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Commonwealth Of Kentucky

Court of Appeals

NO. 2005-CA-001775-MR

THOMAS G. WHITE, DERIVATIVELY ON BEHALF OF VENCOR, INC., A DELAWARE CORPORATION, AND VENTAS, INC., FORMERLY VENCOR, INC. — APPELLANT

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE JUDITH E. MCDONALD-BURKMAN, JUDGE
ACTION NO. 98-CI-003669

W. BRUCE LUNSFORD; E. EARL REED, III; MICHAEL R. BARR; THOMAS T. LADT; JILL L. FORCE; JAMES H. GILLENWARTER, JR; R. GENE SMITH; WALTER F. BERAN; ULYSSES L. BRIDGEMAN; ELAINE L. CHAO; DONNA R. ECTON; GREG D. HUDSON; AND WILLIAM H. LOMICA — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: COMBS, CHIEF JUDGE; GUIDUGLI AND JOHNSON, JUDGES.

COMBS, CHIEF JUDGE: On behalf of Ventas, Inc., a Delaware corporation, Thomas G. White appeals from an order of the Jefferson Circuit Court dismissing this shareholder derivative action. We have reviewed the substantive requirements of

Delaware law along with the arguments of counsel. We agree that the complaint fell short of the threshold requirement that there be a **specific showing** of impropriety on the part of the defendants. Under the relevant law, White bore the burden to demonstrate particularized facts that the defendants were tainted by self interest or that they failed to exercise sound business judgment in conducting the affairs of the corporation. Absent such particularity, relevant principles of corporate law justify dismissal of a complaint. We conclude that the court did not err in dismissing the complaint.

Ventas is a publicly traded real estate investment trust headquartered in Louisville. Prior to a corporate reorganization in 1998, the company was known as Vencor, Inc. It operated a national network of integrated healthcare facilities located on real estate that it owned and managed.

A Wisconsin resident and Ventas shareholder, Thomas White, filed suit in Jefferson Circuit Court in 1998 against ten members of the company's board of directors and three of its non-director officers. (He filed an amended complaint within a few days.) In the name of the interests of the corporation, White alleged that the defendants had violated their fiduciary duties to the company from February 10, 1997, through October 21, 1997. During that period, White alleged that the company's officers conspired to inflate the value of the corporation's stock and that they then dumped substantial portions of their holdings. He alleged that the directors were complicit in making false or

misleading statements about the company's operations and its anticipated performance. He also charged that they failed to properly oversee the management of the company, a dereliction that resulted in grave financial harm to Ventas.

In August 1998, the defendants filed a motion to dismiss the action. They relied on a substantive requirement of Delaware's corporate law known as the "demand rule." Under the demand rule, a stockholder can file a derivative action only after he has first made a demand upon the corporation's board of directors to take action in light of his allegation and it has refused to do so. He may be relieved or excused of making a pre-lawsuit demand on the directors only if he can demonstrate that the making of such a demand would be futile because the directors are clearly incapable of making an impartial decision regarding litigation. Levine v. Smith, 591 A.2d 194, 200 (Del.1991). When the action is based on the inability of the directors to act, the stockholder's complaint must state **with particularity** why a demand on the directors to assert a claim would have been futile. Beam v. Stewart, 845 A.2d 1040 (Del.2004).

In their motion to dismiss, the defendants contended that prior to filing the derivative action, White failed to make a demand of the company to pursue the alleged claims involving corporate affairs or that he failed to properly plead in his complaint that such a demand would have been futile. They alleged that both omissions were fatal. Before the court could

consider the motion of the defendant, the proceedings were stayed for various reasons over a prolonged period of time. At long last, on July 26, 2005, an order was entered dismissing the action.

Twenty-two days after this dismissal, White filed two post-judgment motions. Procedurally, he sought permission of the court to file motions out of time based on an inadvertent mistake of counsel. Substantively, he sought to have the judgment set aside in order that he might file a second amended complaint "more concisely setting forth the facts." On August 24, 2005, the trial court summarily denied White's post-judgment motions. This appeal followed.

White raises two alternative issues for our consideration on appeal. He first argues that the trial court erred in concluding that the complaint was deficient; namely, that it failed to charge that a demand on the company's board of directors would have been futile. In the alternative, White contends that the trial court erred by refusing to permit him to file a second amended complaint. We disagree with both of his arguments.

The parties agree that Delaware law governs the substantive issues on appeal and that the demand rule is dispositive. White acknowledged his failure to demand that the company's board of directors take action against the alleged wrongful conduct. Accordingly, he bore the burden to

demonstrate in detail (*i.e.*, with "factual particularity") that any demand on the corporation would have been futile.

Delaware's stringent requirement for factual particularity is based on streamlining and expediting discovery. It is intended to prevent a stockholder from causing a corporation "to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinion or speculation." Brehm v. Eisner, 746 A.2d 244, 255 (Del.2000). The requirement for factual specificity means that a complaint must be dismissed -- regardless of the strength of the claim as alleged on its merits -- if that specificity as to underlying facts has not been established.

In cases where a complaining shareholder alleges that a demand upon a company's board of directors would have been futile, Delaware courts have established two separate (yet overlapping) lines of inquiry. If the shareholder's complaint challenges a specific event or transaction approved by a board of directors, Delaware courts apply a two-prong test set forth by the Delaware Supreme Court in Aronson v. Lewis, 473 A.2d 805 (Del.1984) (the Aronson test). If no specific action undertaken by the board is challenged, however, Delaware courts apply a single-step inquiry set forth in Rales v. Blasband, 634 A.2d 927 (Del.1993) (the Rales test). White's complaint implicates both tests.

White alleged numerous facts in his complaint, which the trial court accepted as true in ruling on the motion to dismiss. He claimed that company executives made overly positive and optimistic statements to market analysts and others during a February 1997 conference call. He believed that these statements affected Wall Street's quarterly earnings projections for the company, causing brokerage firms to reiterate their "buy" or "strong buy" recommendations for the stock. He also criticized the corporation's annual report to shareholders (issued in March 1997) for failing to caution against the sector's possibly harmful exposure to proposed Medicare reforms being considered by Congress at that time.

White alleged that management once again misled analysts following the release of its first quarter earnings results in April 1997. He claimed that the favorable, forward-looking statements affected the corporation's stock price, driving it upward to the benefit of its executives and directors. Despite a clear need to warn its stockholders, White believed that management continued to downplay the potential impact of reduced federal healthcare spending, emphasizing instead only robust growth projections.

White alleged that executives misled analysts and stockholders in press releases filed in May 1997 concerning the corporation's acquisition of Transitional Hospital Corporation for $639 million dollars. He charged that management's excessively optimistic predictions concerning this asset

continued through early July, causing analysts to reiterate or to enhance their ratings of the stock that resulted in a boost to share prices. White claimed that the company's officers and directors sold more than 118,600 shares of stock at an average price of $42.55 per share at or near this time. One brokerage firm actually had a $51.00 per share price tag on the stock.

At the end of July 1997, the corporation announced its second quarter earnings results, which matched analysts' expectations. According to White, management continued to make rosy, forward-looking projections and to minimize the risks associated with changing federal budget demands. On September 5, 1997, R. Gene Smith, a member of the board of directors, sold 16,876 shares of stock.

According to White, the corporation routinely and repeatedly made positive representations about operating trends and growth opportunities at industry conferences, in press releases, and in conference calls. On September 18, 1997, he alleged that Jill L. Force, a senior vice-president and the company's general counsel, sold 39% of her holdings. At the same time, Earl Reed, the company's chief financial officer, sold 28% of his holdings.

On October 22, 1997, the company revised its fourth quarter guidance. Its announcement indicated that earnings per share would fall considerably short of analysts' expectations. The predicted shortfall was attributed by the company to the negative impact of federal budget changes related to Medicare

reimbursement. The company's stock price plunged 28% during the trading day, and analysts quickly began to lose confidence in the company's growth prospects.

White alleged that throughout the entire period at issue, the company's officers and directors knew that the corporation was being grossly mismanaged and that federal budget changes would inevitably have a severely negative impact on the company's growth and earnings. Nevertheless, the officers and directors continued to mislead the market analysts and the investing public about the company's performance and prospects. He also claimed that the company had paid too much when it purchased Transitional Hospital Corporation. He believed that it had over-compensated W. Bruce Lunsford, the company's chief executive officer; W. Earl Reed, the chief financial officer; and Michael R. Barr, the chief operating officer. He contended that company insiders sold $9.5 million in stock at artificially inflated prices. Finally, he charged that the managers and directors exposed the company to a multi-million dollar federal securities class action and that they otherwise damaged the company's finances and reputation.

For purposes of our discussion, the numerous allegations contained in White's complaint can be grouped into the following three categories:

> 1. <u>The disclosure counts</u>: the false, irrationally optimistic, and misleading forward-looking statements about the financial condition, good management, and

growth opportunities of the company (subject to the Rales test);

2. The waste counts: the cost of acquiring Transitional Hospital Corporation and the excessive compensation packages of the three top executives (subject to the Aronson test);

3. The insider-trading counts: insider trading and the proceeds realized from that trading (subject to the Rales test).

Only the waste counts appear to challenge specific and direct board action; *i.e.*, board approval for the acquisition of Transitional Hospital Corporation and approval for the compensation packages offered to three executives.

In analyzing the charges contained in the complaint, we apply the Delaware court's two-part Aronson test to determine whether White has asserted particularized facts sufficient to demonstrate why a demand upon the board would have been futile as to the waste counts. Since the disclosure counts and insider-trading counts do not challenge specific or direct action undertaken by the board as a whole, they will be analyzed under the Rales test. We shall examine the categories individually, beginning our discussion with the waste counts.

The Waste Counts (The Aronson Test)

In order to avoid dismissal under the demand rule, Aronson requires that a plaintiff's allegations raise a reasonable doubt by satisfying either of two criteria: (1) that a majority of the directors were not disinterested and independent and (2) that the challenged transaction was not the

result of a valid exercise of sound business judgment. Aronson, 473 A.2d at 814. To assess the requisite disinterestedness and independence of directors, we consider whether the plaintiff has pleaded particularized facts that demonstrate that the directors were motivated by personal interest, domination, or control. If so, their personal interests would have prevented them from objectively evaluating a demand -- if made -- that the board pursue the best interests of the corporation. Brehm, supra. To assess whether the transaction was undertaken as part of the board's exercise of its business judgment, we consider whether the directors were proper persons to conduct litigation on behalf of the corporation.

White named ten of the company's directors as defendants in the derivative action. Of these, six (Beran, Bridgeman, Chao, Ecton, Hudson, and Lomica) were neither officers nor employees of the company. White alleged no particularized facts to suggest that any of these "outside directors" would have been unable to act independently or disinterestedly if he had he demanded action of them. Instead, White relied on the second Aronson test by claiming that the challenged transactions (*i.e.*, the excessive executive compensation packages and the huge consideration paid by Ventas to acquire Transitional Hospital Corporation) -- constituted corporate waste and that they were not the product of a valid exercise of the board's business judgment.

Corporate directors enjoy substantial deference in exercising their business judgment on behalf of a corporation. Delaware law presumes that a corporation's directors make business decisions on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company. Aronson, 473 A.2d at 812. This presumption of regularity is commonly referred to as the "business judgment rule."

Under the business judgment rule, directors exercise very broad discretion in making decisions relating to executive compensation. See Brehm, 746 A.2d 244. The standard for determining corporate waste is also rigorous and requires proof that directors irrationally squandered or gave away corporate assets. Id.

The waste counts of White's complaint essentially consisted of conclusory allegations. He was quite clear in articulating his personal disagreement with the board's judgment as to the value of retaining top executives and of acquiring Transitional Hospital Corporation. However, he did not allege that the board failed to review and to consider available and relevant information concerning either decision. He did not allege an absence of adequate or substantial consideration inuring to Ventas in exchange for the corporate assets paid to compensate the executives and for the asset represented by the acquisition of Transitional Hospital Corporation. On balance, the allegations were insufficient to overcome the presumption of

regularity or to raise a reasonable doubt that the directors validly exercised sound business judgment with respect to both issues.

The Disclosure Counts and the Insider-Trading Counts (The <u>Rales</u> Test)

We shall next address the disclosure counts and the insider-trading counts of White's complaint. In these counts, White did not complain of any specific transaction or enterprise undertaken by the board as a whole. Nor did he allege that the board members had an affirmative duty to act in a particular manner and that they disregarded that duty. Rather, he claimed in general terms that the board was complicit in the challenged conduct and that it was lax in its management of the affairs of the company. Under these circumstances, the allegations of the complaint are analyzed under the <u>Rales</u> standard.

Under <u>Rales</u>, <u>supra</u>, a court essentially applies the first prong of the <u>Aronson</u> test to determine whether the complaint asserted particularized facts sufficient to create "a reasonable doubt that . . . the board of directors could have properly exercised its independent and disinterested business judgment in responding to a stockholder's a demand for action." 634 A.2d at 934. Under this inquiry, the court then asks whether any of the directors was rendered "interested" by the

conduct at issue and, if so, whether the disinterested (impartial) directors were nonetheless capable of acting independently from those interested (partial) directors. Id. A director is considered "interested" if he or she: (1) received from the challenged conduct or transaction a personal financial benefit that was not equally shared by the other stockholders; (2) might have suffered "a materially detrimental impact" from the proposed legal action; or (3) was "incapable, due to domination and control, of objectively evaluating a demand, if made, that the board assert the corporation's claims." Rales 634 A.2d at 936.

Pursuant to subsection (1) of the Rales test, White's complaint does not contain factual allegations sufficiently particularized to raise a reasonable doubt as to whether the Ventas board of directors could have -- or would have -- properly exercised its independent, disinterested business judgment in responding to a demand for action if he had posed such a demand prior to filing suit. White did not allege that the outside directors, who comprised a majority of the board, received any personal benefit (in the sense of self-dealing) from any of the challenged transactions so as to render those directors incapable of properly responding to the concerns of a shareholder.

Additionally, pursuant to subsection (2) of the Rales standard, White did not sufficiently plead that any of the outside directors would have been unwilling to act on behalf of

the company because they would have been subject to "a substantial likelihood" of liability stemming from legal action.

The complaint's bare and unsubstantiated allegation that the outside directors participated in the challenged conduct falls far short of meeting the strict pleading requirement. In Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1055 (Del.Ch. 1996), the Delaware court observed that:

> the simple expedient of naming a majority of otherwise disinterested and well-motivated directors as defendants and charging them with laxity or conspiracy etc., will not itself satisfy the standards for permitting a shareholder to be excused from demand.

Finally, pursuant to subsection (3) of the Rales rule, we note that White did allege that the outside directors were so motivated by improper influences as to be arguably dominated by -- or beholden to -- Lundsford, Reed, and Barr (the company's chief executive officer, chief financial officer, and chief operating officer, respectively). However, that bare allegation was insufficient to meet the strict requirement of particularity. The Delaware courts have consistently held that an unsupported, conclusory allegation of "domination" does not excuse demand. Aronson, 473 A.2d at 815. Instead, the plaintiff must allege specific facts that would demonstrate that the challenged directors were controlled by the offending directors through personal or other relationships. Id. White failed to make such a demonstration.

In addition to falling short of demonstrating bias or self-interest, While also failed to allege facts sufficient to cast doubt as to whether the Ventas board of directors court have properly exercised its independent, disinterested business judgment in responding to a shareholder demand for action. The trial court did not err by concluding that these counts of the complaint were also subject to dismissal under the strict requirements of Delaware's demand rule.

Although he believes that the court erred in dismissing his complaint for insufficiency, White nonetheless argues in the alternative that the trial court erred by failing to permit him leave to amend. We observe that White's post-judgment motion for relief was filed out of time. Regardless of this procedural shortcoming, we would still decline to reverse the court's refusal to permit the second amendment of his complaint.

Kentucky Rule of Civil Procedure (CR) 15.01 provides that a plaintiff may file one amended complaint prior to the filing of a responsive pleading but that "[o]therwise a party may amend his pleading **only by leave of court** or by written consent of the adverse party. . . ." (Emphasis added.) Although leave to amend shall be freely given when justice so requires, that decision remains within the sound discretion of the trial court. Lambert v. Franklin Real Estate Co., Ky.App., 37 S.W.3d 770 (2000).

We shall recapitulate the sequence of procedural events in this case:

> July 1998 -- White filed the complaint (followed within a few days by a first amended complaint);
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> January 2000 -- the appellees filed a motion to dismiss;
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> July 26, 2005 -- the court dismissed the complaint;
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> 22 days later, White filed two post-judgment motions, including a motion to file the second amended complaint;
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> August 24, 2005 -- the court denied the motions.

In their motion to dismiss in January 2000, the appellees cited unmistakably fatal flaws in White's complaint and relied on an established and well developed body of law. More than five years then elapsed until July 26, 2005, when the trial court dismissed White's complaint. During that considerable interval, White did nothing to attempt to remedy or to supplement the deficiencies of which he had been made aware. We cannot conclude that justice required the court to permit White to file an amended complaint more than seven years after the original complaint had been filed. The trial court did not abuse its discretion by refusing to grant White's motion.

We affirm the order of the Jefferson Circuit Court.

ALL CONCUR.

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