to acquire another 75,000 shares at an exercise price of $0.13 per share.

Except for the 2009 grant, any cause of action relating to the stock options accrued before March 18, 2008. The complaint does not contain allegations that would support equitable tolling with respect to the 2004 and 2005 option grants, and the plaintiffs do not argue for equitable tolling. The challenges to the pre-March 18, 2008 option grants are therefore time-barred.

The challenge to the 2009 grant may proceed. The defendants contend vigorously that this grant did not go to Eric but rather to other Company employees. To that end, the defendants submitted documents purporting to show that the 2009 options were not issued to Eric. I have not considered these documents, which "are not . . . cognizable on a Rule 12 motion." *Pettinaro Enters.*, 870 A.2d at 524.

E. The Déjà View Real Estate Transaction

In 2006, the Apfels decided that the Company needed a larger facility. They formed a new entity, Déjà View Realty LLC, owned not by the Company but rather by themselves. During a board meeting on December 21, 2006, they authorized the Company to advance $1.8 million to Déjà View in the form of a non-interest-bearing loan, payable on demand, and further authorized the Company to backstop Déjà View by guaranteeing up to $8.5 million in debt. The Apfels planned for Déjà View to use the funds to acquire land and construct a new corporate headquarters and distribution facility. The Company then would lease the facility from Déjà View.

During 2007, 2008, and 2009, the Apfels caused the Company to advance to Déjà View approximately $1,186,555. Unfortunately, the construction project was a failure. In 2009, the Apfels decided to abandon the project and caused the Company to write off the $1,186,555 receivable from Déjà View. In 2011, after receiving the plaintiffs' Section 220 demand, the Apfels decided to have Déjà View reimburse the Company on terms set unilaterally by the Apfels.

The complaint challenges four temporally distinct decisions with respect to Déjà View: the initial deal in 2006, the advances in 2007, 2008, and 2009, the write-off in 2009, and the repayment in 2011. The latter two decisions fall within the limitations period, and challenges to those decisions may proceed.

The advances took place both before and after the March 18, 2008, tolling date. The plaintiffs can challenge any advances that post-dated March 18, 2008. For earlier advances, they rely on equitable tolling. but they have not pled when they learned of the advances. For the same reasons discussed with respect to the loan to Jason, the plaintiffs have leave to file an amended complaint curing this omission.

The original decision to form and fund Déjà View occurred approximately two years before March 18, 2008. The plaintiffs again argue for equitable tolling, but the complaint again fails to address when they learned of the transaction. Instead, the plaintiffs asserted in their answering brief that they first learned of the Déjà View transaction in July 2008. Here too, and for the same reasons, the plaintiffs may replead their claim.

III. CONCLUSION

The plaintiffs shall have sixty days in which to file an amended complaint and replead their challenges to (i) the loan to Jason, (ii) advances to Déjà View prior to March 18, 2008, and (iii) the decision to form and fund Déjà View. The challenges to the options granted in 2004 and 2005 are time-barred. The challenges to the rent-free sublease and the employment agreements are time-barred for the period before March 18, 2008. In all other respects, the defendants' motion for judgment on the pleadings is denied. **IT IS SO ORDERED.**