Park v W.P. Carey & Co. LLC
2009 NY Slip Op 33446(U)
March 23, 2009
Supreme Court, New York County
Docket Number: 601236/2008
Judge: Richard B. Lowe III

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: HON. [illegible] PART 56

Index Number : 601236/2008

PAYSON, HERBERT

VS.

PARK, JOHN J.

SEQUENCE NUMBER : 001

DISMISS

INDEX NO. _____

MOTION DATE 10/10/08

MOTION SEQ. NO. _____

MOTION CAL. NO. _____

this motion to/for _____

PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☒ No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 3/23/09

HON. [illegible], J.S.C.

Check one: ☒ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE CDSP

SUPREME COURT OF THE STATE OF NEW YORK

COUNTY OF NEW YORK: PART 56

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HERBERT PAYSON, Derivatively On Behalf Of Nominal Defendant W.P. CAREY & CO. LLC,

Plaintiff,

Index # 601236/2008

-against-

JOHN J. PARK, CLAUDE FERNANDEZ, WM. POLK CAREY, FRANCIS J. CAREY, NATHANIEL S. COOLIDGE, GORDON F. DUGAN, EBERHARD FABER, IV, DR. LAWRENCE R. KLEIN, GEORGE E. STODDARD, DR. KARSTEN VON KOLLER and REGINALD WINSSINGER

Defendants,

and

W.P. CAREY & CO. LLC,

Nominal Defendant

----------x

Hon. Richard B. Lowe, III

Motion 001 made by nominal defendant W. P. Carey & Co. LLC ("WPC") and defendants Wm. Polk Carey, Nathaniel S. Coolidge, Gordon F. Dugan, Eberhard Faber, IV, Dr. Lawrence R. Klein, George E. Stoddard and Dr. Karsten von Koller[1], motion 002 made by defendant John J. Park and motion 003 of defendant Claude Fernandez are hereby consolidated for disposition.

These motions seek an order dismissing this shareholder's derivative suit pursuant to CPLR 3211 (a) (1) and (7). The principal issue presented is whether plaintiff and WPC

[1]At the time these motions were filed named defendants Francis J. Carey and Reginald Winssinger had not been served.

shareholder, Herbert Payson has plead with factual particularity why demand futility as to WPC's board.

BACKGROUND

WPC is a Delaware limited liability company listed on the New York Stock exchange which sponsors and manages real estate investment trusts ("REITs"). The REITs' investors receive dividends from the real estate portfolio's earned income. Carey Financial LLC ("CF"), is WPC's broker-dealer subsidiary which acts as a wholesaler of the REITs to retail broker-dealers. The REITs are not traded on any exchange, but are sold to investors through retail broker-dealers which are compensated by the REITs. Applicable regulations limit the broker-dealers' compensation to 10 percent of the total raised proceeds plus .5 percent for due diligence expenses.

The United States Securities and Exchange Commission ("SEC"), following a broker-dealer examination of CF, sent it a letter in or about March 2004 alleging various infractions, including the sale in 2002 and 2003 of shares of phase II of a REIT when the registration statement was not yet effective. This, and the potential consequences if the SEC pursued its claims, were disclosed by WPC in its annual 10-K report for the period ending December 31, 2003 (*See* Windels' aff., exh. C). In late 2004 the scope of the SEC's investigation was broadened to include WPC's compensation arrangement with retail broker-dealers which distributed the REITs. This too was disclosed by WPC in its 2004 and 2005 10-K forms, including the possibility of litigation and sanctions, which could have a material adverse effect on WPC (*Id.*).

The SEC ultimately issued a complaint charging WPC, CF and defendants Park and Fernandez with various securities law violations (*See* Windels' aff., exh. B). In essence it alleged that WPC, through the actions of Park, the CFO and Managing Director of Strategic Planning of WPC and the REITs, who was claimed to have acted knowingly and/or recklessly, entered into illegal revenue sharing agreements with several broker-dealers to make payments in excess of the permitted 10 percent cap; caused invoices to be mischaracterized so as to evade the cap; and impermissibly passed on millions of dollars in expenses to the REITs. It further alleged that the purposeful circumvention of the cap caused the REITs to pay millions in improper fees to CF and to at least one retail dealer-broker, and increased management fees to WPC as a result of increased sales of REIT shares by the broker-dealers involved in the revenue sharing plan (*Id.*).

It was also claimed that Park was assisted in these improprieties by defendant Fernandez, an accountant who served as the managing director and chief accounting and/or chief administrative officer of WPC and the REITs, who was alleged to have acted knowingly or negligently by, among other things, issuing checks that did not reflect legitimate payments. The SEC complaint charged that "Park and Fernandez engaged in practices by which they each knowingly circumvented a system of internal accounting controls and or knowingly falsified, directly or indirectly, or caused to be falsified, books, records and accounts of the ... REITs" (Windels' aff., exh. B, ¶ 108). WPC, through Park and Fernandez, was also charged, in connection with the revenue sharing agreements, with intentionally or recklessly making material misstatements and omitting material facts in prospectuses, registration statements and required filings (*Id.*).

In addition WPC was charged with a number of other violations. Specifically WPC, through Park, was alleged to have knowingly or negligently caused the REITs to make an undisclosed proxy solicitation payment of $100,000. Also WPC was charged with selling shares of Phase II of a REIT before the registration for that phase was effective. That alleged impropriety was not attributed to anyone in particular at WPC. However, the SEC complaint (*see* Windels' aff., exh. B, ¶ 79) recited that WPC's action in this regard was based on the erroneous advice of outside counsel. The SEC complaint further charged that WPC failed to indicate in various materials that one senior executive had previously served as the CFO of another company that had filed for bankruptcy about 19 months after that individual had left the other company. WPC was also charged with causing the REITs to fail to disclose that the REITs' officers and directors were late in making their filings about whether they had any ownership interest in the company's securities.

The SEC complaint, which was filed four years after the SEC had commenced its investigation, did not contain any charges or allegations against any of WPC's thirteen board members, including the nine independent board members who make up the majority.

On February 28, 2008 WPC issued a press release indicating that it had in principle reached a settlement with the SEC (Windels' aff., exh. D). WPC and CF, while not admitting or denying the SEC's charges, agreed to the entry of an injunction against securites laws violations in the future, and consented to pay the REITs about $20 million and to pay a $10 million penalty. In connection with the agreement in principle, WPC established a charge of about $30 million. Park and Fernandez, neither of whom admitted nor denied the charges, separately settled with the SEC.

On April 24, 2008, about five weeks after the SEC filed its complaint, Payson, without having served a demand on WPC's board and without requesting information from WPC, filed the instant action naming as defendants WPC, Park and Fernandez, neither of whom is a WPC board member, and nine of the board's thirteen directors. Of those nine, Coolidge, Faber, Klein, von Koller and Winssinger are outside directors. Coolidge, Faber and Winssinger were on WPC's Audit Committee. Four other independent directors were not named. The remaining named director defendants are W.P. Carey, WPC's founder, who has served as Chairman since 1996, his brother, F. Carey, WPC's Chief Ethics Officer, who had served as its Vice Chairman, Dugan, WPC's President and CEO and the CEO of the REITs, and Stoddard[2], WPC's Senior Managing Director, who serves on the investment committee of a WPC subsidiary, which is involved in finding appropriate properties for the REITs (*See* Complaint, ¶ 16, 17, 19, 22, 31).

As is relevant, WPC's Limited Liability Company Agreement in effect from 1997 through the present insulates its directors and officers from liability to WPC and its shareholders for acts and omissions "except in the case of fraudulent or illegal conduct" and provides that if any act or omission is the result of advice from WPC's counsel that "shall be evidence of good faith and lack of fraudulent conduct" (Windels' aff., exh E, at 29).

Payson's complaint, which seems to be derived largely from the SEC's complaint, takes the allegations which the SEC asserted against Park and Fernadez, mentions their alleged actions, and then lumps all of the defendants together, charging them, in conclusory language, with "knowingly and deliberately" causing WPC to violate the 10 percent cap rule, creating sham invoices and concealing their misconduct, thereby causing WPC to file false financial

[2] Stoddard left the board shortly after this action was commenced, allegedly for reasons unrelated to this lawsuit.

statements (*See* Complaint, ¶¶ 3, 6, 8, 35, 50). Payson alleges, without referring to any particular defendant, that because of their positions, the defendants "exercise[d] control over the wrongful acts complained of herein" and "had knowledge of material non-public information regarding" WPC (*Id.*, ¶ 27). Payson indicates that the individual defendants signed and reviewed the periodic SEC filings and then asserts that they had "knowledge" that they were false (*Id.*, ¶ ¶ 39, 87). The specific source of that alleged knowledge is not revealed by Payson, who merely alleges that unspecified reports, statements, and conversations resulted in the "defendants" knowledge (*Id.*, ¶ 68

The complaint alleges that the "[i]ndividual defendants," Park, Fernandez and the defendant Audit Committee members were responsible for establishing adequate internal financial controls for WPC. Why each and every one of the individual defendants would have that duty is not revealed. The complaint further alleges that the Audit Committee's Charter requires the committee to, among other things, review financial statements with management, including the adequacy of financial controls, recommend to the board of directors that the company's audited statements be included in WPC's 10-K forms, review the internal reports "prepared by those responsible for the internal audit function," review the 10-Ks with the independent auditors and financial management, "review the integrity of the organization's financial reporting processes" [i]n consultation with the independent auditors and those responsible for the internal audit function", and meet with management, the independent auditors and personnel responsible for the company's internal audit function to oversee that function and internal controls (Complaint, ¶ 30). The complaint (¶ 32) then asserts that "the Individual defendants failed to implement and maintain adequate internal control systems" thereby

violating their duties of loyalty and good faith, GAAP and the Audit Committee Charter. What in particular each of these defendants failed to do is not set forth.

The complaint further charges the "individual defendants" with "knowing" that Park paid the undisclosed proxy solicitation payment of $100,000 and "knowingly causing" the REITs to make that payment (Complaint, ¶ 61). The source of each defendant's knowledge is not revealed. As to the unregistered offering, Payson charges the "[i]ndividual defendants" with knowingly overselling shares of the initial offering when they knew that the second offering was not effective" (*Id.*, ¶63). The complaint (¶ ¶ 65, 66) also baldly charges the "[i]ndividual defendants" with knowingly failing to disclose that the other company that Dugan had left had filed for bankruptcy, and knowingly and falsely failing to report delinquencies in filings regarding changes in ownership by officers and directors of the REITs of the issuer's equity securities. In addition, Payson claims that WPC repeatedly stated that it "was not involved in any material litigation," evidently claiming that while the company was under investigation by the SEC it was required to state that it was involved in litigation (*See Id.*, ¶ 9).

Based on the foregoing, Payson charges the defendants with breaches of their fiduciary duty of good faith. His complaint alleges that a demand on WPC's board is excused because in light of the "facts" alleged in his complaint such demand "would be futile because the board is incapable of making an independent and disinterested decision to institute and vigorously prosecute this action" (*Id.*, ¶ 95). In particular he claims that the board member defendants knowingly and deliberately participated in the unlawful practices and that there is, accordingly, a substantial likelihood of their being held liable, thereby rendering them incapable of being

disinterested and independent (*Id.*, ¶ 96). He further posits that the their misconduct could not have been "an exercise of good faith business judgment," thereby excusing a demand (*Id.*).

THE INSTANT MOTIONS

The movants, who urge that Delaware law on demand excusal applies, seek dismissal of the complaint as to them on the ground that Payson has failed to plead with particularity why a demand on the board should be excused, urging in essence that Payson's complaint is a conclusory reshuffling of the SEC's complaint that groups all the defendants together with Park and Fernandez, who were the focus of the SEC's complaint, and fails to factually particularize on a director-by-director basis why a demand would be futile as to the majority of the board, most of whom are outside directors. The movants maintain that the complaint does not adequately allege that a majority of the individual board members faces personal liability with respect to the claims asserted by Payson.

Movants assert that the test for evaluating demand futility in this case is the one set forth by the Delaware Supreme Court in *Rales v Blasband* (634 A2d 927 [Del 1993]), namely that the court must decide "whether or not the particularized allegations of [the]... complaint create a reasonable doubt that, as of 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." Movants, noting that the complaint does not truly appear to allege that the majority of the board lacks independence or that the majority has any financial interest in the transactions, assert that the complaint fails to allege facts as to each director's knowledge and conduct which raise a reasonable doubt that a majority of the board members are disinterested because they face a "substantial likelihood" of personal liability (*Aronson v Lewis*, 473 A2d 805, 815 [Del 1984],

overruled in part on other grounds by Brehm v Eisner, 746 A2d 244, 253 [Del 2000]). Movants further observe that, because of WPC's Limited Liability Company Agreement, which limits the liability of directors and officers, Payson could not rely on mere negligence or on an ordinary breach of the duty of care to meet his burden.

Payson, who agrees that Delaware law applies, opposes the motions, asserting that the allegations of the complaint are adequate to raise a reasonable doubt that the actions of the board were a valid exercise of the board's business judgment and that the board was disinterested. Payson maintains that test set forth in *Rales v Blasband* (634 A2d at 927) is inapplicable here because that test applies when there are claims of inaction, rather than of action, by the board.

Payson maintains that the test set forth in *Aronson v Lewis* (473 A2d at 805) applies. Payson contends that he has met the *Aronson* test which excuses pre-suit demand where the plaintiff demonstrates demand futility by alleging particularized facts raising a reasonable doubt that a majority of the board is independent or disinterested or that the transaction which is challenged was the result "of a valid exercise of business judgement" (*Id.*, 473 A2d at 814). According to Payson, the board's knowing approval of illegal payments in excess of the 10 percent cap and their acts of signing financial statements with knowledge that they were false and misleading cannot be viewed as the valid exercise of business judgment, and that since the majority of the board faces "a substantial likelihood of liability" (*Id.*, 473 A2d at 815; *Kohls v Duthie*, 791 A2d 772, 778 [Del Ch 2000]) in connection with these transactions, they cannot be viewed as disinterested.

Payson alsorequests that, in the event his complaint is found to be deficient, he be given leave to replead after he has had the benefit of discovery (*See* Opposing Memorandum of Law, at 16, n 9; Oral argument transcript, at 21).

Movants reply that the *Aronson* (473 A2d at 805) test is inapplicable because the board has not taken conscious affirmative action, and because Payson has only set forth conclusory allegations that the board knowingly approved the wrongdoing. Nonetheless movants urge that under either test the complaint fails to adequately plead demand futility, because there are no particularized allegations that a majority of the board acted in bad faith.

DISCUSSION

Under Delaware law, which concededly applies, the pleadings in derivative suits, whether by a shareholder of a corporation or of a limited liability company, are governed by Chancery Rule 23.1, which requires the plaintiff shareholder to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors ... and the reasons for the plaintiff's failure to obtain the action or for not making the effort" (Del Ch Ct R 23.1; *see also* 6 Del C § 18-1003). This requirement reflects that under Delaware law it is the directors, and not the shareholders, who manage the affairs of the entity (*Aronson v Lewis*, 473 A2d at 811). The demand requirement permits the "exhaustion of intracorporate remedies ... which might avoid litigation altogether," allows the entity to "control the proceedings," and, if excused or impermissibly refused, allows the stockholder to control the proceedings (*Brehm v Eisner*, 746 A2d at 254). The particularity requirement serves to deter baseless, expensive "suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed

solely in conclusory terms," but permits suit by a shareholder who is able to particularize facts under the applicable test *(Id.)*.

While on a motion to dismiss for failure to make a demand "well-pleaded allegations of fact must be accepted as true; conclusory allegations of fact ... unsupported by allegations of specific fact may not be taken as true" (*Grobow v Perot*, 539 A2d 180, 187 [Del 1988], *overruled in part on other grounds by Brehm v Eisner*, 746 A2d at 253). Moreover, a 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" *(Id.)*. Under Delaware law there is a heightened pleading requirement to excuse demand (*Id.*; *White v Panic*, 783 A2d 543, 546 [Del 2001]; *Wilson v Tully,* 243 AD2d 229, 234 [1st Dept 1998]).

As previously discussed, there are in general two different tests to determine whether pre-suit demand is excused. The test under *Aronson v Lewis* (473 A2d at 805) applies when the board has approved the challenged transaction or has consciously chosen not to act, while the test enunciated in *Rales v Blasband* (634 A2d 933) applies to claims involving the directors' failure to act. In the former case the plaintiff is required to "overcome the powerful presumption of the business judgment rule before they will be permitted to pursue the derivative claim" *(Id.)*. In the latter case, since there has been no conscious decision by the directors, the business judgment rule in inapplicable *(Id.)*.

The complaint in this case, in addition to being conclusory, is rather vague as to the directors' alleged improprieties and as to whether, and to what extent, Payson is alleging improper board action, failures to act, or both. However under any test, he has failed to meet his burden.

Payson's claim that the directors, including those on the Audit Committee, failed to establish adequate internal financial controls clearly falls within *Rales v Blasband* (634 A2d 927, *supra*), thereby requiring the court to decide whether Payson has raised a reasonable doubt that the board can fairly consider the merits of this claim "without being influenced by improper considerations" (*Id.* at 934).

Payson's claim fails as the complaint does not set forth with the requisite particularity what each individual board member's roles were with respect to establishing adequate internal financial controls, so as to establish that a majority of directors had a duty in this regard which could render him liable to the company, and affect their impartiality (*See Rattner v Bidzos,* 2003 WL 2284323, at * 12 [Del Ch 2003], 2003 Del Ch LEXIS 103, at * 44-45). A review of the Audit Committee Charter, referred to in the complaint, strongly suggests that not every director had the duty to establish financial controls. The complaint's references to the "individual defendants" generally is "impermissible" (*Ferre v McGrath*, 2007 WL 1180650, at * 9 [SD NY 2007], 2007 U S LEXIS 29490, at * 26). In addition, the complaint fails to set forth what particular steps each board member should have taken to establish adequate financial controls (*See Matter of IAC/ Interactive Corp Securities Litigation*, 478 F Supp 2d 574, 604 [SD NY 2007]).

Also, as previously indicated WPC's Limited Liability Company Agreement limits the directors' liability to cases of fraud or illegal conduct. In order to hold a director liable for inadequate financial controls, bad faith would have to be alleged (*see Wood v Baum*, 953 A2d 136, 141 [Del 2008]), and to the extent that the complaint asserts bad faith, the allegations are conclusory and not particularized as to each director. In addition to the extent that Payson faults

the three members of the Audit Committee for inadequate financial controls, those three members do not make up a majority of the board, and in any event membership on an Audit Committee is not in and of itself adequate to raise the likelihood of director liability (*Id.* at 142-143; *see also Rattner v Bidzos,* 2003 WL 22284323, at * 13; *Ferre v McGrath,* 2007 WL 1180650, *supra*).

Nor does the complaint allege with factual particularity a "sustained or systemic failure of the board to exercise oversight - such as an utter failure to attempt to assure reasonable information and reporting systems exist" so as to establish bad faith on the part of the board with respect to the alleged failure to institute adequate financial controls (*Matter of IAC*/Interactivecorp Securities, 478 F Supp 2d at 604, citing *Matter of Caremark Int'l Derivative Litig.*, 698 A2d 959, 971 [Del Ch 1996]). Also the complaint fails to allege with particularity that there were any red flags which the majority of the board should have seen or that such signs were waived in the faces of the board's majority (*Matter of IAC*/Interactive *Securities*, 478 F Supp 2d at 606; *Rattner v Bidzos*, 2003 WL 22284323, at * 13). Thus Payson's allegations of insufficient financial controls are inadequate.

For similar reasons the claim that demand is excused because various board members at one time or another signed WPC's financial statements, including 10-K forms, coupled with the conclusory assertion that the board had "knowledge" of their falsity, is unavailing (*Wood v Baum*, 953 A2d at 142; *Seminaris v Landa*, 662 A2d 1350 [Del Ch 1995]). Also the allegation that WPC's issuance of statements that it was not involved in material litigation at the time it was being investigated excuses the demand is rejected, since an investigation is not litigation. The court does note however that the 10-K forms revealed the fact that an investigation was

ongoing, and had the potential to lead to litigation which could have a material adverse effect on the company.

The balance of the complaint's charges against the board which are based on generalized group pleadings, that baldly charge the directors with knowing misdeeds regarding the violation of the 10 percent cap rule and its alleged cover-up, Park's payment of the undisclosed proxy solicitation fee, the failure to disclose that another entity that Dugan had served filed for bankruptcy, the sale of shares of phase II of a REIT when the second offering was not yet effective, and the failure to report delinquencies in filings regarding changes in the REITs' officers' and directors' ownership interest in the issuer's equity securites, are also inadequately particularized to establish demand futility, since they do not raise a reasonable doubt that the majority of the directors are disinterested and independent, or that the challenged transactions were the result of the proper exercise of business judgement. Further, assuming for argument's sake that the *Rales* test applies, the complaint fails to raise a reasonable doubt that the majority could have impartially exercised its judgement when responding to a demand. There is no factually particularized claim of domination and control of the board or that the majority of the board had a financial interest in the alleged transactions. Payson's claim seems to be that the majority of the board is interested merely because they face liability in light of their bad faith activities which raise a reasonable doubt as to whether the alleged transactions were the result of their valid exercise of business judgement, thereby excusing a demand on the board. This assertion is without merit because, again, Payson has failed to adequately plead knowledge on the part of the board's majority. Simply stating that the board members had knowledge because of their positions (*see* Complaint, ¶ 27; *Rattner v Bidzos*, 2003 WL 22284323, at *10) or from

unspecified statements, reports or conversations, is inadequate to meet the pleading requirements.

In the instant case Payson has failed to plead with the requisite particularity facts raising a reasonable doubt that the majority of the board is disinterested because they face a substantial risk of liability in connection with their exercise of business judgement, because the requisite particularized allegations of scienter are absent to raise an issue as their bad faith (*Wood v Baum*, 953 A2d at 141-144). Thus the complaint does not adequately plead that the majority of the board knowingly engaged in any of the alleged misdeeds. Accordingly, under either test, the complaint fails to adequately plead demand futility. Thus the motions to dismiss are granted.

Payson's request made in a footnote of his brief, and again at oral argument, for leave to replead after disclosure, is denied. Payson had access to several information gathering methods prior to instituting this action had he chosen to avail himself of those means, and according to movants' counsel he did not seek any information from WPC before instituting this action *(See Wood v Baum*, 953 A2d at 143-144; *Rales v Blasband*, 643 A2d at 935, n 10). Further, this is not one of those "unusual" and "close cases" warranting leave to replead (*Brehm*, 747 A2d at 249, 267).

Accordingly it is,

ORDERED that motion 001 of defendants W. P. Carey & Co. LLC, Wm. Polk Carey, Nathaniel S. Coolidge, Gordon F. Dugan, Eberhard Faber, IV, Dr. Lawrence R. Klein, George E. Stoddard and Dr. Karsten von Koller to dismiss is granted and the complaint is dismissed as to these defendants with costs and disbursements to them as taxed by the Clerk of the Court; and it is further

ORDERED that motion 002 of defendant John J. Park to dismiss is granted and the complaint is dismissed as to him with costs and disbursements to him as taxed by the Clerk of the Court; and it is further

ORDERED that motion 003 of defendant Claude Fernandez to dismiss is granted and the complaint is dismissed as to him with costs and disbursements to him as taxed by the Clerk of the Court; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

Dated: March 23, 2009

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