Vaughan v Standard Gen. L.P.
2016 NY Slip Op 31657(U)
August 30, 2016
Supreme Court, New York County
Docket Number: 653918/2015
Judge: Anil C. Singh
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 45

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KENNETH VAUGHAN, on behalf of himself and all others similarly situated

Plaintiff,

-against-

STANDARD GENERAL L.P., STANDARD GENERAL MASTER FUND, L.P., and P STANDARD GENERAL LTD.

Defendant.

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DECISION AND ORDER

Index No. 653918/2015

Mot. Seq. No. 001

HON. ANIL C. SINGH, J.:

In this class action, *inter alia*, for breach of fiduciary duty and unjust enrichment, Kenneth Vaughan (the "plaintiff"), on behalf of himself and all the other similarly situated stockholders (the "class") of American Apparel, Inc. ("AA") alleges, pursuant to the New York Civil Practice Law and Rules ("CPLR") § 901, that Standard General L.P. ("SG LP"), Standard General Master Fund L.P. ("SG Fund"), P Standard General Ltd. ("PSG," and together with SG LP and SG Fund, the "defendants") took control over AA and deprived the Class of the opportunity to sell their shares in the Acquisition Offer. Defendants move to dismiss plaintiff's complaint ("Compl.") for failure to state a claim, pursuant to CPLR §§ 3211(a)(1), (a)(3), and (a)(7). Plaintiff opposes.

FACTS

[* 2]

In mid-June, 2014, SG allegedly entered into an agreement with AA's founder and recently-suspended Chief Executive Officer ("CEO"), Dov Charney ("Charney"). The agreement provided that SG would purchase 10% of AA's outstanding shares and sell them back to Charney through a loan secured by all of his shares. After AA suspended Charney on June 18, he called for a special shareholders meeting on June 27 concerning the membership in AA's board of directors (the "Board"). Charney and SG (the "SG Group"), collectively owning 44% of AA's shares, entered into a nomination agreement. The agreement provided that SG would supply $15 million to AA as needed, and five Board members, including Charney, would resign. SG Group would appoint three new members, and SG Group and the remaining two Board members who did not resign would appoint two new members. The size of the Board would increase from seven to nine members. The Board's ability to consider any "extraordinary transaction," such as an offer to acquire AA, would be restricted.

In December 2014, when the market value of AA's shares was $0.69 per share, Irving Place Capital ("Irving Place") allegedly extended an unsolicited offer to acquire AA's outstanding shares for $1.40 per share, which would potentially result in a premium of 103% for shareholders. The Board, which is now controlled by SG, allegedly took several precautions to prevent third parties from acquiring AA's control, including a "poison pill" anti-takeover provision that would increase

the cost of acquisition by approximately $573 million, and a non-disclosure agreement that prevented third party offerors from contacting Charney. When Irving Place allegedly "lost interest" pursuing its proposal in March 2015, negotiations ended. On October 5, 2015, with its shares having plummeted to $0.12 per share, AA filed for bankruptcy. See Compl. ¶ 65. On January 27, 2016, the United States Bankruptcy Court for the District of Delaware confirmed the debtor's plan. See In re American Apparel, Inc., C.A. No. 15-12055 (BLS) (Bankr. D. Del. Jan. 27, 2016).

Plaintiff alleges that while he and many other similarly situated shareholders received nothing from AA's bankruptcy reorganization, SG allegedly obtained full recovery of $77 million it sought for its claims against AA. See Plaintiff's Memorandum of Law in Opposition to Defendant's Motion to Dismiss ("Mem. Opp."), p. 8; see also Compl. ¶ 68. As a result, plaintiff brought this class action suit against defendant for breach of fiduciary duty and unjust enrichment. Defendants move to dismiss plaintiff's complaint pursuant to CPLR §§ 3211(a)(1), (a)(3) and (a)(7) (mot. seq. 001). Plaintiff opposes.

DISCUSSION

The standard for a motion to dismiss is well settled. On a motion to dismiss a complaint for failure to state a cause of action pursuant to CPLR 3211(a)(7), all factual allegations must be accepted as true, the complaint must be construed in the light most favorable to plaintiffs, and plaintiffs must be given the benefit of all

reasonable inferences. Allianz Underwriters Ins. Co. v. Landmark Ins. Co., 13 A.D.3d 172, 174 (1st Dept 2004). The court determines only whether the facts as alleged fit within any cognizable legal theory. Leon v. Martinez, 84 N.Y.2d 83, 87-88 (1994). "Whether a plaintiff can ultimately establish its allegations is not part of the calculus in determining a motion to dismiss." ENC 1, Inc. v. Goldman, Sachs & Co., 5 N.Y.3d 11,19 (2005). The court must deny a motion to dismiss, "if, from the pleading's four corners, factual allegations are discerned which, taken together, manifest any cause of action cognizable at law." 511 West 232nd Owners Corp. v. Jennifer Realty Co., 98 N.Y.2d 144, 152 (2002).

"[N]evertheless, allegations consisting of bare legal conclusions, as well as factual claims either inherently incredible or contradicted by documentary evidence, are not entitled to such consideration." Quatrochi v. Citibank, N.A., 210 A.D.2d 53, 53 (1st Dept 1994) (internal citation omitted). Where the defendant seeks to dismiss the complaint based upon documentary evidence, "the documentary evidence [must] utterly refute[] plaintiffs' factual allegations, conclusively establishing a defense as a matter of law." Goshen v. Mutual Life Ins. Co., 98 N.Y.2s 314, 326 (2002) (internal citations omitted). "A CPLR 3211 dismissal may be granted where documentary evidence submitted conclusively established a defense to the asserted claims as a matter of law." Goldman v. Metro Life Ins. Co., 5 N.Y.3d 561, 570-71 (2005) (internal citations omitted).

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Under New York rules governing the choice of law, Delaware law will apply to the claims because AA is incorporated in Delaware. See Compl. ¶ 15; Hart v. Gen. Motors Corp., 129 A.D.2d 179, 182 (1st Dept 1987) ("the issue of corporate governance ... is governed by the law of the State in which corporation is chartered."); Lerner v. Prince, 119 A.D.3d 122, 128 (1st Dept 2014) (holding same).

Defendants argue that plaintiff's breach of fiduciary duty and unjust enrichment claims are derivate –not direct- in nature, and that plaintiff does not have standing to individually bring these claims. See Memorandum of Law in Support of Defendants' Motion to Dismiss ("MTD"), p. 8. In order to determine whether a stockholder's claim is derivate or direct, the court should consider "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004). In Feldman v. Cutaia, 951 A.2d 727 (Del. 2008), the court elaborated on the distinction between derivative and direct claims,

> If the corporation alone, rather than the individual stockholder, suffered the alleged harm, the corporation alone is entitled to recover, and the claim is derivative. Conversely, if the stockholder suffered harm independent of any injury to the corporation that would entitle him to an independent recovery, the cause of action is direct.

Id. at 732.

Plaintiff argues that defendants breached their fiduciary duty to other shareholders by allegedly using their influence over the Board to block Irving Place's unsolicited offer to acquire AA, which resulted in "millions of dollars lost by Plaintiff and the class for the inability to partake in the offer that offered a 103% premium over the stock's trading price," which shortly plummeted to $0.12 per share. Mem. Opp. at 13-14; see Compl. ¶ 78-82. Plaintiff argues that this alleged harm is independent of any injury to AA. See Mem. Opp. at p. 12. However, plaintiff and the class allegedly lost millions of dollars and missed the opportunity to get a lucrative premium only because the "directors wrongly failed to pursue business combinations." In re Paxson Commc'n Corp. S'holders Litig., No CIV.A. 17568, 2001 WL 812028, at *6 (Del. Ch. July 12, 2001). The only way the shareholders could have been harmed as alleged is if the corporation suffered harm by lost business opportunities and plummeting share values, therefore, this allegation is "derivative in nature." Id.; see Thermopylae Capital Partners, L.P. v. Simbol, Inc., C.A. No. 10619-VCG, 2016 WL 368170, at *10 (Del. Ch., Jan. 29, 2016) ("Claims based on the diminution in value of the stock held by plaintiffs are generally derivative in nature."). Since "the plaintiff [did not] suffer[] some individualized harm [which was] not suffered by all of the shareholders at large," plaintiff failed to allege a direct claim. Feldman, 951 A.2d at 733.

Plaintiff also claims that "SG's control of the Board permitted SG" to "enrich themselves to the detriment" of other shareholders by wrongly forcing AA to accrue debt in the amount of $77 million on unfavorable terms, and only to recover fully later in bankruptcy filing. See Mem. Opp. at p. 8, 12; see also Compl. ¶¶ 7, 34, 38, 41, 46, 56, 80. However, courts have consistently held that this type of claim is derivative in nature. In Agostino v. Hicks, 845 A.2d 1110 (Del. Ch. 2004), Delaware's Chancery Court found that the minority shareholders' claims for breach of fiduciary duty which ultimately injured the shareholders and the company and benefitted the lender after the company filed for bankruptcy were claims of duties owed only to the company and were therefore derivative in nature. Id. at 1115. In making this determination, the Chancery Court stated that the plaintiff must show "that he or she can prevail without showing an injury to the corporation[]" Id. at 1112; see also Levine v. Smith, 591 A.2d 194 (Del. 1991); Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254 (Del. 1995).

In Caspian Select Credit Master Fund Ltd. v. Gohl, C.A. No. 10244-VCN, 2015 WL 5718592 (Del. Ch., Sept. 28, 2015), claims challenging the terms of a loan from controlling stockholder to asserting mismanagement resulting in corporate waste can only be asserted derivatively, even where plaintiff alleges that the loan uniquely benefitted the controller and uniquely harmed minority shareholders. Id. at *3-5. Here, plaintiff failed to show a harm suffered by shareholders without showing

an injury to the corporation based on allegedly unfavorable terms of a loan that SG later recovered in the amount of $77 million. Therefore, Plaintiff has only asserted derivative claims.

Since these claims are derivative, instead of direct, in nature, they belong to the company, not to the individual shareholders, and consequently can only be asserted by, or on behalf of, the company. However, plaintiff's failure to plead demand futility and AA's bankruptcy proceedings bar any such derivate claims. Pursuant to the Court of Chancery requirements, the complaint must "allege ... the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors and comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Del. Ch. Ct. R. 23.1(a); see Pogostin v. Rice, C.A. No. 6235, 1983 WL 17985, at *7 (Del. Ch. Aug. 12, 1983), aff'd 480 A.2d 619 (Del. 1984) (holding that the claim of a plaintiff, who chooses not to make a demand prior to suit and fails to demonstrate why such demand would have been futile, will be dismissed "even if he has an otherwise meritorious claim.").

Plaintiff here has not even attempted to plead that the demand would have been futile. See Sumers v. Beneficial Corp., C.A. No. 8788, 1988 WL 23948, at *4-5 (Del. Ch., Mar. 9, 1988); see also Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (dismissing plaintiff shareholders' claim for their failure to comply with Rule 23.1 pleading standards).

Furthermore, when a company files for bankruptcy, derivative claims become the property of the trustee or debtor-in-possession by operation of law. See In re Ambac Fin. Group, Inc., 487 Fed. App'x 663, 665 (2d Cir 2012); In re Ionosphere Clubs., Inc., 17 F.3d 600, 604 (2d Cir 1994). It is undisputed either by defendants or plaintiff that on January 27, 2016, the Bankruptcy Court for the District of Delaware confirmed AA's plan of reorganization, which included a broad release. The release provides that

> to the fullest extended permitted by law ... on behalf of themselves and their affiliates, the Estates [including American Apparel, Inc.] and their respective successors, assigns, and any and all Entities who may purport to claim by, through, for or because of them, shall forever release, waive and discharge all Liabilities that they have, had or may have against any Released Party [including Standard General]."

Selden Aff. Ex. D, Plan § IX.E.1. This release prevents Plaintiff from pleading any derivate claims here.

Plaintiff is also barred from asserting any claims on behalf of AA because he and other similarly situated members of the class are no longer AA's shareholders. Plaintiff concedes that AA's bankruptcy filing wiped out all common shareholder equity. See Compl. ¶ 66. Under Delaware law, a plaintiff must "not only be a stockholder at the time of the alleged wrong and at the of commencement of suit but ... must also maintain shareholder status throughout the litigation." Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984); see also Bronzaft v. Caporali, 162

Misc. 2d 281, 283-84 (NY Sup. Ct. 1995). As a result, plaintiff is no longer a shareholder and cannot bring a claim on behalf of AA.

Furthermore, the facts alleged in the complaint failed to support plaintiff's assertion that the "SG-controlled board never meaningfully evaluated [Irving Place's acquisition offer]." Compl. ¶ 10. Irving Place submitted their proposal in December 2014, whereupon the Board retained an investment bank to advise it and negotiations that stalled by early-mid March 2015 ended after Irving Place lost interest in pursuing its offer. See id. at ¶¶ 44, 49, 52, 54. "During the period in question, the board ... consulted with its legal and financial advisors, and then concluded that it would be best to continue with its [informed decision]," consequently, "[t]he record is insufficient ... to overcome the presumption that directors made a well-informed decision that they believed was in the best interest of [the corporation]." Kahn v. MSB Bancorp, Inc., C.A. No. 14712-NC, 1998 WL 409355, at *10-12 (Del. Ch. July 16, 1998), aff'd 734 A.2d 158 (Del. 1999). Therefore, these claims do not support a breach of duty.

In sum, the complaint alleges derivative claims, even though plaintiff is barred from pleading such claims due to AA's bankruptcy filing and his failure to comply with the demand requirements. Based on these foregoing reasons, the Court dismisses plaintiff's complaint for lack of standing.

Defendant's motion to dismiss plaintiff's allegation that "as a controlling shareholder [Standard General] owed fiduciary duties to other shareholders" is granted. See Complaint ¶10. Plaintiff's breach of fiduciary duty claim rests upon the premise that SG is a controlling shareholder of American Apparel. Id. Under Delaware law, a person or entity can be a controlling shareholder either through ownership of more than 50% of the corporation's outstanding shares or by exercising actual control over the business affairs of the corporation. See Kahn v. Lynch Commc'ns Sys., 638 A.2d 1110, 1113-14 (Del. 1994); see also Citron v. Fairchild Camera and Instrment Corp., 569 A.2d 53, 70 (Del. 1989); Ivanhoe Partners v. Newmont Min. Corp., 535 A.2d 1334, 1344 (Del. 1987) (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985))[1].

As SG did not control more than 50% of American Apparel's stock[2], plaintiff must demonstrate that SG exercised actual control over American Apparel's business affairs. See Kahn, 638 A.2d at 1114 ("Alcatel held a 43.3 percent minority share of stock in Lynch. Therefore, the threshold questions to be answered by the Court of Chancery was whether, despite its minority ownership, Alcatel exercised control over Lynch's business affairs."); see also Super. Vision Servs., Inc. v.

[1] New York courts apply Delaware law when determining stockholder control of a Delaware corporation. See Nemazee v. Premier Purchasing Partners, L.P., 24 A.D.3d 196 (1st Dept 2005).
[2] Taking the allegations made by plaintiff as true, as the court must when deciding a motion to dismiss, plaintiff alleges that through an agreement between SG and Dov Charney, SG beneficially owned or controlled nearly 44% of American Apparel's stock. See Complaint ¶4, ¶27, ¶45.

ReliaStar Life Ins. Co., 2006 Del. Ch. LEXIS 160, at *19-20 (Aug. 25, 2006) ("there may be circumstances where the holding of contractual rights, couple with a significant equity position and other factors, will support the finding that a particular shareholder is, indeed a 'controlling shareholder,' *especially if those contractual rights are used to induce or to coerce the board of directors to approve (or refrain from approving) certain actions*.") (emphasis added).

The test to determine whether a stockholder has established actual control is "not an easy one to satisfy." In re PNB Holding Co. S'holder Litig., 2006 WL 2403999, at *9 (Del. Ch. Aug 18, 2006). Although there is "no absolute percentage of voting power that is required in order for there to be a finding that a controlling stockholder exists...[the test is only met where] stockholders who, although lacking a clear majority, have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control." Id. The test is "focused on control of the board." Superior Vision Servs. 2006 WL 2521426 at *4. "An independent director is one whose decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influence. A controlled director is not an independent director." Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 407 (Del. Ch. 1999). "The manner in which someone is nominated to the board is not evidence of their lack of independence." Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc., 68

A.3d 197, 230 (Del. Ch. 2013); see also Frank v. Elgamal, 2014 WL 957550, at *22 (Del. Ch. Mar. 10, 2014) ("Merely because a director is nominated and elected by a large or controlling stockholder does not mean that he is necessarily beholden to his initial sponsor.")

Here, the complaint fails to allege how any of the directors lacked independence or were controlled by Standard General. Specifically, the complaint asserts,

> Pursuant to the Standstill Agreement, on August 2, 2014, SG unilaterally appointed two new directors, David Glazek ("Glazek") and Thomas J. Sullivan, to the Board, and SG and the Company jointly appointed two additional new directors, Colleen B. Brown and Joseph Magnacca ("Magnacca"), to the Board. Glazek has been an SG partner since January 2014. None of these Board members held any significant investment in Company stock and therefore had no interests to protect that were independent of those dictated by SG. In addition, on August 8, 2014, the Board appointed Laura A. Lee, designated by SG, as a director.

Compl. ¶ 35.

SG only had the "right to appoint…three of its own designees." See Compl. ¶30. Two additional directors had to be "mutually agreed upon by [SG] and the company." Id. As a result, at most, only three of the nine board directors could be appointed by SG, which is not a majority. Although plaintiff has adequately shown that Magnacca was not independent of SG, plaintiff has failed to allege any facts that Sullivan, Brown, or Lee were not independent directors and therefore controlled by SG. See Edgewater Growth Capital Partners, 68 A.3d 197.Therefore, only one of the

five alleged shareholders can be said to be controlled by SG. This does not satisfy the requirement laid out in Superior Vision Servs., that the plaintiff show that SG controlled the board. Id. at *4.

Plaintiff also alleges that SG is a controlling shareholder by virtue of their status as a creditor of American Apparel. "As a general rule, there is no fiduciary relationship between a debtor and a creditor...and, therefore, there can be no breach of fiduciary duty." Keith v. Sioris, WL 544039, at *7 (Del. Super. Jan. 10, 2007); see also Bank Leumi Trust Co. v. Block 3102 Corp., 580 N.Y.S.2d 299 (1st Dept 1992). "In Delaware, a party alleging that a creditor owes fiduciary duties to the company's stockholders must show that the creditor exerted control over a majority of a company's board of directors..." Edgewater Growth Capital Partners, 68 A.3d at 229. However, plaintiff has not offered any evidence that SG, as a creditor, exercised any control over any of the company's board of directors. See Compl. ¶¶35-36. Therefore, SG is not a controlling shareholder.

Plaintiff's reliance on In re Primedia, Inc. S'holders Litigation, 67 A.3d 455 (Del. Ch. 2013) is misplaced. "When a corporation with a controlling stockholder is sold to a third party, the entire fairness standard applies if the controlling stockholder receives a benefit not shared with the minority." Id. at 486. When the controlling stockholder receives a "unique benefit in the merger not shared with other stockholders, the standard of review for purposes of evaluating whether the

complaint states a claim is entire fairness." Id. at 487-88. Finally, in Primedia, the court determined that KKR, at all times, owned over 50% of the outstanding common stock and therefore did not need to determine whether KKR was indeed a controlling stockholder. Id. at 460; see also In re Primedia Derivative Litig., 910 A.2d 248, 251 (Del. Ch. 2006). As discussed *supra*, SG is not the majority stockholder and has not plead any facts to show actual control of the board of directors. Therefore, defendant's motion to dismiss is granted[3].

Plaintiff's claim for unjust enrichment is denied. Under Delaware law, "unjust enrichment is the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience." Caspian Select Credit Master Fund Ltd. v. Gohl, 2015 WL 5718592, at *16 (Del. Ch. Sep. 28, 2015) (quoting Base Optics Inc. v. Liu, 2015 WL 3491495, at *22 (Del. Ch. May 29, 2015). In order for a plaintiff to successfully make out a claim for unjust enrichment, they must demonstrate, "(1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and impoverishment, (4) the absence of justification, and (5) the absence of a remedy provided by law." Nemec v. Shrader, 991 A.2d 1120, 1130 (Del. 2010).

[3] As the plaintiff cannot establish that SG is a controlling stockholder under Delaware law, plaintiff's breach of fiduciary duty claim cannot be substantiated. See Plaintiff's Memorandum of Law, pp. 18-20.

"At the pleadings stage, an unjust enrichment claim that is entirely duplicative of a breach of fiduciary duty claim – i.e., where both claims are premised on the same purported breach of fiduciary duty- is frequently treated in the same manner when resolving a motion to dismiss." Calma v. Templeton, 114 A.3d 563, 591 (Del. Ch. 2015); see also Agostino v. Hicks, 845 A.2d 1110 (Del. Ch. 2004). A claim is considered to be duplicative when the "unjust enrichment [claim is not] separate or distinct from the alleged breach of fiduciary duty." Id. at 592.

Here, plaintiff's unjust enrichment claim is duplicative of their breach of fiduciary duty claim as the unjust enrichment claim relies upon the same facts as the breach of fiduciary duty claim. Plaintiff during oral argument admitted that, "it's [the unjust enrichment claim] is based on the identical facts as the derivative claim." See Oral Argument, p. 22. Even if the claim was not duplicative, SG was not enriched by the failure of the acquisition by Irving Place, as they lost the one hundred and three percent value along with all of the other shareholders. The acquisition never occurred because Irving Place lost interest in the acquisition. Additionally, plaintiff did not have any actual losses as a result of the failed acquisition. SG and plaintiff were both in the same position as before the acquisition. Therefore, plaintiff has failed to adequately show that there was an enrichment and an impoverishment. Defendant's motion to dismiss plaintiff's claim for unjust enrichment is granted.

In opposing the motion to dismiss, plaintiff informally moves to amend the pleadings in the event the motion to dismiss is granted. This application is denied. Pursuant to CPLR 3025(b), the Court will grant a motion to amend "absent prejudice or surprise resulting therefore, unless the proposed amendment is palpably insufficient or patently devoid of merit." MBIA Ins. Corp. v. Greystone & Co., 74 A.D.3d 499, 499 (1st Dept 2010) (citations omitted). "Plaintiff need not establish the merit of its proposed new allegations but simply show that the proffered amendment is not palpably insufficient or clearly devoid of merit." Id. at 500 (citations omitted); see also Wattson v. TMC Holdings Corp., 135 A.D.2d 375, 377 (1st Dept 1987) ("The requirements for obtaining leave to amend ... include an evidentiary demonstration ... that the party has good ground to support his cause of action") (internal quotations and citations omitted).

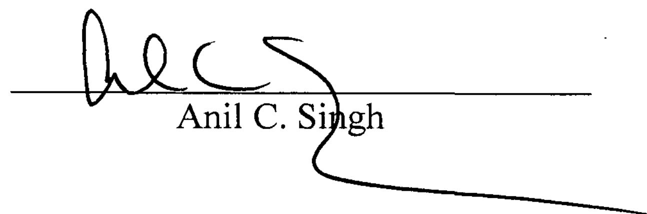
While there is no showing of prejudice or surprise here, plaintiff cannot possibly cure the complaint to assert claims on behalf of the company because the bankruptcy proceedings bar any claims to be asserted in the court on behalf of AA. See In re American Apparel, Inc., C.A. No. 15-12055 (BLS) (Bankr. D. Del. Jan. 27, 2016). The Court agrees with defendants on the grounds that any amendment based on the assertion that these claims here are direct would be "devoid of merit," since the Court herein ruled that all claims asserted are derivative. See MBIA Ins.

Corp., 74 A.D.3d at 500. Therefore, the Court denies plaintiff a leave to amend the complaint.

Accordingly it is,

ORDERED that defendants' motion to dismiss plaintiff's complaint be granted without leave to amend.

Date: August 30, 2016
New York, New York



Anil C. Singh