IN THE

Supreme Court of the State of Delaware

BEVERLY PFEFFER, individually and on behalf of all other similarly situated,
Plaintiff Below,
Appellant,

v.

SUMNER M. REDSTONE, GEORGE S. ABRAMS, DAVID R. ANDELMAN, JOSEPH A. CALIFANO, JR., WILLIAM S. COHEN, PHILIPPE P. DAUMAN, ALAN C. GREENBERG, JAN LESCHLY, SHARI REDSTONE, FREDERIC V. SALERNO, WILLIAM SCHWARTZ, PATTY STONESIFER, ROBERT D. WALTER, NATIONAL AMUSEMENTS, INC., JOHN F. ANTIOCO, RICHARD J. BRESSLER, JACKIE M. CLEGG, MICHAEL D. FRICKLAS, LINDA GRIEGO, JOHN L. MUETHING AND CBS CORP. (f.k.a. VIACOM, INC.),

Defendants Below,
Appellees..

NO. 115, 2008

APPEAL FROM THE COURT OF CHANCERY OF THE STATE OF DELAWARE, HONORABLE STEPHEN P. LAMB (C.A. No. 2317-VCL)

BRIEF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICUS CURIAE* IN SUPPORT OF DEFENDANTS-APPELLEES

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SEPTEMBER 2, 2008

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STATEMENT OF INTEREST

Amicus curiae The Chamber of Commerce of the United States of America (the "Chamber") comprises more than three million business and professional organizations of every size and in every sector and geographic region of the country. An important function of the Chamber is to represent the interests of its members by filing *amicus curiae* briefs in cases involving issues of substantial concern to American business. The Chamber has filed with this brief a motion for leave pursuant to Delaware Supreme Court Rule 28. As the principal voice for American businesses, the Chamber has a significant interest in the issue presented here. The rocketing costs of discovery and the increasing size of settlements in securities class actions – regardless of merit – have made doing business in the United States a risky proposition. *See* Institute for Legal Reform, *Securities Class Action Litigation*, 5, 35 (July 2008), http://www.institute forlegalreform.com/issues/ docload.cfm?docId=1213 ("ILR Report"). The Chamber therefore has a substantial interest in ensuring that meritless securities fraud claims are weeded out at the pleading stage by courts applying the proper analytical framework for evaluating allegations of knowledge.

ARGUMENT

TO PLEAD SCIENTER IN A FRAUD CLAIM THE PLAINTIFF MUST ALLEGE SUFFICIENT FACTS TO GIVE RISE TO A REASONABLE INFERENCE OF SCIENTER[1]

This Court requested supplemental briefing on two issues. The Chamber addresses only the first of those: the proper standard for pleading "knowledge" in connection with the asserted claims.

A. Delaware Courts Have Applied A Rigorous "Reasonable Inference" Standard For Pleading Knowledge In Fraud Claims

Less than six months ago, in *Hauspie v. Stonington Partners,* 945 A.2d 584 (Del. Mar. 7, 2008), this Court addressed the standard for pleading knowledge in a fraud case. *Hauspie* involved claims that the plaintiff was induced to enter into a

[1] Although plaintiff's claim is for breach of fiduciary duty, the conduct underlying the alleged breach sounds in fraud: namely, that defendants breached their fiduciary duties by making fraudulent misstatements and omitting material information from a prospectus distributed to stockholders. *Pfeffer v. Redstone*, 2008 WL 308450, at *7-8 (Del. Ch. Feb. 1, 2008).

stock-for-stock exchange transaction with the company based upon false financial statements. The plaintiff alleged "in some detail" that the defendants had made material misrepresentations, and further alleged that the company's executives, including (in particular) its managing director, "were deliberately hiding the fact that the reported revenue numbers were . . . inflated." *Id.* at 587-88. But those allegations were insufficient to state a claim against the managing director, because the complaint did not provide a sufficient basis for the necessary inference of knowledge. Although it was "fairly inferable that *one or more* [company] insiders knew that its financial statements were grossly inflated," *id.* at 588 (emphasis added), no such inference could be drawn as to the managing director. As the Court noted, there was no description of the managing director's "actual participation in the transaction at issue." Accordingly, and even if the Court were to have indulged the assumption that the managing director had made material misrepresentations, "there is no reason to infer that he *knew* that those representations were false." *Id.* (emphasis added) (citing *Trenwick Am. Litig. Trust. v. Ernst & Young,* 906 A.2d 168, 208 (Del. Ch. 2006), *aff'd,* 931 A.2d 438 (Del. 2007)).

The Court was not making new law in *Hauspie*; it was merely applying the pleading standard that Delaware courts have long invoked in fraud cases. In *Trenwick,* for example (which the *Hauspie* Court cited, 945 A.2d at 588), the Court held that, in determining whether a plaintiff has sufficiently pleaded knowledge in a fraud claim "that has at its core the charge that the defendant knew something," courts should look to whether there are "sufficient well-pled facts from which it can *reasonably be inferred* that this 'something' was knowable and that the defendant was in a position to know it." *Trenwick,* 906 A.2d at 208 (citing *Iotex Commc'ns, Inc. v. Defries,* 1998 WL 914265, at *4 (Del. Ch. Dec. 21, 1998)) (emphasis added).[2] *Trenwick* involved allegations that the directors fraudulently concealed inaccuracies in the company's financial statements in order to paint a misleading picture of the company's financial condition. *Id.* at 208. The Court held that, although there is no duty under Rule 9(b) to plead knowledge with particularity, at the very least, plaintiffs must plead circumstances giving rise to a reasonable inference of knowledge on the part of defendants. *Id.* at 208, 210-11 (citing *Iotex Commc'ns,* 1998 WL 914265, at *3). The *Trenwick* complaint fell short of that standard because

[2] *See also Weiss v. Swanson,* 948 A.2d 433, 449 (Del. Ch. Mar. 7, 2008) ("'Where pleading a claim of fraud or breach of fiduciary duty that has at its core the charge that the defendant knew something, there must, at least, be sufficient well-pleaded facts from which it can reasonably be inferred that this 'something' was knowable and that the defendant was in a position to know it'") (citation omitted); *Metro Commc'n Corp. v. Advanced Mobilecomm Techs., Inc.,* 854 A.2d 121, 147 (Del. Ch. 2004) (same); *Albert v. Alex Brown Mgmt. Servs.,* 2005 WL 2130607, at *11 (Del. Ch. Aug. 26, 2005) (same).

plaintiffs did not sufficiently "describe the level of involvement" of the directors in preparing the financial statements, nor did they allege "when or how specific information was . . . concealed by the directors" or whether the directors were in a position to know they were making misstatements. *Id.* at 210. Such "speculative conclusions unsupported by fact" were insufficient to meet the "reasonable inference" standard. *Id.* at 210-12.

As applied by Delaware courts, the "reasonable inference" standard has teeth. It requires that plaintiffs who want to level fraud charges must come armed with actual *facts*, not just conclusory assertions. Nor is this requirement in any way at odds with the basic principles of notice pleading; it just requires sufficient facts from which the court can infer, as a matter of common sense, that the defendant knew that his representations were false. Thus, for example, it is reasonable to infer that a corporate director would be familiar with information that is routinely disclosed to the board of directors as a whole. *See Pfeffer v. Redstone*, 2008 WL 308450, at *10 (Del. Ch. Feb. 1, 2008). It is likewise reasonable to infer that a defendant knew of an inaccuracy concerning the company's financial condition if the complaint specifically alleges that the defendant was directly involved in discussions about the company's financials. *See Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1051 (Del. Ch. 2006) ("reasonable inference" test satisfied where complaint alleged that defendant "was in close contact with the Company's management . . . regarding the financials of the Company" and discussed "the Company's poor financial performance"); *see also Anglo Am. Sec. Fund v. S.R. Global Int'l Fund*, 829 A.2d 143, 158-59 (Del. Ch. 2003) ("reasonable to infer that those responsible for the preparation of the [financial] report know it to be misleading"). On the other hand, it is *not* reasonable to infer that a corporate director must have known of a misstatement relating to a specific transaction if there are no specific allegations that the director was personally involved. *See Hauspie*, 945 A.2d at 588. By the same token, it is not reasonable to infer that a director knew about the details of a report allegedly generated by a lower-level employee of a subsidiary that is not presented as a routine matter to the board. *See Pfeffer*, 2008 WL 308450, at *11.

B. Meaningful Application Of The "Reasonable Inference" Test Discourages Meritless Securities Class Actions That Are Brought Only To Coerce Settlement

As courts and commentators have recognized across the board, the securities class action is a species of litigation that is particularly ripe for abuse, with devastating effects on the economy. *See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) ("Private securities fraud actions . . . if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."). The sharp

upward trend in the filing of securities class actions continues, with federal filings currently at pace to reach record highs in 2008.[3]

These sobering facts vividly illustrate the dangers of lax or unclear pleading standards. Once a case proceeds past the pleading stage, the enormous financial costs of discovery and the uncertainty and inconvenience of lengthy litigation place tremendous pressure on companies to settle even meritless lawsuits. *Bell Atl. Corp. v. Twombly,* 127 S. Ct. 1955, 1967 (2007) (noting that "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases"). Even setting aside the serious blow to a company's financial resources, prolonged litigation also takes a toll on company management and creativity, creating a "massive distraction" for American businesses, and "[taking] away time with customers, time with employees, and time thinking about moving the business forward." NERA Report at 14 (citation and quotation marks omitted). The uptick in securities class actions and settlement amounts poses a serious threat to the vitality of American business and the continued willingness of investors to contribute to the growth of the U.S. economy. ILR Report at 11 ("'One out of three companies in [a survey of foreign senior executives] that considered going public in the United States rated litigation as an 'extremely important' factor in their decision'") (citation omitted).

If vague or relaxed pleading standards in Delaware permit meritless securities claims to proceed to discovery, the danger is that Delaware will become the forum of choice for such lawsuits. This State's judicial resources already are stretched thin enough (*see* Del. Super. Ct. 2007 Statistical Information, *Civil Caseload Trends,* http://courts.delaware.gov/AOC/Annual %20Reports/FY07/?SuperiorCivilCaseloadTrendChart.pdf (filings in 2007 are at 12,869, compared to 7,485 civil filings in 1998)), and there certainly is no compelling reason to attract additional *baseless* claims by allowing conclusory assertions of scienter to enable a plaintiff to proceed to discovery. The Court

[3] *See* NERA, *2008 Trends,* 2 (July 2008), http://www.nera.com/image?BRO_Recent_Trends_8.5x11_0808.pdf ("NERA Report") (estimating that 280 securities class actions will be filed in 2008, a number not attained since 2002); Cornerstone, *2008 Mid-Year Assessment,* 3 (2008), http://securities.stanford.edu/clearinghouse_research/2008_YIR/ 20080728.pdf (estimating that 220 securities class actions will be filed in 2008, a 27.2% increase over 2007). The size of settlements in securities cases is also on the rise, with the average settlement in 2008 hovering at $32 million. NERA Report at 14; *see also* ILR Report at 8-9 (noting the "exponential growth trend in average settlement values"). Researchers estimate that the total value of private securities class action settlements in the last decade is an astonishing $51.8 billion. ILR Report at 8. Discovery costs are astronomical as well, with discovery expenses for 2007 alone approaching $3 billion. *Id.* at 35.

therefore should take this opportunity to reaffirm the "reasonable inference" approach to pleading knowledge in fraud cases. Not only is this standard firmly grounded in Delaware precedent, but it fairly takes account of both the "liberal pleading" standard inherent in the Rules (*Hauspie*, 945 A.2d at 587 (citing Del. Ch. Ct. Rule 9(b)), and the need to "discourage the initiation of suits brought solely for their nuisance value." *Id.* (citation and quotation marks omitted).

CONCLUSION

For the foregoing reasons, this Court should uphold the Chancery Court's holding that the proper standard in Delaware for pleading knowledge in claims alleging fraud is that there must be "sufficient well-pleaded facts from which it can reasonably be inferred" that the information at the core of the fraud claim "was knowable" and "the defendant was in a position to know it." *Pfeffer*, 2008 WL 308450, at *11 (citation and quotation marks omitted).

Respectfully submitted,
YOUNG CONAWAY STARGATT
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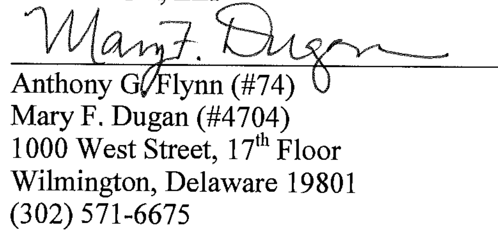

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September 2, 2008

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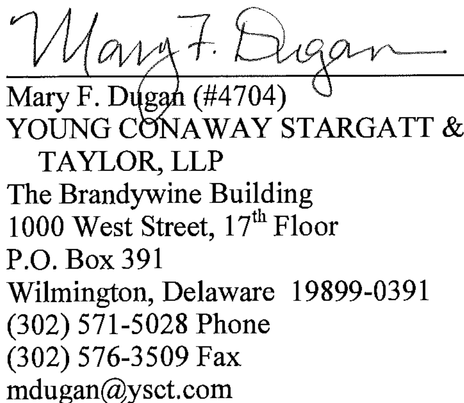

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Tab 1

Albert v. Alex. Brown Management Services, Inc.
Del.Ch.,2005.

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.
Todd ALBERT, Joseph M. Bryan, Jr., Kevin Calderwood, Katherine D. Crothall, Scott W. Frazier, FU Family Revocable Trust, Robert B. Goergen, Sr., Robert G. Goergen, Jr., Todd A. Goergen, Hasan 1995 Living Trust, Wai Yan Ho, Willis James Hindman, Johnson Family Living Trust, Michael R. Kidder Revocable Trust, Mark and Ann Kington, Jeffrey A. Koser, Marlenko Inc., Elaine McKay Family, LP, David Mixer, MRW Trust, James Murray, Jim K. Omura 1996 Trust, Jennifer Owen and Michael J. Ross, Nicholas Peay, Douglas G. Smith, Frederick G. Smith, Jane Vei-Chun Sun, Mark Wabschall, Karen L. Walsh, Warmenhoven 1995 Children's Trust, Yan 1996 Revocable Trust, Barbara J. Zale, and Charles A. Ziering, Plaintiffs,
v.
ALEX. BROWN MANAGEMENT SERVICES, INC.; Deutsche Bank Securities, Inc.; Deutsche Bank, AG; Richard Hale; Gary Fearnow; Bruns Grayson; E. Robert Kent, Jr.; Truman T. Semans; DC Investment Partners, LLC; Doctor Robert Cants, III; and Michael W. Devlin, Defendants.
Elizabeth J. BAKER, Bender 1996 Revocable Trust, Dr. Steven J. Berlin, Estate of Robert B. Blow, Luther C. Boliek, Stephen E. Coit, Sara Crowder, Gerald K. and Teresa K. Fehr, FU Family Revocable Trust, Ralph Glasgal, Robert G. Goergen, Jr.1985 Trust, Todd A. Goergen 1985 Trust, Peter O. Hausmann, Willis James Hindman, William F. Kaiser, Mark and Ann Kington, Timothy K. Krauskopf, William T. McConnell, Philip R. McKee, David Mixer, MRW Trust, James Murray, Paul D. and Judith F. Newman, W.L. Norton, Gregory Packer, Howard E. Rose, Ruben Family Limited Partnership, 5 S Trust, Saladrigas Family Ltd. Partnership, Ricardo A. Salas, Jose M. Sanchez, Samuel Siegel, Silverman 1996 Irrevocable Trust, Douglas G. Smith, Frederick G. Smith, Ronald B. Stakland, Strauch Kulhanjain Family Trust, Bruce E. Toll, Alexander R. and Marjorie L. Vaccaro, Yanover Family Ltd. Partnership, Michael Yokell, and Justin A. Zivin, Plaintiffs,
v.
ALEX. BROWN MANAGEMENT SERVICES; Deutsche Bank Securities, Inc.; Deutsche Bank, AG; Richard Hale; E. Robert Kent, Jr.; Truman T. Semans; DC Investment Partners, LLC; Doctor Robert Crants, III, and Michael W. Devlin, Defendants.
No. Civ.A. 762-N, Civ.A. 763-N.

Submitted July 22, 2005.
Decided Aug. 26, 2005.

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Daniel Griffith, Marshall Dennehey, Warner, Coleman & Goggin, Wilmington, Delaware, for Defendants DC Investment Partners, LLC, Dr. Robert Crants, III, and Michael W. Devlin.
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MEMORANDUM OPINION

LAMB, Vice Chancellor.

I.

*1 In a recent opinion in these two related cases on the defendants' motion to dismiss under Court of Chancery Rule 12(b)(6), the court addressed the defendants' statute of limitations argument and concluded that any claims arising before November

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11, 2000, the date upon which the parties entered into an agreement tolling the statute of limitations, were barred.[FN1] Because it was unclear which, if any, claims for relief set out in the complaints arise after that date, the court requested additional submissions from the parties.

FN1. The facts alleged in the complaints are recited in detail in the earlier opinion. *Albert v. Alex. Brown Mgmt. Servs.,* 2005 Del. Ch. LEXIS 100, at *43-58, 2005 WL 1594085 (Del. Ch. June 29, 2005). Reference is made to that opinion for a complete recitation of the facts and for the definition of terms used herein. However, to avoid confusion, the court refers in this opinion to Alex. Brown Management Services, Inc. as "AB Management." Unless otherwise noted, the facts recited in this opinion are taken from the well-pleaded allegations of the complaints.

In this opinion, the court now addresses the issues raised in the additional submissions as well as the remaining issues raised by the defendants' motion to dismiss. Included among the latter are: (i) whether any surviving claims are derivative, rather than direct claims as to which demand was neither made nor excused; and (ii) whether the court can exercise personal jurisdiction over several defendants (the "DCIP Defendants") who served as agents, or employees of agents, of the partnerships.

II.

In the earlier opinion, the court noted that some of the factual allegations in the complaints occurred after November 11, 2000 and that, therefore, viable claims based on these factual allegations are not time-barred.[FN2] The Plaintiffs' Response Brief [FN3] identified five other factual allegations in the complaints (all involving allegedly material misrepresentations or non-disclosures) which, they contend, support viable claims for relief. These are: (i) the Managers' failure in the December 2000 semi-annual reports (dated on or about February 28, 2001) to inform the defendants that hedging was desirable, but the Funds could not afford to do so; (ii) the allegedly misleading statement in the December 31, 2000 report to the unitholders that the Managers remained "comfortable with the broad diversification achieved by the Fund[s'] portfolio of public securities and private investments ....;" (iii) the defendants' failure to inform the unitholders of the Funds' "liquidity issues," "steps that the management could take to improve liquidity," and "alternatives to raise additional liquidity," although these themes were the focus of the Management Committee meetings of October 3, 2000, March 23, 2001, and September 6, 2001; (iv) the defendants' failure to inform the unitholders that, in June of 2001, AmSouth Bank withdrew from the credit syndicates for the Funds, thereby leaving Bank of America as the only lender for the Funds; and (v) the defendants' failure to inform the unitholders of the Funds violation of their credit arrangements with their lenders, including their eventual defaults, on June 5, 2002 (for the Fund I loan), and June 28 and September 30, 2002 (for the Fund II loan).

FN2. The factual allegations specifically discussed in the earlier opinion are as follows: First, the Managers failed to provide financial statements and reports as they are required to under the Partnership Agreements and Delaware law. Second, the Managers wrongfully allowed certain withdrawals from the Funds, thereby causing or exacerbating a liquidity crisis. Specifically, the Fund II Complaint alleges that three withdrawals from Fund II occurred after November 11, 2000. These allegedly occurred on January 17, 2001, October 25, 2001, and December 31, 2001 (the "Fund II 2001 Withdrawals"). Additionally, the Fund I Complaint alleges approximately $8.0 million in withdrawals occurred in December of 2000 from Fund I (the "Fund I December 2000 Withdrawals"). Third, the Managers failed to provide active and competent management of the Funds. *Alex. Brown,* 2005 Del. Ch. LEXIS 100, at *78-*79, 2005 WL 1594085 (Del.Ch.).

FN3. The Plaintiffs' Response Brief is titled "Plaintiffs' Brief In Response To The Court's Memorandum Opinion And Order Of June 29, 2005" and was filed on July 15, 2005.

All five of these factual allegations are found in the complaints. Furthermore, they allegedly occurred after November 11, 2000. Therefore, claims based on

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these allegations are timely. However, a threshold question is whether the information that the plaintiffs allege should have been disclosed, or was disclosed but was allegedly false and misleading, is material. If this information is not material as a matter of law, the allegations will not support claims that the Managers violated their disclosure duties.

*2 The determination of materiality is a mixed question of fact and law that generally cannot be resolved on the pleadings.[FN4] Therefore, the court cannot (and does not) make any final findings on the materiality of these alleged disclosure allegations. However, on a Rule 12(b)(6) motion, the court must determine whether, under the facts alleged in the complaints, these disclosure (or non-disclosure) allegations support a reasonable inference of materiality. If they do not, these factual allegations cannot support a claim for relief.

FN4. *O'Malley v. Boris,* 742 A.2d 845, 850 (Del.1999)

An omitted fact is material if "under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[FN5]

FN5. *Rosenblatt v. Getty Oil Co.,* 493 A.2d 929, 944 (Del.1983) (quoting *TSC Indus. v. Northway, Inc.,* 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976)).

The first alleged non-disclosure is that the Managers' failed in the December 2000 semi-annual reports to inform the unitholders that hedging was desirable, but the Funds could not afford to do so. This allegation of non-disclosure, viewed in the context of the allegations contained in the complaints, supports a reasonable inference that this information is material. According to the complaints, the defendants marketed the Funds as being actively managed by experienced, professional managers. Viewed in this context, a unitholder would likely find it important to know that the Managers could not manage the Funds in what they believed to be the Funds' best interests, because they were facing liquidity problems and could not afford to purchase collars.

The second alleged non-disclosure is that the defendants failed to inform the unitholders of the Funds' "liquidity issues," "steps that the management could take to improve liquidity," and "alternatives to raise additional liquidity." As alleged in the complaints, the real cause of the Funds' losses was the lack of liquidity. The lack of liquidity allegedly prevented the Managers from properly hedging the Funds as they (allegedly) thought was best for the Funds. Viewed in that context, a reasonable investor would likely find it important to know such information.

The third alleged non-disclosure is that the defendants failed to inform the unitholders that, in June of 2001, AmSouth Bank withdrew from the credit syndicates for the Funds, thereby leaving Bank of America as the only lender for the Funds. Under the facts alleged, the court cannot reasonably infer that this information is material. The complaints allege that the unitholders understood from the very beginning that the Funds would have to borrow money. This is because the contributed securities were illiquid and the Funds needed cash to purchase collars. Given that fact, it is unlikely that a reasonable investor would find it important to know that the Funds were borrowing from one lender as opposed to multiple lenders. In fact, such information would likely only confuse an investor by giving him more information than is necessary to understand the Funds. Therefore, the plaintiffs cannot bring any claims based on this factual allegation.

*3 The fourth alleged non-disclosure is that the defendants failed to inform the unitholders of the Funds' violations of the credit arrangements with their lenders, including the eventual defaults, on June 5, 2002 (for the Fund I loan), and June 28 and September 30, 2002 (for the Fund II loan). This allegation supports a reasonable inference of materiality. As opposed to the information about a bank withdrawing from the credit syndicate, the fact that the Funds were in default on their loans directly speaks to the financial condition of the Funds. A reasonable investor would want to know this information.

Finally, the plaintiffs allege that the claim in the December 31, 2000 report that the Managers

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remained "comfortable with the broad diversification achieved by the Fund[s'] portfolio of public securities and private investments" was materially false and misleading. This allegation does *not* support a reasonable inference that this information is material. It is simply a statement of the Managers' opinion. Furthermore, there is no allegation in the complaints that this statement of opinion was not honestly held, i.e. false. Therefore, the plaintiffs cannot bring any claims based on this factual allegation.

The Non-Disclosure Allegations [FN6] relate to failures to disclose allegedly material information. There is not, of course, any general duty to disclose information. To bring a non-disclosure claim, a party must allege either a fiduciary duty or a contractual duty to disclose. The plaintiffs have attempted to allege both. Therefore, the court will address the Non-Disclosure Allegations in the context of the plaintiffs' claims for breach of fiduciary duty and breach of contract.

FN6. Collectively, the court refers to the three remaining factual allegations of non-disclosure as the "Non-Disclosure Allegations."

III.

The allegations set out in the two complaints are nearly identical and the complaints are both set out in eleven counts: breach of fiduciary duty (Count 1); aiding and abetting a breach of fiduciary duty (Count 2); common law fraud (Count 3); aiding and abetting common law fraud (Count 4); breach of contract against AB Management (with respect to Fund I) and breach of contract against DCIP (with respect to Fund II) (Count 5); breach of the covenant of good faith and fair dealing against AB Management (with respect to Fund I) and breach of the covenant of good faith and fair dealing against DCIP (with respect to Fund II) (Count 6); gross negligence (Count 7); unjust enrichment against all defendants (Count 8); conspiracy liability (Count 9); an accounting (Count 10); and agency liability against Deutsche Bank and DBSI (Count 11). The court first addresses each of the substantive claims (Counts 1, 3, 5-8, & 10). The court then considers the vicarious liability claims (Counts 2, 4, 9, & 11).

A. *Breach Of Fiduciary Duty (Count 1)*

1. *Failure To Provide Financial Statements*

The complaints allege that the Managers failed to provide the unitholders with the 2001 audited financial statements until 2003, and failed to provide any investor reports or audited financial statements for 2002. The plaintiffs argue that this amounted to a breach of the Managers' fiduciary duties.

***4** There is not, of course, a general fiduciary duty to provide financial statements. Instead, under the Partnership Agreements, the Managers had a contractual duty to provide the unitholders with such reports.[FN7] The plaintiffs have not articulated why the violation of this contractual right amounted to a breach of fiduciary duty.[FN8] Thus, this factual allegation does not state a claim for breach of fiduciary duty.

FN7. Partnership Agreements § 11.2.

FN8. In the Plaintiffs' Response Brief, the plaintiffs argue that the Managers failed to make material disclosures, when they had a fiduciary obligation to do so. They further outline specific factual allegations, the Non-Disclosure Allegations, they contend are material and should have been disclosed. The Non-Disclosure Allegations are discussed below.

2. *Withdrawal Allegations*

The plaintiffs argue that the Managers wrongfully allowed the Fund I December 2000 Withdrawals and the Fund II 2001 Withdrawals. The plaintiffs contend that the defendants violated their fiduciary duties "by failing to ensure that the Funds had 'sufficient financial resources' to accomplish their 'investment objectives,' and failed to ensure that the Managers were providing professional and active supervision, oversight and management of the Funds."[FN9]

FN9. Pls.'s Resp. Br. at 7.

From these factual allegations, the court cannot reasonably infer a breach of the fiduciary duty of loyalty. The complaints do not allege that the Managers benefited personally in any way by

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allowing the withdrawals. In fact, the amount of fees that the Managers received were based on the amount of money the Funds had under management. Therefore, if anything, the Managers had an incentive *not* to allow redemptions.

Likewise, the plaintiffs' allegations relating to the Fund I December 2000 Withdrawals and the Fund II 2001 Withdrawals do not rise to the level of a breach of the duty of care. Director liability for breaching the duty of care "is predicated upon concepts of gross negligence."[FN10] A court faced with an allegation of lack of due care should look for evidence of whether a board has acted in a deliberate and knowledgeable way in identifying and exploring alternatives.[FN11]

FN10. *Aronson v. Lewis,* 473 A.2d 805, 812 (Del.1984); *accord* *Citron v. Fairchild Camera & Instrument Corp.,* 569 A.2d 53, 66 (Del.1989).

FN11. *Citron,* 569 A.2d at 66

Gross negligence has a stringent meaning under Delaware corporate (and partnership) law, one "which involves a devil-may-care attitude or indifference to duty amounting to recklessness."[FN12] "In the duty of care context with respect to corporate fiduciaries, gross negligence has been defined as a reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason."[FN13] In order to prevail on a claim of gross negligence, a plaintiff must plead and prove that the defendant was "recklessly uninformed" or acted "outside the bounds of reason." [FN14]

FN12. William T. Allen, Jack B. Jacobs and Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law,* 56 BUS. LAW. 1287, 1300 (2001); *accord* *Tomczak v. Morton Thiokol, Inc.,* 1990 Del. Ch. LEXIS 47, at *35, 1990 WL 42607 (Del. Ch. Apr. 5, 1990) ("In the corporate context, gross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason." ') (citations omitted).

FN13. *In re Walt Disney Co. Derivative Litig.,* 2005 Del. Ch. LEXIS 113, at *162, 2005 WL 2056651, 907 A.2d. 693, (Del. Ch. Aug. 9, 2005) (internal citations and quotations omitted).

FN14. *Cincinnati Bell Cellular Sys. Co. v. Ameritech Mobile Phone Serv. of Cincinnati, Inc.,* 1996 Del. Ch. LEXIS 116, at *42, 1996 WL 506906 (Del. Ch. Sept. 3, 1996) (citations omitted), *aff'd,* 692 A.2d 411 (Del.1997) (TABLE); *see also* *Solash v. Telex Corp.,* 1988 Del. Ch. LEXIS 7, at *24-*25, 1988 WL 3587 (Del. Ch. Jan. 19, 1988) (stating that the standard for gross negligence is a high one, requiring proof of "reckless indifference" or "gross abuse of discretion") (citations omitted).

The plaintiffs argue that the Fund I December 2000 Withdrawals and the Fund II 2001 Withdrawals were actionably wrongful. Yet, the plaintiffs specifically allege in the complaints that the Partnership Agreements gave limited partners, in defined circumstances, the right to redeem. While the agreements also gave the Managers the power to delay or deny redemption requests "in [their] sole discretion," [FN15] it is difficult to read that discretionary power as imposing a positive duty to exercise that power to prevent or delay a withdrawal in order "to ensure that the Funds had 'sufficient financial resources' to accomplish their 'investment objectives." ' Thus, while the redemptions may have exacerbated the Funds' liquidity crunch, this is not enough to say that the Managers' failure to delay or deny those redemptions can give rise to a duty of care claim.

FN15. Fund I Compl. ¶ 82; Fund II Compl. ¶ 94.

***5** Therefore, the factual allegation that the Managers wrongfully allowed the Fund I December 2000 Withdrawals and the Fund II 2001 Withdrawals does not give rise to a claim for breach of fiduciary duty.

3. *Active And Competent Management And Disclosure Allegations*

First, the complaints allege that the Managers lacked the experience and expertise to manage the Funds. Second, the complaints allege that the Managers

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devoted inadequate time and attention to managing the Funds. The complaints also allege that the Managers failed to disclose material information, and made misleading disclosures.

The claim that the Managers lacked the experience and expertise to manage the Funds is completely without merit. The defendants disclosed the qualifications of the Funds' Management Committee in the Private Placement Memoranda (the "PPMs") that the defendants gave to all of the unitholders. The "Management" sections of the PPMs disclosed the names, titles, affiliations, ages, educations, and experience of the Management Committee members, DCIP's principals, and DCIP's degree of experience with exchange funds.[FN16] The unitholders received this information before they ever made their investment in the Funds. They, therefore, implicitly agreed that the Managers were sufficiently qualified to manage the Funds.

> FN16. *See* Fund I PPM at 27-29; Fund II PPM at 29-31.

However, the plaintiffs' other claim, that the Managers devoted inadequate time and attention to managing the Funds and committed disclosure violations, is more substantial. The complaints allege that the Managers made false and misleading statements to the unitholders, and failed to disclose material information. While many of the alleged misstatements took place before November 11, 2000, some (specifically, the Non-Disclosure Allegations) took place after this date.

The complaints allege that the Managers met only sporadically, less than once a year since the inception of the Funds. During this time, the Funds were facing difficult challenges. The Managers originally set up the Funds with collars, attempting to limit the upside and downside potential of the Funds.[FN17] The appreciation of certain contributed securities (especially Yahoo!) was causing the Funds to blow through the collars. The Managers then made the decision to remove the collars on the Funds, a decision that had beneficial effects in the short-term, but over the long-term, when the defendants failed to reinstate the collars, resulted in sharp losses.

> FN17. "Collaring" is financial jargon for purchasing offsetting calls and puts on a security to limit upside and downside exposure. At the inception of the Funds, the Managers attempted to limit upside and downside exposure to roughly 10%. *Alex. Brown,* 2005 Del. Ch. LEXIS 100, at *9, 2005 WL 1594085 (Del.Ch.).

Viewed in the light most favorable to the plaintiffs, these alleged facts do (just barely) raise a duty of care claim. Whether the Managers exercised the requisite amount of due care in managing the Funds is, of course, a fact sensitive inquiry. In certain circumstances, meeting once a year to manage an investment vehicle would be sufficient. This would be the case when the investment is relatively straight-forward, or where the complexity of the investment lies in its original design. In fact, a typical exchange fund could require less active management than other types of investments. These funds are often designed to avoid tax liability and to provide diversification, *not* to generate spectacular returns. Therefore, under normal circumstances, a properly hedged and diversified exchange fund might need less active management than, say, a typical mutual fund.

***6** The facts alleged in the complaints, however, paint a picture of the Funds being faced with exceptional challenges, first by the sharply rising value of the securities that made up the Funds, and second by the rapid fall in value of those same securities. The response of the Managers was, allegedly, almost nonexistent, meeting less than once a year.

Furthermore, the complaints allege that the Managers failed to disclose the challenges facing the Funds and the meager steps they were taking to meet those challenges. These alleged disclosure violations were potentially material because, had the plaintiffs known the truth, they could have asked for withdrawals, or brought suit before the value of the Funds plummeted.

It is quite possible that the Managers acted appropriately in both the amount of time they spent managing the Funds and the disclosures they made. However, the complaints paint a picture of the Managers taking almost *no* action over the course of several years to protect the unitholders' investments, while the value of the Funds first skyrocketed and later plummeted. Under the circumstances, the

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plaintiffs should at least be allowed discovery to find out if, as the complaints imply, the Managers received millions of dollars in fees for doing almost nothing.

Therefore, for all of the above reasons, the court holds that the plaintiffs have plead sufficient facts to give rise to a duty of care claim.

B. *Breach Of Contract And The Implied Covenant Of Good Faith And Fair Dealing (Counts 5 & 6)*

In order to survive a motion to dismiss for failure to state a breach of contract claim, a plaintiff must demonstrate: (i) the existence of the contract, (ii) a breach of an obligation imposed by that contract, and (iii) resultant damages to the plaintiff.[FN18]

FN18. *VLIW Tech., L.L.C. v. Hewlett-Packard Co.,* 840 A.2d 606, 612 (Del.2003).

1. *Failure To Provide Financial Statements Allegations*

The complaints allege that the Managers had a contractual duty under the Partnership Agreements to provide semi-annual unaudited financial statements reporting on the financial condition of the Funds, and an annual audited report. The complaint further alleges that the Managers did not provide the unitholders with these reports for 2002 and did not provide the 2001 audited financial statements until 2003. Further, the court reasonably infers from the facts alleged in the complaints that the plaintiffs were harmed by either not being able to ask for a redemption, or not being able to sue for rescission or a like remedy. Therefore, the plaintiffs have satisfied the pleading requirements for a breach of contract claim and this claim cannot be dismissed.

2. *Withdrawal Allegations*

The plaintiffs argue that the Fund I December 2000 Withdrawals and the Fund II 2001 Withdrawals constituted a breach of contract. They argue that the withdrawals caused, or made worse, the Funds' liquidity crunch. However, the Partnership Agreements gave the unitholders the right to withdraw their investments after two years.[FN19] As alleged in the complaints, the unitholders' right to withdraw was limited by the power of the Managers to delay or deny redemptions "in [their] sole discretion." [FN20]

FN19. *See* Partnership Agreements ¶¶ 6.3.

FN20. Fund I Compl. ¶ 82, Fund II Compl. ¶ 94.

*7 This contractual provision did not create a duty for the Managers to individually assess the financial position of the Funds and the effect that such a withdrawal would have each time a unitholder requested a withdrawal. Instead, it placed a restriction on the unitholders' right to receive withdrawals. It gave the Managers the power to limit withdrawals, in their sole discretion. Therefore, the plaintiffs have not identified a contractual obligation that the Managers have violated and this claim must be dismissed. [FN21]

FN21. In the Plaintiffs' Response Brief, the plaintiffs implicitly admit that the Managers had the authority to allow the withdrawals. Instead of arguing this point, the plaintiffs argue that the Managers had a contractual obligation to report the withdrawals.

3. *Active And Competent Management And Disclosure Allegations*

The plaintiffs allege that the defendants owed them a contractual duty to provide active management and to disclose all material information. The complaints allege that the Managers made false and misleading statements to the unitholders, failed to disclose material information, and that the Managers met only sporadically, less than once a year since the inception of the Funds.

As stated above, the Managers are alleged to have owed the unitholders a contractual duty to provide regular financial reports. Of course, concomitant to the duty to provide information is the duty that such information not be false or misleading. In other words, the defendants had a contractual duty to provide the information in good faith. The complaints allege that the Managers failed to provide reports when they were contractually obligated to do so, and that, when they did provide the reports, they were false and misleading. Specifically, the plaintiffs argue

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that the Managers failed to disclose certain material information-the Non-Disclosure Allegations and the withdrawals.

These allegations, if proven, are sufficient to support a claim for breach of contract. Therefore, this claim survives the motion to dismiss.

C. *Fraud (Count 3)*

The plaintiffs' third claim is for fraud. Common law fraud in Delaware requires that: (1) the defendant made a false representation, usually one of fact; (2) the defendant had knowledge or belief that the representation was false, or made the representation with requisite indifference to the truth; (3) the defendant had the intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff acted or did not act in justifiable reliance on the representation; and (5) the plaintiff suffered damages as a result of such reliance.[FN22] In addition to overt representations, where there is a fiduciary relationship, fraud may also occur through deliberate concealment of material facts, or by silence in the face of a duty to speak.[FN23] Fraud claims are subject to the heightened pleading standards of Rule 9(b). This means that the pleading must identify the "time, place and contents of the false representations, the facts misrepresented, as well as the identity of the person making the misrepresentation and what he obtained thereby."[FN24]

FN22. *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del.1983).

FN23. *Id.*

FN24. *York Linings v. Roach*, 1999 Del. Ch. LEXIS 160, at *25, 1999 WL 608850 (Del. Ch. July 28, 1999). (internal quotations and citations omitted).

The plaintiffs argue that the defendants committed fraud by failing to disclose material information which they had a contractual and fiduciary duty to disclose, specifically the Non-Disclosure Allegations. Obviously, this claim (resting principally on alleged omissions) is merely a rehash of Count 1's claim of breach of fiduciary duty and Count 5's claim for breach of contract. It does not independently support a claim for relief. Moreover, the plaintiffs fail to plead with particularity what the defendants obtained through their alleged fraud. The plaintiffs plead generally that the Managers received management fees based on the amount of money that the Funds had under management, thereby giving them an incentive to keep money in the Funds. But the plaintiffs' arguments on this score are inherently contradictory. While they argue that the defendants had an incentive to keep money in the Funds to earn great management fees, they also argue that the Managers wrongfully allowed withdrawals, thereby reducing the amount of money they had under management. Are the withdrawals also part of the alleged fraud?

***8** For the above reasons, the plaintiffs have failed to adequately state a claim for fraud. Therefore, Count 3 will be dismissed without prejudice to the claims asserted in Count 1 or Count 5.

D. *Gross Negligence (Count 7)*

The plaintiffs' fourth claim is for gross negligence. Both of the Funds' Partnership Agreements contain an exculpatory provision, limiting the liability of the Managers for losses the unitholders incurred with respect to the Funds. Except for misrepresentation or breach of the Partnership Agreements, the General Partners of the Funds (AB Management for Fund I and DCIP for Fund II), and those who perform service on their behalf, are not liable to the unitholders, unless their conduct constituted "gross negligence or intentional misconduct." [FN25] As such, the unitholders are forced to argue that the Managers' alleged misconduct amounted to gross negligence.

FN25. Partnership Agreements § 3.5.

First, as discussed above, the allegations of the Fund I December 2000 Withdrawals and the Fund II 2001 Withdrawals do not state a claim for gross negligence. Second, also as stated above, claims for breach of the duty of care are predicated on concepts of gross negligence. The court has already found that the plaintiffs' claim for breach of the duty of care survive the motion to dismiss. Therefore, this claim survives as well.

E. *Unjust Enrichment (Count 8)*

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The plaintiffs, in the alternative, plead both a claim for breach of contract and a claim for unjust enrichment. In some circumstances, alternative pleading allows a party to seek recovery under theories of contract or quasi-contract. This is generally so, however, only when there is doubt surrounding the enforceability or the existence of the contract. Courts generally dismiss claims for *quantum meruit* on the pleadings when it is clear from the face of the complaint that there exists an express contract that controls .[FN26]It is undisputed that a written contract existed between the unitholders and the defendants. The Partnership Agreements for the Funds spelled out the relationship between the parties, and the plaintiffs specifically brought claims based on these contracts.

FN26.*Rossdeutscher v. Viacom, Inc.,* 768 A.2d 8, 24 (Del.2001) (applying New York law); *ID Biomedical Corp. v. TM Tech., Inc.,* 1995 WL 130743, at *15 (Del.Ch. Mar.16, 1995) (applying Delaware law).

Notwithstanding the existence of these contractual relationships, the plaintiffs make the bald claim that the Managers were unjustly enriched at the unitholders expense. This is insufficient to state a claim for unjust enrichment, when the existence of a contractual relationship is not controverted. Thus, this claim must be dismissed.

F. *Agency Liability (Count 11)*

The plaintiffs also bring claims against Deustche Bank and DBSI (as controlling persons of AB Management) based on agency liability. A parent corporation can be held liable for the acts of its subsidiary under either of two theories of agency liability. The first is where "piercing the corporate veil" is appropriate. While many factors are considered in deciding whether to pierce the corporate veil, "the concept of complete domination by the parent is decisive."[FN27]

FN27.*Phoenix Canada Oil Co. v. Texaco, Inc.,* 842 F.2d 1466, 1477 (3d Cir.1988).

***9** Second, while one corporation whose shares are owned by a second corporation does not, by that fact alone, become the agent of the second company, a corporation-completely independent of a second corporation-may assume the role of the second corporation's agent in the course of one or more specific transactions. This restricted agency relationship may develop whether the two separate corporations are parent and subsidiary or are completely unrelated outside the limited agency setting. Under this second theory, total domination or general alter ego criteria need not be proven.[FN28]

FN28.*Id.* (citing RESTATEMENT (SECOND) OF AGENCY § 14M, cmt. (a) (1958)).

With respect to DBSI, the plaintiffs argue that AB Management was dominated and controlled by DBSI. In essence, the plaintiffs ask the court to disregard AB Management's corporate form [FN29] and impose liability on DBSI. The complaints allege that: (i) DBSI and AB Management operate out of the same Maryland office; (ii) AB Management, although incorporated, has no functioning board of directors and no business other than the management of the Funds; (iii) AB Management is run by its Management Committee, which is comprised of employees and executives of DBSI; (iv) DBSI provided margin accounts for the Funds; and (v) DBSI served as the placement agent and custodian for the Funds' accounts.[FN30]

FN29. AB Management is a corporation, organized under the laws of Maryland.

FN30. Fund I Compl. ¶¶ 44, 45, 247, 250, 332, 334; Fund II Compl. ¶¶ 54, 179, 253-259.

"Persuading a Delaware Court to disregard the corporate entity is a difficult task. The legal entity of a corporation will not be disturbed until sufficient reason appears."[FN31]Allegations (i), (iv) and (v) above, while consistent with an obviously close relationship between DBSI and its wholly owned subsidiary, do not alone or together support any inference that would lead this court to disregard the separate legal existence of AB Management; nor does the allegation that AB Management's business is run by DBSI employees. However, the well pleaded factual allegation that AB Management has "no functioning board of directors," when viewed most favorably to the plaintiffs in light of the other facts alleged, if proven, could provide a basis to conclude

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that the corporate form should be ignored. The corporate veil may be pierced where a subsidiary is in fact a mere instrumentality or alter ego of its parent.[FN32] The complaints allege that AB Management does not have board meetings or follow other corporate formalities. Instead, employees of DBSI allegedly perform the activities that, in a properly functioning corporation, the board of directors would perform. If these facts are true and the other relationships are shown to exist, an adequate basis for piercing the corporate veil could be established. Therefore, this claim against DBSI cannot be dismissed.

FN31. *Mason v. Network of Wilmington, Inc.*, 2005 Del. Ch. LEXIS 99, at *9, 2005 WL 1653954 (Del. Ch. July 1, 2005) (internal quotations omitted).

FN32. *Mabon, Nugent & Co. v. Texas Amer. Energy Corp.*, 1990 Del. Ch. LEXIS 46, at *14-*15, 1990 WL 44267 (Del. Ch. Apr. 12, 1990); *Phoenix Canada Oil*, 842 F.2d at 1477.

The complaints make additional allegations as to why AB Management is a mere agent of Deutsche Bank. These are: (i) Deutsche Bank purchased Alex. Brown, Inc. (the parent company of AB Management) thereby acquiring 100% ownership of AB Management; (ii) Deutsche Bank changed the name of the Funds the reflect the "Deutsche Bank" name; (iii) when the liquidity crisis became acute, the Management Committee decided that it needed to alert officials at Deutsche Bank; and (iv) in July of 2002, Deutsche Bank fired all the members of the Management Committee.[FN33]

FN33. Fund I Compl. ¶¶ 153, 163, 239-240; Fund II Compl. ¶¶ 179, 253-259.

***10** First, these factual allegations do not give rise a reasonable inference that Deutsche Bank dominated and controlled AB Management and the Management Committee. These factual allegations show little more than Deutsche Bank owned the parent company of AB Management and, indirectly, AB Management itself. Ownership alone is not sufficient proof of domination or control.[FN34] The complaints allege that Deutsche Bank bought AB Management in June of 1999 and changed its name a few months later. The complaints do not allege any action by Deutsche Bank to influence or control the management of the Funds until July of 2002, when it fired the majority of the Management Committee. From these bare factual allegations, the court simply cannot infer domination or control.

FN34. *Aronson*, 473 A.2d at 815; *see also In re W. Nat'l S'holders Litig.*, 2000 Del. Ch. LEXIS 82, 2000 WL 710192 (Del. Ch. May 22, 2000) (holding that a 46% shareholder does not control or dominate the board due to stock ownership alone).

Second, these factual allegations do not give rise a reasonable inference that, in the managing and/or sale of the Funds, AB Management and the Management Committee were Deutsche Bank's agent. Under the rubric of agency liability, there are two main theories-actual authority and apparent authority. Because the plaintiffs do not describe which theory of liability they assert, the court addresses both.

Actual authority is that authority which a principal expressly or implicitly grants to an agent.[FN35] There is simply no allegation in the complaints that Deutsche Bank expressly gave either AB Management or the Management Committee the authority to bind it as its agent.

FN35. *Billops v. Magness Constr. Co.*, 391 A.2d 196, 197 (Del.1978).

Apparent authority is that authority which, though not actually granted, the principal knowingly or negligently permits an agent to exercise, or which he holds him out as possessing.[FN36] In order to hold a defendant liable under apparent authority, a plaintiff must show reliance on indicia of authority originated by principal, and such reliance must have been reasonable.[FN37] The plaintiffs have not alleged any facts showing that Deutsche Bank held out either AB Management or the Management Committee as its agent; nor have the plaintiffs alleged facts from which the court can reasonably infer reliance.

FN36. *Henderson v. Chantry*, 2002 Del. Ch. LEXIS 14, at *14, 2002 WL 244692 (Del. Ch. Feb. 5, 2002).

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FN37.*Billops,* 391 A.2d at 198.

For the above reasons, the plaintiffs have failed to plead sufficient facts to support a claim for agency liability against Deutsche Bank and Count 11 against Deutsche Bank must be dismissed. However, the plaintiffs plead sufficient facts to support a claim for liability against DBSI. Therefore, Count 11 against DBSI will not be dismissed.

G. *Conspiracy, Aiding And Abetting Fraud, And Breach Of Fiduciary Duty (Count 2, 4, & 9)*

The plaintiffs allege that the defendants conspired to commit fraud and to commit a breach of fiduciary duty. The elements for civil conspiracy under Delaware law are: (i) a confederation or combination of two or more persons; (ii) an unlawful act done in furtherance of the conspiracy; and (iii) damages resulting from the action of the conspiracy parties.[FN38] While the plaintiffs caption their claim as aiding and abetting breach of fiduciary duty, the court treats it as a claim for civil conspiracy. Claims for civil conspiracy are sometimes called aiding and abetting.[FN39] However, the basis of such a claim, regardless of how it is captioned, is the idea that a third party who *knowingly* participates in the breach of a fiduciary's duty becomes liable to the beneficiaries of the trust relationship.[FN40]

FN38.*AeroGlobal Capital Mgmt., LLC v. Cirrus Indus.,* 871 A.2d 428, 437 n. 8 (Del.2005); *Nicolet, Inc. v. Nutt,* 525 A.2d 146, 149-50 (Del.1987).

FN39.*See* *Benihana of Tokyo, Inc. v. Benihana, Inc.,* 2005 Del. Ch. LEXIS 19, at *26, 2005 WL 583828 (Del. Ch. Feb. 28, 2005).

FN40.*Gilbert v. El Paso Co.,* 490 A.2d 1050, 1057 (Del.Ch.1984), *aff'd,* 575 A.2d 1131 (Del.1990).

*11 However captioned, civil conspiracy is vicarious liability.[FN41] It holds a third party, not a fiduciary, responsible for a violation of fiduciary duty.[FN42] Therefore, it does not apply to the defendants which owe the unitholders a direct fiduciary duty. Instead, the plaintiffs attempt to hold Deustche Bank and DBSI responsible for the Managers' alleged breaches of fiduciary duty.

FN41.*See, e.g.,* *Parfi Holding AB v. Mirror Image Internet, Inc.,* 794 A.2d 1211, 1238 (Del.Ch.2001) ("Civil conspiracy thus provides a mechanism to impute liability to those not a direct party to the underlying tort."), *rev'd on other grounds,* 817 A.2d 149 (Del.2002).

FN42.*Gilbert,* 490 A.2d at 1057.

The defendants argue that the plaintiffs have not adequately alleged that Deustche Bank and DBSI had knowledge of the alleged wrongful acts, the breach of fiduciary duty and fraud. Where a complaint alleges fraud or conspiracy to commit fraud, the Rules of this court call for a higher pleading standard, requiring the circumstances constituting the fraud or conspiracy to "be pled with particularity." [FN43] While Rule 9(b) provides that "knowledge ... may be averred generally," where pleading a claim of fraud or breach of fiduciary duty that has at its core the charge that the defendant knew something, there must, at least, be sufficient well-pleaded facts from which it can reasonably be inferred that this "something" was knowable and that the defendant was in a position to know it.[FN44]

FN43.*Atlantis Plastics Corp. v. Sammons,* 558 A.2d 1062, 1066 (Del.Ch.1989) (citing Rule 9(b), which states: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

FN44.*IOTEX Communs., Inc. v. Defries,* 1998 Del. Ch. LEXIS 236, at *12-*13, 1998 WL 914265 (Del. Ch. Dec. 21, 1998).

Furthermore, Delaware law states the knowledge of an agent acquired while acting within the scope of his or her authority is imputed to the principal.[FN45] With respect to DBSI, the complaints allege repeatedly that its employees, acting within the scope of their employment, had knowledge of the underlying factual allegations. Specifically, the complaints allege that the Funds were run by the Management Committee, all the members of which were employees of DBSI.[FN46] This knowledge is thereby

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imputed to DBSI.

FN45. *J.I. Kislak Mtg. Corp. v. William Matthews Bldr., Inc.,* 287 A.2d 686, 689 (Del.Super.1972), *aff'd,* 303 A.2d 648 (Del.1972).

FN46. Fund I Compl. ¶¶ 45, 47-51, 247-251; Fund II Compl. ¶¶ 55, 57-61, 261-266.

With respect to Deutsche Bank, the plaintiffs allege that AB Management and the Management Committee are mere agents of Deutsche Bank. However, as discussed above, the factual allegations in the complaints are insufficient to infer that AB Management and the Management Committee are the agents of Deutsche Bank.

For the above reasons, the court holds that the plaintiffs have not adequately pleaded facts that, if proven, would support an inference that Deustche Bank had knowledge of the alleged wrongful acts, the breach of fiduciary duty and fraud. The plaintiffs have adequately pleaded that DBSI had knowledge of the alleged wrongful acts. Therefore, with respect to Deutsche Bank, Counts 2, 4, and 9 must be dismissed. With respect to DBSI, these counts will not be dismissed.

H. *Accounting (Count 10)*

The plaintiffs' tenth claim is for an accounting. An accounting is an equitable remedy that consists of the adjustment of accounts between parties and a rendering of a judgment for the amount ascertained to be due to either as a result.[FN47] As it is a remedy, should the plaintiffs ultimately be successful on one or more of their claims, the court will address their arguments for granting an accounting.

FN47. *Jacobson v. Dryson Acceptance Corp.,* 2002 Del. Ch. LEXIS 4, at *12-*13, 2002 WL 31521109 (Del. Ch.2002).

V.

The defendants argue that several of the claims in the complaints are derivative and that, since the plaintiffs did not make demand upon the Funds, and demand was not excused, these claims should be dismissed pursuant to Rule 23.1.[FN48]

FN48. The claims that the defendants contend are derivative are as follows: breach of fiduciary duty (Count 1), aiding and abetting breach of fiduciary duty (Count 2), breach of contract (Count 5), breach of the covenant of good faith (Count 6), gross negligence (Count 7), unjust enrichment (Count 8), accounting (Count 10), and agency liability (Count 11). As the court has already dismissed the claim for unjust enrichment (Count 8) and agency liability as to Deutsche Bank (Count 11), and deferred granting the equitable remedy of an accounting (Count 10), it will not discuss those claims here.

***12** The demand requirement in the limited partnership context is codified in 6 *Del. C.* § 17-1001. That statute states:

A limited partner or an assignee of a partnership interest may bring an action in the Court of Chancery in the right of a limited partnership to recover a judgment in its favor if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed.

Likewise, the determination of whether a claim is derivative or direct in nature is substantially the same for corporate cases as it is for limited partnership cases.[FN49] Accordingly, throughout this decision, the court relies on corporate as well as partnership case law for its determination of this lawsuit's nature.

FN49. *Litman v. Prudential-Bache Prop., Inc.,* 611 A.2d 12, 15 (Del.Ch.1992).

The Delaware Supreme Court's recent decision in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.* revised the standard for determining whether a claim is direct or derivative. Now, the determination "turn[s] solely on the following questions: (i) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (ii) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[FN50] "[U]nder *Tooley,* the duty of the court is to look at the nature of the wrong alleged, not

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merely at the form of words used in the complaint."[FN51]"Instead the court must look to all the facts of the complaint and determine for itself whether a direct claim exists."[FN52]

FN50. 845 A.2d 1031, 1033 (Del.2004).

FN51. *In re Syncor Int'l Corp. S'holders Litig.*, 857 A.2d 994, 997 (Del.Ch.2004).

FN52. *Dieterich v. Harrer*, 857 A.2d 1017, 1027 (Del.Ch.2004).

As they are factually distinct, the court deals with the claims separately. First, the court addresses the claims for breach of contract and the breach of fiduciary duty based on the Non-Disclosure Allegations. Second, the court addresses the claims for gross negligence and failing to provide active and competent management, and the fiduciary duty claims based thereon.

A. *Breach Of Contract And The Non-Disclosure Allegations*

The claims for breach of contract and the claims for breach of fiduciary duty based on the Non-Disclosure Allegations are direct. First, the unitholders, not the partnerships, suffered the alleged harm. In order to show a direct injury under *Tooley,* a unitholder "must demonstrate that the duty breached was owed to the [unitholder] and that he or she can prevail without showing an injury to the [partnership]."[FN53] The gravamen of these claims is that the Managers failed to disclose material information when they had a duty to disclose it and made other misleading or fraudulent statements, in violation of their contractual and fiduciary duties. Generally, non-disclosure claims are direct claims.[FN54]Moreover, the partnerships were not harmed by the alleged disclosure violations. Any harm was to the unitholders, who either lost their opportunity to request a withdrawal from the Funds from the Managers, or to bring suit to force the Managers to redeem their interests.

FN53. *Tooley,* 845 A.2d at 1039.

FN54. *See, e.g.,* *Dieterich,* 857 A.2d at 1029 (characterizing non-disclosure claims as direct claims); *Abajian v. Kennedy,* 1992 Del. Ch. LEXIS 6, at *10, 1992 WL 8794 (Del. Ch. Jan. 17, 1992) (same).

***13** Second, the unitholders would receive any recovery, not the Funds. Under the second prong of *Tooley,* in order to maintain a direct claim, stockholders must show that they will receive the benefit of any remedy.[FN55] While the best remedy for a disclosure violation is to force the partnership to disclose the information, due to the passage of time since the alleged wrongdoing, that remedy would likely be inadequate. In order to compensate the unitholders for their alleged harm, the court may find it appropriate to grant monetary damages. Such damages would be awarded to the unitholders, and not the partnerships.

FN55. *Tooley,* 845 A.2d at 1033.

For all of the above reasons, the court concludes that the claims based on the Non-Disclosure Allegations and the alleged breach of contract are direct claims and, thus, demand was not required.

B. *Gross Negligence And Failure To Provide Competent And Active Management*

The claims for gross negligence and failure to provide competent and active management are clearly derivative. First, as stated above, in order to show a direct injury under *Tooley,* a unitholder "must demonstrate that the duty breached was owed to the [unitholder] and that he or she can prevail without showing an injury to the [partnership]."[FN56] The gravamen of these claims is that the Managers devoted inadequate time and effort to the management of the Funds, thereby causing their large losses. Essentially, this a claim for mismanagement, a paradigmatic derivative claim.[FN57]The Funds suffered any injury that resulted from the Managers' alleged inattention. Any injury that the unitholders suffered is derivative of the injury to the Funds.

FN56. *Tooley,* 845 A.2d at 1039.

FN57. *See, e.g.,* *Kramer v. W. Pac. Indus., Inc.,* 546 A.2d 348, 353 (Del.1988) ("A claim of mismanagement ... represents a direct wrong to the corporation that is indirectly experienced by all shareholders.

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Any devaluation of stock is shared collectively by all the shareholders, rather than independently by the plaintiff or any other individual shareholder. Thus, the wrong alleged is entirely derivative in nature.").

Second, the Funds, not the unitholders, would receive any recovery. Again, under the second prong of *Tooley,* in order to maintain a direct claim, stockholders must show that they will benefit from the remedy.[FN58] If the court finds that the Managers violated their fiduciary duties by failing to devote adequate time and effort to managing the Funds, any recovery would go to the party harmed, namely the Funds. Thus, these claims are derivative claims.

FN58. *Tooley,* 845 A.2d at 1033.

If a party brings derivative claims without first making demand, and demand is not excused, those claims must be dismissed.[FN59] In this case, the plaintiffs have not alleged that they made demand on the Fund, nor have they alleged why demand should be excused. Accordingly, the derivative claim must be dismissed. However, in the interest of justice, the court dismisses these claims with leave to replead.[FN60]

FN59. *Haber v. Bell,* 465 A.2d 353, 357 (Del.Ch.1983).

FN60. In a letter to the court, the plaintiffs stated that AB Management sent letters to all the unitholders of the Funds (the "Redemption Letters"), stating that the Managers would allow the unitholders to redeem their units and that the Managers are pursuing the dissolution of the Partnerships. The plaintiffs argue that the Redemption Letters bolster their contention that their claims are direct, not derivative. However, the complaints do not contain the information in the Redemption Letters and the Redemption Letters are not referenced in the complaints. Therefore, these documents are not properly before the court on a Rule 12(b)(6) motion.

VI.

The DCIP Defendants argue that, with respect to the Fund I Complaint, this court lacks personal jurisdictions over them. With respect to the Fund II Complaint, they argue that this court lacks personal jurisdiction over Crants and Devlin.[FN61]

FN61. DCIP is the General Partner of Fund II. As such, there is no dispute that the court has personal jurisdiction over DCIP viz. Fund II. *See RJ Assocs. v. Health Payors' Org. Ltd. P'ship.,* 1999 Del. Ch. LEXIS 161, at *12, 1999 WL 550350 (Del. Ch. July 16, 1999) (quoting 6 *Del. C.* § 17-109(a) and holding that, as a matter of law, by accepting the position of general partner, a corporation consents to be subjected to a Delaware court's jurisdiction if the limited partnership has chosen to incorporate under Delaware law).

In support of their Rule 12(b)(2) motion, the DCIP Defendants adduced affidavits of both Devlin and Crants. The plaintiffs have not adduced any affidavits rebutting the Devlin and Crants affidavits, nor have they asked to take discovery. Instead, they have decided to rely on the well-pleaded allegations in their complaint. Moreover, since they have not been rebutted, the court must take as true the facts contained in the Devlin and Crants affidavits. However, where the well-pleaded allegations in the complaints are not rebutted by affidavit, the court will, for the purposes of this Rule 12(b)(2) motion, assume the truthfulness of those allegations.[FN62]

FN62. *See Hart Holding Co. v. Drexel Burnham Lambert, Inc.,* 593 A.2d 535, 539 (Del.Ch.1991) (citing *Marine Midland Bank, N.A. v. Miller,* 664 F.2d 899, 904 (2nd Cir.1981)) (stating that a trial court is vested with broad discretion in shaping the procedure by which a motion under Rule 12(b)(2) is resolved).

***14** According to the Devlin and Crants affidavits, DCIP is a Tennessee limited liability company, with its principal place of business in Nashville, Tennessee. Both Crants and Devlin are residents of Tennessee and perform the vast majority of their duties from their office in Nashville. Neither Crants nor Devlin recall ever traveling to Delaware. None of

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the DCIP Defendants solicit any business in Delaware or engage in any regular conduct with Delaware.

When a defendant moves to dismiss for lack of personal jurisdiction, the plaintiff bears the burden of showing a basis for the court's exercise of jurisdiction over the nonresident defendant.[FN63] In determining whether it has personal jurisdiction over a nonresident defendant, the court will generally engage in a two-step analysis. First, was service of process on the nonresident authorized by statute? Second, does the exercise of jurisdiction, in the context presented, comport with due process? [FN64]

FN63. *See* *Plummer & Co. Realtors v. Crisafi,* 533 A.2d 1242, 1244 (Del.Super.1987); *see also* *Finkbiner v. Mullins,* 532 A.2d 609, 617 (Del.Super.1987) (stating that, on a Rule 12(b)(2) motion, "the burden is on the plaintiff to make a specific showing that this Court has jurisdiction under a long-arm statute.") (citing *Greenly v. Davis,* 486 A.2d 669 (Del.1984)).

FN64. *LaNuova D & B, S.P.A. v. Bowe Co.,* 513 A.2d 764, 768 (Del.1986).

A. *The Long-Arm Statute*

The plaintiffs argue that the court has personal jurisdiction over the DCIP Defendants under 10 *Del. C.* § 3104, the Delaware long-arm statute. Section 3104(c) provides, in relevant part: "As to a cause of action brought by any person arising from any of the acts enumerated in this section, a court may exercise personal jurisdiction over any nonresident ... who ... (1) Transacts any business or performs any character of work or service in the State ... [or] (4) Causes tortious injury in the State or outside of the State by an act or omission outside the State if the person regularly does or solicits business, engages in any other persistent course of conduct in the State or derives substantial revenue from services, or things used or consumed in the State...." Section 3104 has been broadly construed to confer jurisdiction to the maximum extent possible under the due process clause.[FN65] Furthermore, when *in personam* jurisdiction is challenged on a motion to dismiss, the record is construed most strongly against the moving party. [FN66]

FN65. *Id.*

FN66. *RJ Assocs.,* 1999 Del. Ch. LEXIS 161, at *13, 1999 WL 550350 (Del.Ch.).

The complaints lay out detailed allegations of the connections between the DCIP Defendants and the Funds. The Funds were established as Delaware limited partnerships and are governed by Delaware law. DCIP is the Sub-Advisor of Fund I and the General Partner and Sub-Advisor of Fund II. Crants and Devlin are the managing members and owners of DCIP. DCIP acts principally through Crants and Devlin. The PPMs touted the DCIP Defendants' experience and qualifications in order to sell units in the Funds.

The PPMs also state that DCIP is responsible for the day-to-day management of the Funds. DCIP, in the persons of Crants and Devlin, attended every meeting of the Management Committee (none of which took place in Delaware). Also, DCIP, which acted through Crants and Devlin, was primarily responsible for choosing the securities included in the Funds.

In *RJ Associates,* Justice (then-Vice Chancellor) Jacobs held that this court could exercise personal jurisdiction over a limited partner in a Delaware limited partnership under Section 3104(c)(1). Justice Jacobs held that the following three contacts, taken together, were sufficient to constitute "transacting business" under the Delaware long-arm statute: (i) the limited partner participated in the formation of the limited partnership, (ii) the limited partnership indirectly participated in the limited partnership's management by 'controlling' the general partner, and (iii) the limited partner caused the Partnership Agreement to be amended to alter the method of distributions to the partners.[FN67]

FN67. *RJ Assocs.,* 1999 Del. Ch. LEXIS 161, at *18, 1999 WL 550350 (Del.Ch.).

***15** The operative facts of this case, as alleged in the complaints, are similar to those in *RJ Associates.* First, DCIP participated in the formation of the Funds. In fact, DCIP was primarily responsible for selecting the initial securities accepted by the

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Funds.[FN68] Second, DCIP not only participated in the management of the Funds, DCIP was primarily responsible for the management of the Funds. The PPMs state that "the Sub-Advisor will provide day-to-day management and administration of the Fund and investment advisory services, including, among other matters, the screening of contributed securities, advice regarding the selection of the illiquid Assets and hedging and borrowing strategies."[FN69] Finally, DCIP received millions of dollars in fees to manage the two Delaware entities.

FN68. *See* Fund I Compl. ¶ 71; Fund II Compl. ¶¶ 82, 241.

FN69. Fund I PPM at 3-4, Fund II PPM at 3.

With respect to Crants and Devlin, the complaints allege that they are the owners and managing partners of DCIP. The complaints further allege that DCIP only acts through Crants and Devlin. In essence, the complaints allege that it was Crants and Devlin who selected the securities for the Funds, and managed the Funds on a day-to-day basis.

The court finds that these contacts are sufficient to constitute "transacting business" under the long-arm statute.

B. *Due Process*

The focus of a minimum contacts inquiry is whether a nonresident defendant engaged in sufficient minimum contacts with the State of Delaware to require it to defend itself in the courts of the state consistent with the traditional notions of fair play and justice.[FN70] In order to establish jurisdiction over a nonresident defendant, the nonresident defendant's contacts with the forum must rise to such a level that it should reasonably anticipate being required to defend itself in Delaware's courts.[FN71] The minimum contacts which are necessary to establish jurisdiction must relate to some act by which the defendant has deliberately created obligations between itself and the forum.[FN72] Consequently, the defendant's activities are shielded by the benefits and protection of the forum's laws and it is not unreasonable to require it to submit to the forum's jurisdiction.[FN73]

FN70. *AeroGlobal,* 871 A.2d at 440 (citing *Int'l Shoe Co. v. Washington,* 326 U.S. 310, 66 S.Ct. 154, 90 L.Ed. 95 (1945)).

FN71. *Id.*

FN72. *Sternberg v. O'Neil,* 550 A.2d 1105, 1120 (Del.1988).

FN73. *Id.; see also* *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 475, 105 S.Ct. 2174, 85 L.Ed.2d 528 (U.S.1985) (requiring "purposeful availment" of the benefits of the state's laws to satisfy the minimum contacts test).

In addition to the contacts outlined above that the complaints allege between DCIP Defendants and the Funds, the plaintiffs also allege that the DCIP Defendants enjoyed the benefits of Delaware law. They claim that the DCIP Defendants have received millions of dollars in fees for managing the Delaware partnerships and are entitled to claim limited liability under the terms of the Partnership Agreements, which established the Funds and limit the DCIP Defendants' liability to cases of gross negligence.[FN74]

FN74. Partnership Agreements § 3.5.

In *RJ Associates,* Justice Jacobs found that the following contacts were sufficient to satisfy due process: (i) the limited partner took an active role in establishing the Delaware Partnership; (ii) the limited partner owned a 50% interest in the partnership's general partner, and appointed four of the general partner's seven board members; (iii) the limited partner received 49 .5% of the partnership's cash flow distributions; (iv) the limited partner allegedly controlled the partnership; (v) the limited partner allegedly caused the partnership agreement to be amended under Delaware law to change the agreed-upon cash flow distribution payments to the limited partners; and (vi) the limited partner agreed to a Delaware choice of law provision in the partnership agreement.[FN75]

FN75. *RJ Assocs.,* 1999 Del. Ch. LEXIS 161, at *19-*20, 1999 WL 550350 (Del.Ch.).

***16** While not exactly the same, the contacts that DCIP has with Delaware are substantially similar to

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those in *RJ Associates.*DCIP took part in the formation of the Funds, two Delaware entities. DCIP managed the Funds on a day-to-day basis and received millions of dollars in fees for doing so. In addition, the Partnership Agreements which established the Funds limited the DCIP Defendants' liability to cases of gross negligence.[FN76]They have, thereby, benefited by expressly limiting their liability under Delaware law. Given all of these contacts, DCIP should have reasonably expected to be haled before the courts in Delaware.

FN76. Partnership Agreements § 3.5.

Crants and Devlin also should have reasonably expected to be haled before the courts of this state. As stated above, the complaints allege that DCIP could only act through Crants and Devlin. All the actions attributed to DCIP were really performed by them. Moreover, in the case of Fund II, Crants and Devlin are alleged to be the managing partners of the general partner of a Delaware limited partnership. In the case of Fund I, Crants and Devlin are alleged to have managed a Delaware limited partnership, despite the fact that DCIP is not that entity's general partner.

In *In re USACafes,* former Chancellor Allen found that the directors of a corporation that was the general partner of a Delaware limited partnership were subject to the jurisdiction of this state's courts, due to their positions with the general partner .[FN77]Chancellor Allen focused on the important state interest that Delaware has in regulating entities created under its laws, and how that interest could only be served by exercising jurisdiction over those who managed the Delaware entity.

FN77.600 A.2d 43, 52 (Del.Ch.1991).

The relationship between the General Partner and the limited partners was created by the law of Delaware. The state empowered defendants to act, and this state is obliged to govern the exercise of that power insofar as the issues of corporate power and fiduciary obligation are concerned. These factors bear importantly on the fairness of exercising supervisory jurisdiction at this point in the relationship of the various parties. The wrongs here alleged are not tort or contract claims unconnected with the internal affairs or corporate governance issues that Delaware law is especially concerned with.[FN78]

FN78.*Id.*

Likewise, the wrongs alleged in this case go essentially to the management of a Delaware limited partnership. The DCIP Defendants voluntarily undertook to mange the Funds and received millions of dollars in compensation for doing so. Now, limited partners in the Delaware entity seek to hold them accountable for alleged wrongs they committed. It is both necessary and proper for the courts of this state to ensure that the managers of a Delaware entity are held responsible for their actions in managing the Delaware entity. When a person manages a Delaware entity, and receives substantial benefit from doing so, he should reasonably expect to be held responsible for his wrongful acts relating to the Delaware entity in Delaware.[FN79]

FN79.*See* Assist Stock Mgmt. L.L.C. v. Rosheim, 753 A.2d 974, 975 (Del.Ch.2000) ("When nonresidents agree to serve as directors or managers of Delaware entities, it is only reasonable that they anticipate that ... they will be subject to personal jurisdiction in Delaware courts.").

***17** For the above reasons, the court concludes that it has personal jurisdiction over the DCIP Defendants in both cases. Therefore, the DCIP Defendants' motion to dismiss pursuant to Rule 12(b)(2) must be denied.

VII.

For the above reasons, the defendants' motion to dismiss is GRANTED in part and DENIED in part. The defendants are directed to submit a form of order, on notice, within 10 days.

Del.Ch.,2005.
Albert v. Alex. Brown Management Services, Inc.
Not Reported in A.2d, 2005 WL 2130607 (Del.Ch.), 31 Del. J. Corp. L. 267

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Tab 2

Iotex Communications, Inc. v. Defries
Del.Ch.,1998.

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.
IOTEX COMMUNICATIONS, INC., a Delaware corporation, Plaintiff and Counterclaim Defendant,
v.
Anthony DEFRIES and David Bayendor, Defendants,
andIOTA, INC., a Delaware corporation, Defendant and Counterclaim and Third-Party Plaintiff,
v.
ioWAVE, INC., Third-Party Defendant.
No. 15817.

Dec. 21, 1998.

Grover C. Brown, Esquire, Michael J. Maimone, Esquire and Joseph C. Schoell, Esquire, of Morris, James, Hitchens & Williams, Wilmington, Delaware, Attorneys for Plaintiff and Counterclaim Defendant Iotex Communications, Inc.
Iota, Inc., Defendant and Counterclaim and Third-Party Plaintiff (C.A. No. 15817);Anthony Defries and David Bayendor, Defendants (C.A. No. 15817);Urs Maag, Plaintiff and Counterclaim Defendant (C.A. No. 16082); Neosoft, A.G., Plaintiff (C.A.16036).[FN*]

FN* On December 18, 1998, an Order was entered permitting counsel for these parties to withdraw his representation and allowing 60 days for Iota, Inc. to secure new counsel.

Allen M. Terrell, Jr., Esquire and Srinivas M. Raju, Esquire, of Richards, Layton & Finger, P.A., Wilmington, Delaware; Of Counsel: Blair G. Brown, Esquire and Lynn F. Kaumann, Esquire, of Zuckerman, Spaeder, Goldstein, Taylor & Kolker, L.L.P., Washington, D.C., Attorneys for Counterclaim Defendant ioWave, Inc.

MEMORANDUM OPINION

LAMB, Vice Chancellor.

I. INTRODUCTION

*1 These motions arise out of a complex, multi-party, multi-suit [FN1] litigation begun in July 1997. Various motions to dismiss were filed by several of the parties and oral argument on these motions was held on November 10, 1998. At the conclusion of the hearing held in these consolidated matters, I reserved decision on the motion of David Bayendor to dismiss the complaint against him in C.A. No. 15817 for want of personal jurisdiction, the motions of David Bayendor ("Bayendor") and Anthony Defries ("Defries") to dismiss the Eighth Claim for Relief alleged by counterclaim in C.A. No. 15817 for failure to state a claim (as well as the motion of Defries to dismiss for lack of personal jurisdiction over the Eighth Claim for Relief), and the motion of Urs Maag ("Maag") to dismiss the counterclaims filed against him in C.A. No. 16082 for failure to state a claim upon which relief may be granted. For the reasons that follow, these motions will be granted.

FN1. Three actions have been consolidated for all purposes, C.A. Nos. 15817-NC, 16036-NC, and 16082-NC.

A. Background [FN2]

FN2. Except as otherwise noted, the facts recited herein are taken from the Amended Complaint in C.A. No. 15817 and the counterclaim in C.A. No. 16082.

In 1991, Defries caused the formation of Iota, Inc. ("Iota"), a Delaware corporation, to serve as a vehicle for continuing research into certain wireless communications technology ("Technology') under development since the late 1980s. In 1993, Iota succeeded in inventing the Technology and undertook further development work in order to create a commercially viable product. That same year, Defries caused Iota to transfer its rights to all of the intellectual property associated with the Technology to NeoSoft, A.G. ("Neosoft"), a Swiss company he created for that purpose.

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In 1994, Defries entered into discussions with Peter Friedli ("Friedli") concerning a commitment to invest $5.4 million in the further development of the Technology. On July 22, 1994, a certificate of incorporation was filed with the Delaware Secretary of State organizing a corporation that is now known as IOTEX COMMUNICATIONS, INC. ("IOTEX"). Defries and Maag were named as directors of IOTEX. It is not alleged that Defries, or persons or entities affiliated or associated with him, controlled IOTEX. Rather, it appears from one or more pleadings that a majority of the shares of IOTEX were issued to Friedli or persons associated with him.

In July 1994, IOTEX began negotiations over a License Agreement with NeoSoft whereby NeoSoft would grant IOTEX restricted rights to certain applications of the Technology in North America for a fifteen year term. In return, IOTEX would pay NeoSoft royalties based on a percentage of revenues from the use of these applications. As part of these discussions, IOTEX also negotiated a Project Management Agreement with Iota, whereby Iota would agree to act as project manager for IOTEX's research and development of the Technology licensed from NeoSoft.

Maag resigned as a director of IOTEX on October 24, 1994. There is no allegation of fact in the counterclaims filed in C.A. No. 16082 that Maag participated in the negotiation of either of these agreements. Nor is there any allegation that Maag did anything, while he was an IOTEX director or afterward, in furtherance of or in connection with either of them.

***2** The License Agreement and Project Management Agreement (collectively, the "Agreements") were executed on or about November 2, 1994. Under the terms of the Project Management Agreement, IOTEX agreed to fund the costs and expenses associated with the development of the Technology in accordance with a detailed, four-page document (the "Budget") establishing the amounts, timing and manner in which all of the money invested by IOTEX would be spent by Iota. Iota agreed to comply with the provisions of the Budget and further agreed that no material changes would be made to the Budget without first submitting a variance report and obtaining IOTEX's approval for the change. Iota was also required to submit written reports detailing its expenditures to IOTEX. The Budget provided for an 18-month development period that was to be continued only if the parties were satisfied with the progress in the development of the Technology.

In late 1995 and early 1996, IOTEX became concerned that Iota was not complying with the provisions of the Budget and was not developing the Technology as required under the Agreements. Allegedly having concluded that Iota breached the Project Management Agreement, IOTEX stopped making payments to Iota in February 1996. Iota then terminated the Project Management Agreement. Thereafter, IOTEX transferred all of its employees and operations to ioWave, Inc. ("ioWave"), also a Delaware corporation.

On July 18, 1997, IOTEX filed C.A. No. 15817 against Defries, David Bayendor,[FN3] and Iota, alleging claims of breach of fiduciary duty, fraud, aiding and abetting and civil conspiracy arising out of the negotiation and performance of the Project Management Agreement. IOTEX amended its complaint on November 7, 1997, *inter alia,* to add claims against Defries and Bayendor under the federal Racketeer Influenced and Corrupt Organization Act (RICO"), 18 U.S.C. § 1961, *et seq.* Iota answered and counterclaimed against IOTEX on August 19, 1997. On October 27, 1997, Iota amended its counterclaims to assert claims against ioWave, as an additional third-party defendant.

FN3. Bayendor is Defries' nephew. Bayendor was a former President of IOTEX, resigning his position on October 14, 1994, and a former director and Vice President of Iota. He resigned from these latter position on June 18, 1997.

On November 13, 1997, NeoSoft filed C.A. No. 16036 against IOTEX for failure to make payments as required by the License Agreement. On December 10, 1997, Maag, as a stockholder of IOTEX, filed C.A. No. 16082, a derivative suit on behalf of IOTEX against Friedli, alleged to be the sole director of IOTEX, Taher Behbehani, the former CEO of IOTEX, and ioWave, alleging that they wrongfully transferred the business of IOTEX to ioWave. In response, IOTEX brought five counterclaims against Maag, alleging essentially the same claims it set forth in its July 18, 1997 complaint against Defries,

Bayendor and Iota.

II. DISCUSSION

A. Standard

A claim will be dismissed where it fails to allege facts that entitle plaintiff to relief. *See* Ch. Ct. R. 12(b)(6); *Rabkin v. Philip A. Hunt Chem. Corp.,* Del.Supr., 498 A.2d 1099, 1104 (1985). In evaluating a motion to dismiss, the allegations of fact must be construed in the light most favorable to the plaintiff and all well-pleaded facts must be accepted as true. *In re Tri-Star Pictures, Inc., Lit.,* Del.Supr., 634 A.2d 319, 326 (1993). Conclusions "will not be accepted as true without specific allegations of fact to support them."*Id.*

***3** Where a complaint alleges fraud or conspiracy to commit fraud, the Rules of this Court call for a higher pleading standard, requiring the circumstances constituting the fraud or conspiracy to "be pled with particularity." *Atlantis Plastics Corp. v. Sammons,* Del. Ch., 558 A.2d 1062, 1066 (1989) (citing Court of Chancery Rule 9(b), which states: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."). The particularity requirements will be met where the complaint "specif[ies] the time, place, speaker, and sometimes even the content of the alleged mi srepresentations...."*Luce v. Edelstein,* 2d Cir., 802 F.2d 49, 54 (1986).

B. The Maag Motion

In the counterclaim filed in C.A. No. 16082, IOTEX alleges that Maag (plaintiff in that derivative action), together with Defries, Bayendor, Iota and NeoSoft "devised, agreed upon and pursued a scheme" to defraud IOTEX and its stockholders that has resulted in a loss of over $5.2 million and forced IOTEX to abandon its operations. IOTEX alleges that Maag and the others fraudulently induced IOTEX to "(i) incur significant expenses in becoming a newly-created entity to invest funds in connection with the Technology, (ii) realize substantial costs in negotiating and entering into the License Agreement with NeoSoft and the Project Management Agreement with Iota, and operating as an on-going entity, and (iii) raise funds from individual investors and forward an amount greater that $5.2 million to Iota in accordance with the terms of the Budget."IOTEX's Answering Br. at 12 (citations omitted). IOTEX also alleges that monies contributed by IOTEX according to the Agreements have been misappropriated by various individuals associated with Iota and NeoSoft, including, "possibly" Maag.

In his Motion to Dismiss, Maag attacks each of the five counterclaim allegations alleged by IOTEX, which are: (1) breach of fiduciary duty, (2) breach of duty of disclosure, (3) aiding and abetting breach of another's fiduciary duty, (4) common law fraud and (5) civil conspiracy. I will address allegations (1), (2) and (3) together and will do the same for allegations (4) and (5).

1. Breach of Fiduciary Duty, Duty of Disclosure and Aiding and Abetting Breach of Fiduciary Duty

IOTEX claims Maag breached his fiduciary duties, owed in his capacity as an IOTEX director, by allowing IOTEX to negotiate and enter into the Agreements and further, to invest funds over the course of performance of the Project Management Agreement, *knowing* that NeoSoft and Iota "would not satisfy their respective contractual obligations" and would use the Agreements to "fraudulently induce IOTEX to forward funds to Iota," and in failing to inform the IOTEX board of directors of this knowledge.[FN4]Further, IOTEX claims that Maag aided and abetted a breach of Defries' fiduciary duties, owed by Defries in his capacity as an IOTEX director, by failing to prevent Defries from "causing and permitting" IOTEX to enter into the Agreements, when Maag *knew* that Iota and NeoSoft would not meet their contractual obligations.[FN5] In support of these claims, IOTEX alleges with particularity the following: (1) Maag was a director of IOTEX during the negotiation of the Agreements (but had resigned before the Agreements were approved), (2) Maag was a director of NeoSoft during the negotiation of the Agreements, (3) Maag was associated with Defries and (4) Iota, it is alleged, breached the Project Management Agreement.

FN4. For the purpose of this motion, I accept as true IOTEX's averment that Maag was a director of IOTEX between July and October 1994. I do note, however, that this is a disputed fact.

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FN5. IOTEX contends that Maag's actions must be evaluated under the entire fairness standard, since he was a director of both IOTEX and NeoSoft between July 22, 1994 and October 24, 1994, the period in which the Agreements were negotiated. I do not reach this issue, as I find IOTEX's claims are not adequately substantiated by specific allegations of fact.

*4 Thus, a central element of the claims against Maag for breach of fiduciary duty rests on the general allegation that he "knew" as a "fact" (and failed to disclose) something about the state of mind of Defries and others during the period of negotiation of the Agreements. The "fact" that he is alleged to have known is not itself alleged with particularity but, rather, as a conclusion based on events which transpired during the course of performance of the Project Management Agreement. There are also no allegations of fact that Maag played any substantial role in the negotiation or execution of the Agreements, as a director of IOTEX or otherwise.[FN6] Finally, there is no allegation that he profited from the alleged misapplication of the development funds. The best IOTEX is able to say is that funds were transferred to a Swiss bank where it is "possible" that Maag has an account.

FN6. IOTEX's only claim of Maag's participation in the negotiation or approval of the Agreements is made by reference to an October 27, 1994 letter from Defries, on behalf of Iota, addressed to Maag, which states: "Enclosed find three copies of the Project Management Agreement that we have signed on behalf of Iota Inc. Please have Peter Friedli sign and date yellow tabs where indicated on behalf of [IOTEX] retaining one copy for your records and returning one copy to us for our files."Of course, IOTEX concedes that Maag resigned as an IOTEX director on October 24, 1994. Moreover, it makes no allegation of fact that Maag either obtained Friedli's signature or otherwise participated in securing IOTEX's approval of the Project Management Agreement.

While recognizing that Court of Chancery Rule 9(b) provides that "knowledge ... may be averred generally," where pleading a claim of fraud or breach of fiduciary duty that has at its core the charge that the defendant knew something, there must, at least, be sufficient well-pleaded facts from which it can reasonably be inferred that this "something" was knowable and that the defendant was in a position to know it. IOTEX contends the scant well-pleaded facts in its counterclaim support the conclusion that Maag knew that Defries and Iota were not acting in good faith in negotiating the Agreements. I cannot agree. Speculative conclusions unsupported by fact do not allege breaches of fiduciary duty. *See In re Tri-Star,* Del.Supr., 634 A.2d at 326 (conclusions "will not be accepted as true without specific allegations of fact to support them."). For the same reasons, I reject IOTEX's argument that Maag aided and abetted Defries alleged breach of duty.

My decision in this regard is premised importantly on the general rule of law that one cannot "bootstrap" a claim of breach of contract into a claim of fraud merely by alleging that a contracting party never intended to perform its obligations. *See* discussion pages 11 to 12, *infra.*The same considerations lead me to conclude that one cannot, ordinarily, premise a claim for breach of fiduciary duty on the assertion that a director knew and failed to disclose that a party negotiating a contractual arrangement with the corporation did not intend to perform its obligations under the contract. I do recognize that there are rare circumstances in which this general rule should not apply. This is not one of them. Here, there is no allegation that the Technology was not valuable at the time the Agreements were executed. Indeed, it is alleged that Defries had been working on the Technology for some years and it is clear from the positions of the parties that they all regard the Technology as having substantial value. There also is no allegation that Iota failed to begin its performance under the Project Management Agreement and continue rendering some performance for more than a year. In short, despite the conclusory allegations of fraud and breach of fiduciary duty, the dispute between the parties is essentially one for breach of contract, and the well-pleaded facts alleged in that regard do not support the inference that Defries and Iota did not intend to perform the Agreements. In the circumstances, the claims for breach of fiduciary duty against Maag must be dismissed.

2. Fraud and Conspiracy to Commit Fraud

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*5 IOTEX's final two counterclaim allegations contend that Maag committed fraud and conspired to commit fraud. Again, these charges are predicated on the allegations that Maag *knew* that Defries and Iota did not intend to meet their contractual obligations and were "merely using the [Agreements] to fraudulently induce IOTEX to forward funds to Iota."In failing to disclose this *knowledge,* IOTEX argues, Maag participated in a scheme to defraud IOTEX, as it "would not have expended the time and resources negotiating, entering into and satisfying its obligations under the [Agreements] had it been aware of the actual intent of NeoSoft, Iota, Defries and Maag."Further, IOTEX argues that Maag's knowledge and participation in the scheme to defraud IOTEX makes him liable as a conspirator for any other wrongful acts committed in furtherance of the conspiracy.

Under New York law,[FN7] a scheme to defraud is shown where the complaint asserts facts that demonstrate: (1) a scheme, (2) involving defendants (3) directed against the interests of plaintiffs and (4) defendant's conduct in connection with the scheme. *See* Shearson Lehman Bros. Inc. v. Bagley, N.Y.App. Div., 614 N .Y.S.2d 5, 6 (1994). Fraudulent misrepresentation is shown where facts are alleged that "(1) the defendant made a material false representation, (2) the defendant intended to defraud the plaintiff thereby, (3) the plaintiff reasonably relied upon the representation, and (4) the plaintiff suffered damage as a result of such reliance."*Banque Arabe et Internationale D'Investissement v. Maryland Nat'l Bank,* 2d Cir., 57 F.3d 146, 153 (1995). The courts have noted that "[i]t is almost impossible to state in detail the circumstances constituting a fraud where those circumstances are peculiarly within the knowledge of the party against whom the (fraud) is being asserted."*CPC Int'l Inc. v. McKesson Corp.,* N .Y., 519 N.Y.S.2d 804, 812 (1987) (quoting *Jered Contracting Corp. v. New York City Transit Auth.,* N.Y., 292 N.Y.S.2d 98, 104 (1968)). However, a complaint must "allege the misconduct complained of in sufficient detail to inform the defendants of the substance of the claims."*Bernstein v. Kelso & Co., Inc.,* N.Y.App. Div., 659 N.Y.S.2d 276, 280 (1997).

FN7. The parties are in agreement that New York law governs these claims for fraud.

IOTEX's fraud claims suffer from the same defect as its breach of fiduciary duty claims. Moreover, IOTEX has failed to allege sufficient facts to establish that, even if there was fraud, Maag participated in it. *See In re Tri-Star,* Del.Supr., 634 A.2d at 326 (Conclusions "will not be accepted as true without specific allegations of fact to support them.").

IOTEX does allege the elements of a claim for breach of contract against Iota. That claim, however, cannot be "bootstrapped" into a fraud claim merely by adding the words "fraudulently induced" or alleging that the contracting parties never intended to perform. *See Dann v. Chrysler Corp.,* Del. Ch., 174 A.2d 696, 700 (1961) ("Using the word 'fraud' or its equivalent in any form is just not a substitute for the statement of sufficient facts to make the basis of the charge reasonably apparent.").

*6 New York law is decisively to the same effect: "It is well settled under New York law that 'a contract action cannot be converted to one for fraud merely by alleging that the contracting party did not intend to meet its contractual obligations." ' *International CableTel Inc. v. Le Group Videotron LTEE,* S.D.N.Y., 978 F.Supp. 483, 486 (1997) (quoting *Rocanova v. Equitable Life Assurance Soc'y of the U.S.,* N.Y., 612 N.YS.2d 339, 343 (1994)). New York law does recognize that a promise made "with a preconceived and undisclosed intention" of non-performance "constitutes a misrepresentation of a 'material existing fact." ' *Id.* at 487 (quoting *Sabo v. Delman,* N.Y., 164 N.Y.S.2d 714, 716 (1957). Nevertheless, this rule is limited by the requirement that "a false promise can support a claim of fraud only where that promise was 'collateral or extraneous' to the terms [of] an enforceable agreement in place between the parties." *Id.* IOTEX has alleged no facts showing that Maag was aware or participated in a "false promise" that was "collateral or extraneous" to the terms of the Agreements. On the contrary, the false promise alleged by IOTEX goes to the heart of the Agreements. Therefore, I do not find IOTEX to have met the requirements for pleading a fraud claim where, as is true here, the underlying action is for breach of contract.

Since I find IOTEX has failed to meet the pleading requirements for fraud, I need not address the conspiracy claim, as there is no underlying

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independent claim of fraud sufficient to withstand a motion to dismiss. *See* Demalco Ltd. v. Feltner, S.D.N.Y, 588 F.Supp. 1277, 1278 (1984) ("It is well settled in New York that 'civil conspiracy to commit fraud, standing alone, is not actionable .'Instead, the gravamen of a claim of conspiracy is the underlying independent tort, and if the independent tort has not been adequately pleaded, the conspiracy claim will also fail."(quoting *Cullen v. BMW of North Am., Inc.,* E.D.N.Y., 490 F.Supp. 249, 254 (1980) and citing *Danahy v. Meese,* N.Y.App. Div., 446 N.Y.S .2d 611, 614 (1981))).

B. The Bayendor Motion

The complaint in C.A. No. 15817 was served on Bayendor in the manner described in 10 *Del. C.* § 3114, the Delaware director service statute. Apparently, IOTEX relied on that statute due to Bayendor's status as a director of Iota, his co-defendant. On August 19, 1997, Bayendor moved to dismiss for lack of personal jurisdiction and insufficiency of service of process, contending that Section 3114 was unavailable for use by IOTEX as its complaint was unrelated to Bayendor's fiduciary duties to Iota. In response, IOTEX served Bayendor again, this time under 10 *Del. C.* § 3104, the general long-arm service statute, and directed certain discovery at him in connection with his motion to dismiss. On November 21, 1997, IOTEX filed an amended complaint that added claims against Bayendor for civil conspiracy and violations of the federal Racketeer Influenced and Corrupt Organization Act ("RICO"). That amended complaint was served in reliance on Section 3104.

*7 As a result of the briefing on Bayendor's motion, the issue has narrowed to whether or not IOTEX is entitled to rely on the "civil conspiracy" theory of personal jurisdictional to obtain jurisdiction over Bayendor in Delaware. That is, I understand IOTEX fairly to concede that Section 3114 has no application to its claim and that no other head of jurisdiction under Section 3104 is available in this case.

The civil conspiracy theory of personal jurisdiction was recognized by the Delaware Supreme Court in *Istituto Bancario Italiano SpA v. Hunter Eng'g Co.,* Del.Supr., 449 A.2d. 210, 225 (1982), but, because it affords "an easy technique to evade the thrust of the *International Shoe* holding," it has been narrowly construed by this Court. *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.,* Del. Ch., C.A. No. 13950, Allen, C., slip op. at 29 (Nov. 21, 1995). In *Istituto Bancario,* the Supreme Court surveyed the law from other jurisdictions regarding the conspiracy theory of jurisdiction and determined to adopt what it characterized as the "strict test" requiring a plaintiff to satisfy each of five elements:

(1) a conspiracy to defraud existed; (2) the defendant was a member of that conspiracy; (3) a substantial act or substantial effect in furtherance of the conspiracy occurred in the forum state; (4) the defendant knew or had reason to know of the act in the forum state or that acts outside the forum state would have an effect in the forum state; and (5) the act in, or effect on, the forum state was a direct and foreseeable result of the conduct in furtherance of the conspiracy.

Istituto Bancario, Del.Supr., 449 A.2d at 225. While not conceding the existence of elements (1) and (2), Bayendor's argument focuses on the final three elements, and in particular on the absence of any allegation of an act or effect in Delaware in furtherance of the alleged conspiracy.

IOTEX cites three matters that it characterizes as "substantial acts and effects in the State of Delaware."None of these bear analysis.

IOTEX argues that the "principal effect involving Delaware" was "the use of a Delaware corporation-Iota-as the vehicle through which the fraud was committed."Mere use of a Delaware corporate entity in connection with a civil conspiracy has never been held to satisfy this element of the *Istituto Bancario* test. In support of this position, IOTEX cites to *Hercules, Inc. v. Leu Trust & Banking (Bahamas) Ltd.,* Del.Supr., 611 A.2d 476 (1992); *Istituto Bancario,* Del.Supr., 449 A.2d 210; and *Macklowe v. Planet Hollywood, Inc.,* Del. Ch., C.A. No. 13689, Steele, V.C. (Oct. 13, 1994). I do not read any of these cases to hold that "use" of a Delaware corporation in furtherance of a civil conspiracy can alone be found to have a substantial effect in Delaware sufficient to satisfy the "strict" test of *Istituto Bancario.*In *Hercules,* of course, the plaintiff corporation was headquartered in Delaware. *Hercules,* Del.Supr., 611 A.2d at 478. Thus, the effect of the conspiracy was actually felt in this State. In *Istituto Bancario,* a substantial act in furtherance

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of the civil conspiracy-the filing of a certificate of amendment with the Delaware Secretary of State authorizing the issuance of the shares there in question-actually took place in the Delaware.*Istituto Bancario,* Del.Supr., 449 A.2d at 226-27.

***8** *Macklowe* held that personal jurisdiction over a Florida limited partnership could be obtained in Delaware by service on its Delaware incorporated general partner. *Macklowe,* Del. Ch., C.A. No. 13689, slip op. at 11.This result was not followed by Chancellor Allen in *Carlton* in relation to a New York limited partnership. *Carlton Invs.,* Del. Ch., C.A. No. 13950, slip op. at 27.Moreover, while *Macklowe* also discusses the applicability of the civil conspiracy of jurisdiction, nothing in that opinion suggests that persons affiliated with a Delaware corporation who are alleged to "use" that corporation to the injury of a third party by actions wholly outside of Delaware thereby subject themselves to the jurisdiction of our courts. *Macklowe,* Del. Ch., C.A. No. 13689, slip op. at 14-17.

The second and third arguments are that Defries' alleged breach of his fiduciary duties as one of IOTEX's directors caused a "substantial effect" in Delaware simply by virtue of IOTEX's incorporation in this State and that Bayendor's alleged breach of fiduciary while he was President of IOTEX's predecessor (Iotel, Inc.) caused injury in this State. Indeed, IOTEX goes so far as to describe Bayendor's alleged breach of fiduciary (which is not alleged to have happened physically in Delaware) as an "additional act in Delaware [that] supports the assertion of jurisdiction here."These alleged "effects" add nothing to the analysis because they have only a metaphysical connection with this jurisdiction. In my judgment, as a general rule, in the case of Delaware corporations having no substantial physical presence in this State, an allegation that a civil conspiracy caused injury to the corporation by actions wholly outside this States will not satisfy the requirement found in the Supreme Court's opinion in *Istituto Bancario* of a "substantial effect ... in the forum state. *Istituto Bancario,* Del.Supr., 449 A.2d at 225.

For these reasons, I conclude that IOTEX cannot satisfy elements (3), (4) or (5) of the *Istituto Bancario* test for the assertion of personal jurisdiction over persons alleged to be participants in a civil conspiracy. Thus, service under 10 *Del. C.* § 3104 was improper and the amended complaint must be dismissed as to defendant Bayendor.

C. Defries and Bayendor's Motions to Dismiss the Eighth Claim for Relief (RICO) [FN8]

> FN8. Since I have dismissed the amended complaint as it pertains to defendant Bayendor, my discussion of the RICO claim applies only to defendant Defries.

In the amended complaint in C.A. No. 15817, IOTEX alleges that Defries and Bayendor engaged in a pattern of racketeering activity in violation of RICO. Specifically, Defries and Bayendor are alleged to have schemed (through Iota) "to defraud (among others) IOTEX and its stockholders of approximately [$5.2 million] and in devising, agreeing upon and pursuing such scheme to have: (i) misappropriated the approximately $5.2 million that IOTEX invested in connection with the Technology, (ii) forced IOTEX to abandon its operations, (iii) forced IOTEX to defend itself-and expend significant funds-in a recent action concerning the Technology brought against IOTEX by a former employee of Iota, and (iv) forced IOTEX to defend itself in connection with the unmeritorious counterclaim brought by Iota, and in the unmeritorious claims brought by another entity (Neosoft, A.G.) and individual (Urs Maag) controlled by Defries and Bayendor."IOTEX's Answering Br. at 3-4.

***9** The RICO statute provides for civil damages for any person or entity injured in his, her or its business or property by reason of a violation of 18 U.S.C. § 1962. *See*18 U.S.C. § 1964(c). The statute is violated where the injured party demonstrates that defendants are engaged in a "pattern of racketeering activity." *See H.J. Inc. v. Northwestern Bell Tel. Co.,* 492 U.S. 229 (1989). A pattern is defined as "requiring 'at least two acts of racketeering activity within a ten year period." ' *Tabas v. Tabas,* 3d Cir., 47 F.3d 1280, 1290 (1995) (quoting 18 U.S.C. § 1961(5)). Racketeering activity is defined as, *inter alia,* any act that is indictable under 18 U.S.C. § 1961(1), and includes wire fraud and mail fraud, the specific acts alleged to have occurred by IOTEX. *See*18 U.S.C. §§ 1341 (mail), 1343 (wire), 1961(1)(B) (definition); *Tabas,* 47 F.3d at 1290.

Courts have held that a "pattern of racketeering

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activity" is shown where the plaintiff has alleged two or more acts of an indictable offense and further shown "that the racketeering predicates are related, *and* that they amount to or pose a threat of continued criminal activity."[FN9] *H.J. Inc.,* 492 U.S. at 239. "[P]redicate acts are related if they 'have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events." ' *Tabas,* 47 F.3d at 1292 (quoting *H.J. Inc.,* 492 U.S. at 240). Continued criminal activity, i.e., continuity, may be one of two types: closed-end, referring to "a closed period of repeated conduct"; or open-ended, referring to "past conduct that by its nature projects into the future with a threat of repetition." *Id.* (quoting *H.J. Inc.,* 492 U.S. at 241). Analysis of either of the two types is temporal, so "a party may establish continuity as a closed-ended concept by 'proving series of related predicates extending over a substantial period of time." ' *Id.* (quoting *H.J. Inc.,* 492 U .S. at 242).

FN9. The pleading requirements to allege a violation of RICO are the same as previously discussed, see *supra,* p 5-6.

IOTEX contends that both items necessary to establish a pattern of racketeering activity have been met; pointing first to Defries and Bayendor's allegedly false statements made during the IOTEX/Iota negotiations concerning the Project Management Agreement and to Iota's allegedly false status reports as the related predicate acts; and second, to the fact that the conduct "intended to defraud IOTEX had occurred over several years, continues through the present, and represents the normal course of doing business for defendant Defries and defendant Bayendor," as evidence of a continued threat of criminal activity.

In addressing IOTEX's argument, I focus on the latter aspect of the United States Supreme Court's RICO analysis, that the defendants' acts "amount to or pose a threat of continued criminal activity."*H.J. Inc.,* 492 U.S. at 239.[FN10] IOTEX argues that both types of continuing criminal activity (open-ended and closed-ended) are present in the instant case.

FN10. Defendants apparently concede that IOTEX has plead sufficiently to meet the requirement that "the racketeering predicates are related," as they do not address this aspect of the *H.J. Inc.* test in their brief. *See* *H.J. Inc.,* 492 U.S. at 239.

***10** Defendants contend that the allegedly criminal activities (if at all) could in no event have lasted past February 1996 (the last date that IOTEX made payments to Iota) thereby making an open-ended analysis inapplicable. In response, IOTEX cites three events alleged to meet the open-ended standard: (1) Iota's assertion of contract claims in this Court, (2) Iota's alleged refusal to provide an accounting of the funds IOTEX has paid to Iota and (3) Defries alleged grant of an option in IOTEX stock to a former Iota employee.[FN11] In my judgment, these mere conclusory allegations do not evidence continuing fraudulent conduct and require no further discussion. *See* *Continental Realty Corp. v. J.C. Penney Co., Inc.,* S.D.N.Y., 729 F.Supp. 1452, 1455 (1990) ("[The plaintiff's] conclusory allegations fail to satisfy Fed.R.Civ.P. 9(b)'s requirement that averments of fraud be stated with particularity and therefore cannot be relied upon to demonstrate a continuing pattern of fraudulent acts.").

FN11. The option arises out of a Separation Agreement between Iota and Andrew Denis, which grants Denis the choice of either, "shares equal and equivalent to two hundred and fifty shares of Series A Preferred Stock in Iota, or:

b) Shares in Iotex, Incorporated equal and equivalent to that percentage as may be represented by the like number and proportion of shares issued in Iota pursuant to paragraph 6.C.a above when calculated against the Iotex shares which Iota or its associates may hold or control following the initial public offering of Iotex as such offering is defined by the Securities and Exchange Commission.

Defendants argue persuasively that the quoted provision obligates only Iota (and not IOTEX) to perform and, in any event, relates to shares of IOTEX owned or to be owned by Iota.

In the alternative, IOTEX contends that defendants' actions have met the closed-ended requirement of

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continuing criminal activity, i.e., a "series of related predicates extending over a substantial period of time."*H.J. Inc.,* 492 U.S. at 242. In making this determination, courts look to a number of factors, which can include: the number and variety of predicate acts and the length of time over which they were committed, the number of victims, the number of schemes involved and the occurrence of distinct injuries. *Vicom, Inc. v. Harbridge Merchant Services,* 7th Cir., 20 F.3d 771, 781-82"(1) the number of unlawful acts; (2) the length of time over which the acts were committed; (3) the similarity of the acts; (4) the number of victims; (5) the number of perpetrators; and (6) the character of the unlawful activity."(citing *Barticheck v. Fidelity Union Bank/First Nat'l State,* 3d Cir., 832 F.2d 36 (1987))).

IOTEX relies primarily on the Third Circuit's decision in *Tabas* as support for its argument. In *Tabas,* the plaintiff alleged that two brothers formed a partnership to conduct real estate and other business ventures. *Id.* at 1282.In the event of the death of either partner, the partnership agreement provided that the surviving partner would distribute partnership income jointly to himself and the estate of the deceased partner. *Id.* One of the partners died, and the surviving partner began making partnership income payments to the deceased partner's estate. *Id.*

Some years thereafter, the estate filed a civil RICO claim, alleging misappropriation based on its contention that the surviving partner was not allocating an equal share to the deceased partner's estate, in violation of the partnership agreement. *Id.* at 1282-83.The Third Circuit agreed, reversing the district court and finding that the RICO continuity requirement was satisfied. *Id.* at 1281.In its assessment of whether or not continuing criminal activity was shown, the Court focused on "the duration of the underlying scheme," noting that plaintiffs had provided evidence tending to show that the alleged acts of mail fraud began on November 10, 1987 and ended in July 1991, a period of three and a half years. *Id.* at 1294.The Court found a three and a half year period constituted a "substantial" period of time, and comported with the type of "long-term criminal conduct that RICO was enacted to address."*Id.*[FN12]

FN12. IOTEX makes further argument as evidence of the applicability of the closed-ended type by contending that defendants' criminal conduct "began on or before July 20, 1994 (the date IOTEX was formed for the sole purpose of investing capital in connection with the Technology)". Even if this were true, the resulting period is still substantially shorter than that addressed in *Tabas,* and the multi-factor analysis would lead me to conclude that the element of continuity is not present.

***11** *Tabas* is distinguishable from the instant case. While *Tabas* involved conduct occurring over a three and a half year period, the activities here lasted only 15 months, a decidedly shorter period, and one that, alone, will not satisfy the RICO continuity requirement. *See Vemco, Inc. v. Camardella,* 3d Cir., 23 F.3d 129, 135 (1994) ("We cannot conclude that [defendant's] alleged actions here, involving a single victim and single scheme for a single purpose over seventeen months, constitute the type of 'long-term criminal conduct' Congress sought to prohibit with RICO."(quoting *H.J. Inc.,* 492 U.S. at 241-42)). The other factors identified in the case law lead me to conclude that the RICO claim is not properly plead.

First, the predicate acts that IOTEX rely on all arise out of or are related to the same transaction, the Project Management Agreement. This Agreement required periodic status reports and such reports, while independent of each other, were all dependent on and related to the Agreement. Commonsense, which the Supreme Court mandates be used in a RICO analysis, requires a finding that these reports are not separate predicate acts as contemplated by the RICO statute, but are mutually dependent on the Agreement. *See H.J. Inc .,* 492 U.S. at 241 (promulgating an approach to analyzing the continuity requirement that is based on a "commonsense, everyday understanding of RICO's language and Congress' gloss on it"). As one court has stated, "courts must take care to ensure that the plaintiff is not artificially fragmenting a single act into multiple acts simply to invoke RICO."*Schlaifer Nance & Co. v. Estate of Andy Warhol,* 2d Cir., 119 F.3d 91, 98 (1997).[FN13]

FN13. This same analysis applies to the other predicate acts attacked by IOTEX, that the defendants made fraudulent communications during the negotiation of

> the Project Management Agreement that led to IOTEX's payments to Iota. These payments were directly related to the Budget and are an integral part of the Project Management Agreement. They cannot be segmented to create the predicate acts necessary to meet the RICO continuity requirement.

Second, notwithstanding IOTEX's footnote argument to the contrary, the predicate acts allegedly injure only one party, IOTEX itself. IOTEX contends that in addition to itself, allegedly injured by defendants' misappropriation of its funds and fraudulent status reports, its stockholders have also been injured, since the corporation was formed specifically for the purpose of investing in the Technology and by misappropriating funds paid by IOTEX to Iota for the Technology, the defendants injured the stockholders investing in IOTEX. I reject this argument because it would require me to disregard the existence of IOTEX as a legal entity. IOTEX alone experiences any effect of defendants' allegedly fraudulent acts. The shareholders do not suffer any injury separate from or unrelated to that alleged to be experienced by IOTEX. *See Kramer v. Western Pac. Indus., Inc.,* Del.Supr., 546 A.2d 348, 351 (1988) (by analogy in derivative standing cases, "[p]laintiff must allege more than an injury resulting from a wrong to the corporation").

Lastly, the alleged injury itself is a single injury. If defendants, through Iota, did breach the Project Management Agreement by sending false status reports and not complying with the Budget's directives regarding the allocation of the IOTEX funds, then the end result of Iota's noncompliance is a single injury to IOTEX, not multiple injuries based on each allegedly fraudulent communication. To find otherwise would fragment the Project Management Agreement, which is contrary to law and commonsense.

***12** For all of the foregoing reasons, I find that IOTEX has failed to meet the continuity requirement necessary to show a pattern of racketeering activity under the RICO statute. Therefore, defendant Defries and Bayendor's Motions to Dismiss the Eighth Claim for Relief are hereby granted.[FN14]

> FN14. Having reached this conclusion, I do not address Defries' argument that the consent to jurisdiction under 10 *Del. C.* § 3114 is not broad enough to subject him to the personal jurisdiction of this Court for the purpose of adjudicating the RICO claim.

III. CONCLUSION

For all of the foregoing reasons, the motions to dismiss addressed in this Memorandum Opinion, i.e., (1) Urs Maag's Motion to Dismiss for Failure to State a Claim upon which Relief can be Granted (C.A. No. 16082),(2) David Bayendor's Motion to Dismiss for Lack of Personal Jurisdiction (C.A. No. 15817), and (3) Anthony Defries and David Bayendor's Motions to Dismiss the Eighth Claim for Relief (C.A. No. 15817), are all GRANTED. IT IS SO ORDERED.

Del.Ch.,1998.
Iotex Communications, Inc. v. Defries
Not Reported in A.2d, 1998 WL 914265 (Del.Ch.), RICO Bus.Disp.Guide 9699, 24 Del. J. Corp. L. 718

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Tab 3

C Pfeffer v. Redstone
Del.Ch.,2008.
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UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.
Beverly PFEFFER, individually and on behalf of all others similarly situated, Plaintiff,
v.
Sumner M. REDSTONE, George S. Abrams, David R. Andelman, Joseph A. Califano, Jr., William S. Cohen, Phillipe P. Dauman, Alan C. Greenberg, Jan Leschly, Shari Redstone, Frederic V. Salerno, William Schwartz, Patty Stonesifer, Robert D. Walter, National Amusements, Inc., John F. Antioco, Richard J. Bressler, Jackie M. Clegg, Michael D. Fricklas, Linda Griego, John D. Muething and CBS Corp. (f.k.a.Viacom, Inc.), Defendants.
C.A. No. 2317-VCL.

Submitted: Nov. 2, 2007.
Decided: Feb. 1, 2008.

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LAMB, Vice Chancellor.
*1 In 2004, a Delaware corporation divested itself of its majority interest in a subsidiary in a transaction that involved the payment of a special dividend by the subsidiary followed by an offer to the corporation's stockholders to exchange shares of the corporation's stock for stock of the subsidiary. Nearly two years later, after a time of declining performance by the former subsidiary, a stockholder who participated in the exchange brought suit alleging a variety of disclosure-based claims as well as various breaches of fiduciary duty by the corporate directors and the majority stockholder of the corporation in approving the transaction. The plaintiff also sues on a claim that the payment of the special dividend amounted to a breach of fiduciary duty to the minority stockholders of the subsidiary, who received that payment. For the following reasons, the court concludes that the complaint fails to state a claim upon which relief can be granted.

I.

A. *The Parties*[FN1]

FN1. The facts recited in this opinion are taken from the amended class action complaint and certain publicly filed documents referenced in the complaint. *In re Wheelabrator Techs., Inc. S'holders Litig.,* 1992 WL 212595, at *12 (Del. Ch.1992).

The plaintiff, Beverly Pfeffer, is a New York resident who allegedly tendered Viacom stock for Blockbuster stock in an exchange offer completed on October 5, 2004. She brings her amended complaint as a putative class action on behalf of all former Viacom stockholders who tendered in the exchange offer. She also purports to represent a class of all Blockbuster stockholders who held stock as of the

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August 27, 2004 record date for a special distribution issued by Blockbuster. Pfeffer first sued on August 3, 2006. She filed an amended complaint on January 12, 2007, in response to the filing of motions to dismiss. FN2

FN2. The amended complaint will be referred to through this opinion as the "complaint."

The plaintiff named 21 defendants in the complaint, including two corporations, National Amusements, Inc. ("NAI") and CBS Corporation. NAI was the controlling stockholder of Viacom, Inc. at all times relevant to this proceeding, holding roughly 71% of the voting power. While Viacom was the controlling stockholder of Blockbuster at the time of the two challenged transactions, a restructuring in December of 2004 separated Viacom and CBS into two companies. In light of this separation, the plaintiff, for reasons unknown and unchallenged, named CBS as the appropriate defendant.FN3

FN3. Oddly, the plaintiff still refers to CBS as Viacom in the complaint.

Turning to the individuals named in the complaint, defendant Sumner Redstone is the Chairman of the Board and the controlling stockholder of NAI. Through Redstone's controlling interest in NAI, he is indirectly the controlling stockholder of Viacom. He served as Viacom's Chief Executive Officer and Chairman of the Board at the time of the two challenged transactions and was also a director of Blockbuster from May 1999 until October 16, 2004.

The complaint separates the remaining 18 individual defendants into two groups. The first group consists of Viacom directors, including Sumner Redstone ("Viacom Director Defendants"). Each of the defendants other than Redstone served on the board of directors of Viacom at the time of the transactions in question.FN4Three of the Viacom Director Defendants, Abrams, Dauman, and Shari Redstone,FN5 also served on the board of NAI. Greenberg and Salerno were on the board of directors of Bear Sterns, which served as co-manager of the challenged exchange offer.

FN4. Those defendants are: George S. Adams, David R. Andelman, Joseph A. Califano, Jr., William S. Cohen, Philippe P. Dauman, Alan C. Greenberg, Jan Leschly, Shari Redstone, Frederic V. Salerno, William Schwartz, Patty Stonesifer, Robert D. Walter.

FN5. Notably, Dauman served on the board of Blockbuster and Shari Redstone is Sumner Redstone's daughter. As of October of 2004, Shari Redstone also served as a director of NAI. She has served as President of NAI since January of 2000.

***2** The second group of individual defendants consists of the Blockbuster directors who approved the special distribution ("Blockbuster Director Defendants"). Redstone and Dauman, as well as six other Blockbuster directors, are named as defendants. Defendant John F. Antioco has been Blockbuster's Chairman and CEO since 1997. Defendant Richard J. Bressler was a director of Blockbuster from May of 2001 until October 16, 2004. Bressler was also Senior Executive Vice President and Chief Financial Officer of Viacom. Defendant Jackie M. Clegg has been a Blockbuster director since July of 2003. Defendant Michael D. Fricklas was a director of Blockbuster from June 2, 2004 until October 16, 2004. During this time, Fricklas was also Executive Vice President, General Counsel, and Secretary of Viacom. Defendant Linda Griego was a director of Blockbuster from July of 1999 through May 11, 2005.

B. *Facts*

Blockbuster is a provider of in-home movies and game entertainment with more than 9,000 stores throughout the Americas, Europe, Asia, and Australia. Viacom, a global media company, is a Delaware corporation with its principal place of business in New York, New York. Viacom acquired Blockbuster in 1994 for $8.4 billion and on August 16, 1999, Blockbuster completed an initial public offering. Through this offering, Blockbuster sold 31 million shares of its class A common stock to the public, representing approximately 18% of the total outstanding stock and 4% of the voting power. Viacom retained all of the Blockbuster class B common stock, which constituted 82% of the equity value of Blockbuster and 95.9% of its voting power.

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In the years following the initial public offering, the competitive landscape for movie rental businesses, such as Blockbuster, drastically changed. Several market forces combined to significantly reduce Blockbuster's core in-store rental business. Foremost, new sources for accessing content, such as online subscription rental programs and video on demand, attracted an increasing number of consumers away from Blockbuster. In addition, consumers began buying movies, instead of renting them, following the format change from VHS to DVD.

In the midst of these growing competitive threats, Viacom announced, on February 10, 2004, that it would pursue the divestiture of its approximately 81.5% interest in Blockbuster. Viacom explained the transaction as "based on the conclusion that Blockbuster would be better positioned as a company completely independent of Viacom."[FN6] While the market largely expected this announcement, Blockbuster's stock closed at $17.59 on February 11, a significant increase from its $16.20 closing price the previous day.

FN6. Compl. ¶ 37.

Following this release, Blockbuster and Viacom, on June 18, 2004, jointly announced the preliminary terms of their proposed separation. The announcement stated that the planned divestiture would be in the form of a voluntary exchange offer, in which existing Viacom stockholders would have the opportunity to exchange Viacom shares for the company's Blockbuster shares ("Exchange Offer"). In the same disclosure, Blockbuster announced that prior to the Exchange Offer, it would pay a pro rata special cash dividend of $5 per share .[FN7] The dividend would cost approximately $905 million, with Viacom receiving $738 million of the distribution, based on its ownership in Blockbuster. Blockbuster also disclosed that the distribution would be financed through a new $1.45 billion credit facility.

FN7. The dividend would be payable September 3, 2004 to stockholders of record August 27, 2004.

*3 The press release also included statements from Redstone and Antioco endorsing the proposed separation. Redstone stated that after the transaction "Viacom will devote all its energies and resources into expanding core areas, particularly the content creation engine that we believe will drive our future growth."[FN8] Antioco said, "we believe that by becoming a separate company we will be better able to pursue our retailing strategy."[FN9]

FN8. Veet Aff. Ex. A.

FN9. *Id.*

On September 8, 2004, Viacom disclosed the final terms of the divestiture in the Exchange Offer Prospectus ("Prospectus"). According to the Prospectus, each Viacom stockholder opting to participate would receive 5.15 shares of Blockbuster stock, consisting of 2.575 shares of class A stock and 2.575 shares of class B stock, in exchange for each Viacom share tendered. Viacom would accept, until the closing on October 5, up to an aggregate of 27,961,165 shares of class A and class B common stock. The offer represented a premium of 17.6% for the Viacom class A stock and a premium of 19.2% for the Viacom class B stock. In the months leading up to this release, Blockbuster's stock had steadily declined and was trading between $12 and $13. By September 8, the stock was trading at $7.48, reflecting the payment of the special dividend.

The Prospectus prominently disclosed that a special committee of the Blockbuster board of directors, comprised of three independent directors, recommended that the full Blockbuster board approve the special dividend and several key aspects of the Exchange Offer.[FN10] Far less conspicuous was a disclosure that a committee of Viacom's board of directors, delegated with the authority to approve the final terms of the divestiture, also approved the transaction. The Prospectus included a number of disclosures warning potential investors of the risks associated with Blockbuster in the current market environment, the challenges ahead, and the potential consequences of not being able to service Blockbuster's increased debt after the special dividend. Notwithstanding these warnings and the well known challenges facing Blockbuster, the Exchange Offer was fully subscribed and Viacom divested its entire interest in Blockbuster.

FN10. The members of the special committee were Jackie M. Clegg, Linda

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Griego, and John L. Muething.

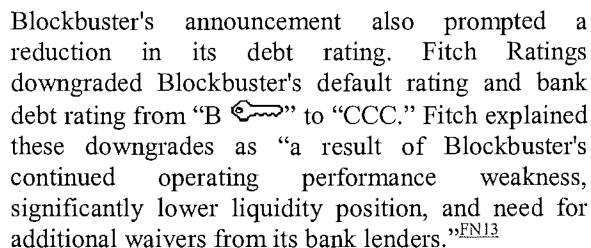
Following the Exchange Offer, Blockbuster struggled to maintain profitability. The plaintiff cites several later public announcements as undermining the veracity of the disclosures in the Prospectus. First, on October 27, 2004, only a few weeks after the Exchange Offer, Blockbuster reported that "profitability for the full-year 2004 [would] decline significantly because of ... continued weakness in the rental business ... and higher interest expense associated with the additional $950 million in debt ."FN11Blockbuster stock reacted accordingly, trading down to $6 .81. Blockbuster also announced that projected softness in rental revenues would adversely affect profitability in 2005.FN12 Despite these setbacks, Antioco remained confident, re-assuring stockholders in the following statement:

FN11. Compl. ¶ 72.

FN12.*Id.*

> *4 We are excited about having successfully completed our divestiture from Viacom.... [W]e successfully launched our online subscription program well ahead of schedule, exceeded our subscription expectations for both our in-store and online passes, and aggressively rolled out movie and game trading to thousands of stores. To support these initiatives, as indicated in our previous guidance, we accelerated investment spending and this, along with continued softness in the movie rental industry, impacted our profitability. However, we believe we are taking the right steps to position Blockbuster for future growth in both revenues and profits.

By the time Blockbuster reported second quarter 2005 earnings on August 9, 2005, the initiatives critical to its success had still failed to improve profitability. The company announced a $57.2 million loss and it withdrew its full year forecasted financial results. For the three months ended June 30, 2005, Blockbuster lost 31 cents per share, compared with a profit of 27 cents per share for the same period in 2004. Blockbuster also disclosed that it had been forced to negotiate with its lenders to prevent a high debt ratio from triggering a default on the company's line of credit. After rebounding from the October 2004 lows, the negative disclosures in this report sent Blockbuster's stock down to $6.70 at the close of trading on August 10, 2005.

Blockbuster's announcement also prompted a reduction in its debt rating. Fitch Ratings downgraded Blockbuster's default rating and bank debt rating from "B " to "CCC." Fitch explained these downgrades as "a result of Blockbuster's continued operating performance weakness, significantly lower liquidity position, and need for additional waivers from its bank lenders."FN13

FN13. Compl. ¶ 75.

Profitability at Blockbuster continued to decline through the third quarter of 2005. In the company's quarterly report, filed on November 8, 2005, Blockbuster reported a loss of $24.6 million, excluding non-cash charges and stock-based compensation. Blockbuster also raised the possibility of seeking bankruptcy protection. This pushed Blockbuster's stock down to $4.11 the following day.

On March 9, 2006, Blockbuster announced a restatement following months of discussions with the SEC. The restatement involved a reclassification of the new releases in its rental library from non-current assets to current assets. This change forced the company to categorize new releases as an operational expense, as opposed to a capital expense, which lead to a reduction in operational cash flow and an equal increase in investment cash flow. Blockbuster restated its reported cash flows for 2003 through 2005. For fiscal year 2003, this involved a reclassification of $836.3 million; for fiscal year 2004, $798 million; and, for the nine months ended September 30, 2005, $638.5 million. The complaint does not allege that the announcement of this restatement caused a decline in the market price of Blockbuster's stock.

C. *Procedural History*

*5 On August 3, 2006, or nearly two years after the Exchange Offer, the plaintiff filed her first complaint.FN14That complaint asserted claims against the Viacom Director Defendants alleging that they breached their fiduciary duties in connection with undertaking the Exchange Offer. In response, on October 27, 2006, the Viacom Director Defendants filed a motion to dismiss, under Court of Chancery

Rule 12(b)(6), and to stay, followed by an opening brief in support of their motion on November 28, 2006. Instead of filing a response, the plaintiff filed her amended complaint on January 12, 2007, and added claims on behalf of Blockbuster stockholders who held stock at the time Blockbuster issued the special dividend. The plaintiff also added NAI, Viacom, and the Blockbuster Director Defendants as defendants. Again, the defendants responded with a Rule 12(b)(6) motion to dismiss and to stay this litigation. The motion to stay was later rendered moot. This opinion addresses the issues raised by the defendants' motion to dismiss.

FN14. Blockbuster's disappointing 2005 performance initially led to the filing of federal securities class action litigation in the Eastern District of Texas on November 11, 2005. That action, which contained factual allegations very similar to the ones found in the complaint in this action, was brought under provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, but was later dismissed. *See Congregation of Ezrashalom v. Blockbuster, Inc.,* 504 F.Supp.2d 151 (E.D.Tex.2007). The district court's dismissal opinion provides a useful reference for many of the issues addressed in this opinion.

II.

A. *The Plaintiff's Claims*

The plaintiff's complaint contains six counts for relief. Counts I through IV are brought on behalf of the Viacom stockholders who tendered shares in the Exchange Offer. Counts V and VI are brought on behalf of Blockbuster's minority stockholders who were allegedly injured as a result of the special dividend.

Count I alleges that the Viacom Director Defendants breached their duty of disclosure by making material misstatements, omissions, and misrepresentations in the Prospectus.[FN15] Count II asserts that the Viacom Director Defendants breached their fiduciary duty of loyalty and good faith by permitting a false and misleading Prospectus to be filed in connection with the Exchange Offer. The plaintiff contends that the entire fairness standard should apply to Counts I and II because NAI and Redstone are said to have been financially interested in the transactions. More specifically, the plaintiff alleges that, "[NAI and Redstone] received, through their substantial Viacom holdings, the overwhelming majority of the special $5 dividend that so devastated Blockbuster's financial prospects, and they enjoyed the increase in their majority control of Viacom that resulted from the Exchange Offer."[FN16]

FN15. The complaint focuses its disclosure allegations on seven omitted or misstated facts:

1. That Blockbuster was without the financial resources required for it to implement its strategic plan following the payment of the special dividend;

2. That, due to outdated equipment, Blockbuster was unable to integrate its in-store and on-line operations;

3. That Blockbuster was experiencing difficulties launching its in-store DVD tracking system because it lacked adequate internal controls;

4. That the Exchange Offer was not engineered to benefit Blockbuster, but rather to allow Viacom to reduce its public float of stock to further solidify the control of NAI and Redstone over Viacom;

5. That it misrepresented Blockbuster's operational cash flow by more than 58%;

6. That it offered an incomplete explanation of the pricing methodology behind the Exchange Offer; and

7. That it omitted those who served on the Viacom special committee that approved the Exchange Offer.

FN16. Compl. ¶¶ 94, 99.

Count III, to the extent it does not repeat Count II, argues that the Viacom Director Defendants breached

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their fiduciary duties by permitting the disclosure violations in the Prospectus and by acting to further the interests of NAI and Redstone over the Viacom minority stockholders.[FN17] Further, Count III contends that NAI and Redstone were financially interested in the Exchange Offer and should therefore carry the burden of demonstrating compliance with Section 144 of the Delaware General Corporation Law ("DGCL").[FN18] In Count IV, the plaintiff alleges that NAI, as the controlling stockholder of Viacom, breached its fiduciary duties to Viacom's minority stockholders by causing the Viacom board to approve the Exchange Offer.

FN17. Throughout the complaint, the plaintiff alleges that the Exchange Offer acted to solidify NAI and Redstone's control over Viacom. In fact, as disclosed in the Exchange Offer Prospectus, the maximum amount of Viacom class A and class B shares that Viacom could acquire through the offer was equal to a mere 1.6% of the Viacom common stock outstanding as of September 30, 2004. NAI already owned Viacom common shares representing approximately 11% of the common equity and 71% of the voting power. A 1.6% reduction in the number of outstanding common shares would increase NAI's equity ownership interest to 11.18%. The plaintiff fails to allege that either this or any possible change in NAI's voting power resulting from the Exchange Offer could have a material affect on NAI's power to control Viacom.

FN18. 8 *Del. C.* § 144.

***6** Count V asserts that the Blockbuster Director Defendants breached their fiduciary duties of loyalty and good faith "by causing Blockbuster to take on crippling debt in order to declare the Special Dividend."[FN19] The plaintiff contends that the entire fairness test should apply because Blockbuster's majority stockholder, Viacom, was financially interested in the transaction. Lastly, in Count VI, the plaintiff alleges that Viacom, as Blockbuster's controlling stockholder, breached its fiduciary duties to Blockbuster's minority stockholders, by causing Blockbuster to declare the Special Dividend and incur the accompanying debt.

FN19. Compl. ¶ 116.

B. *The Defendants' Response*

The Viacom Director Defendants, NAI, and CBS (together, the "Viacom Defendants"), move to dismiss the complaint based on Court of Chancery Rule 12(b)(6). The Viacom Defendants argue that Count I should be dismissed because the alleged omissions cited by the plaintiff were disclosed or were immaterial. With respect to Count II, the Viacom Defendants contend that there is no basis for a duty of loyalty claim because the Exchange Offer was voluntary and it was offered to all Viacom stockholders on the same terms. Additionally, the Viacom Defendants claim the Exchange Offer was not an interested transaction because the directors were not personally benefitting from the transaction and they approved the Exchange Offer to benefit the corporation.[FN20] The Viacom Defendants assert that Count IV also fails to state a claim for breach of fiduciary duty against NAI because the plaintiff did not establish that NAI owed any fiduciary duty to the Viacom minority stockholders in the Exchange Offer and further failed to allege that NAI breached any potential duty. In support of this argument, the Viacom Defendants argue that the plaintiff failed to allege that NAI directed the actions of Viacom in the either of the two challenged transactions.

FN20. The Viacom Defendants do not appear to address Count III.

The Blockbuster Director Defendants move to dismiss Count V on the basis that the plaintiff's claim is derivative and she failed to comply with Rule 23.1. The Viacom Defendants assert that Count VI is also derivative and should not survive for the same reasons.

III.

A motion to dismiss for failure to state a claim under Rule 12(b)(6) invokes a well settled analysis. All well pleaded factual allegations must be accepted as true and all reasonable inferences should be drawn in favor of the nonmoving party.[FN21] However, the court will not assume mere conclusions unsupported by factual allegations as true.[FN22] Indeed, "[w]hile specific allegations of fact, along with reasonable conclusions buttressed by specific allegations of fact,

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will sustain a complaint, mere conclusions of law or fact are insufficient under this standard of review."[FN23] Dismissal under Rule 12(b)(6) is only appropriate where the court finds, with reasonable certainty, that the plaintiff could not prevail on any set of facts inferable from the pleadings.[FN24]

FN21. *Loudon v. Archer-Daniels-Midland Co.,* 700 A.2d 135, 140 (Del.1997).

FN22. *Solomon v. Pathe Commc'ns Corp.,* 672 A.2d 35, 38-39 (Del.1996).

FN23. *Feldman v. Cutaia,* 2007 WL 2215956, at *6 (Del. Ch. Aug. 1, 2007).

FN24. *Solomon,* 672 A.2d at 38.

IV.

*7 As an initial matter, the court turns to why the transaction at issue in this case is not one that is judged by the entire fairness standard. "Delaware law does not impose a duty of entire fairness on controlling stockholders making a non-coercive tender or exchange offer to acquire shares directly from the minority holders."[FN25] Similarly, Delaware law does not judge by the entire fairness standard voluntary, non-coercive offers by corporations to acquire their own shares.[FN26] The fact that Viacom offered to acquire a small percentage of its own shares in exchange for shares it owned in Blockbuster, rather than for cash, does not change the nature of this legal analysis. Viacom's duties (and those of the Viacom Director Defendants) in connection with that offer were to structure its terms non-coercively and to disclose all material facts.[FN27]

FN25. *In re Aquila Inc.,* 805 A.2d 184, 190 (Del. Ch.2003); *see also* Solomon, 672 A.2d at 30-40 ("[i]n the case of totally voluntary tender offers ... courts do not impose any right of the shareholders to receive a particular price.... [I]n the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue.").

FN26. *Frank v. Arnelle,* 1998 WL 668649 at *4 (Del. Ch. Sept. 16, 1998) (recognizing that "neither Delaware law nor federal law requires the issuer in a Dutch auction to offer its stockholders the opportunity to tender at a *fair price* ").

FN27. *Solomon,* 672 A.2d at 39 (citing *Lynch v. Vickers Energy Corp.,* 351 A.2d 570, 576 (Del. Ch.1976), *rev'd on other grounds,* 383 A.2d 278 (Del.1976)).

Disregarding this general principle, the plaintiff argues that the entire fairness standard should apply since she has alleged sufficient facts to give rise to an "inference that directors on the committee to approve the Exchange Offer had a stake in NAI and priced the Exchange Offer to benefit NAI" over the interests of the minority Viacom stockholders and, thus, application of the entire fairness test is appropriate.[FN28] The plaintiff relies on this court's first decision in *Feldman v. Cutaia*[FN29] to support her position.

FN28. Pls.' Answering Br. 38-39.

FN29. 2006 WL 920420 (Del. Ch. Apr. 5, 2006).

In *Feldman,* this court refused to dismiss an entire fairness challenge to a self-tender offer in which the directors were alleged to have received "a financial benefit not equally shared by the company's stockholders."[FN30] The complaint in *Feldman* included allegations that the pricing of the exchange offer was "severely inflated" ($10 per share for a stock that never traded above $4) to allow the directors, holding 89% of the company's otherwise underwater options and warrants, to improperly enrich themselves.[FN31] In addition, the exchange offer purportedly served no legitimate business purpose. These allegations led the court to conclude that the complaint adequately alleged that "the individual director defendants placed their own interests above those of the [ ] stockholders."[FN32] In such a case of a self-interested transaction, the entire fairness test would properly apply.

FN30. *Id.* at *6.

FN31. *Id.* at *4.

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FN32.*Id.* at *6.

In the present case, unlike in *Feldman,* there is nothing to suggest that the Viacom directors who approved the Exchange Offer structured the transaction to put their own interests above those of either Viacom or any identifiable group of Viacom stockholders. The majority stockholder of Viacom, NAI, did not even participate in the Exchange Offer and the Prospectus clearly discloses this fact. Thus, the court will examine the complaint to see if it adequately alleges that the Exchange Offer was accomplished through the use of materially false or misleading disclosures.[FN33]

FN33. The complaint does not allege that the Exchange Offer was coercive.

A. *Count I*[FN34]

FN34. In light of this court's ruling on the issue of entire fairness and the rejection of the disclosure violations alleged in Count I, Count II of the plaintiff's complaint will also be dismissed. Count II claims that the Viacom Director Defendants breached their duty of loyalty by permitting the Exchange Offer to proceed based on a false and misleading Prospectus."Disclosure violations may, but do not always, involve violations of the duty of loyalty.... [W]here there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty."*In re Tyson Foods, Inc.,* 919 A.2d 563, 597-98 (Del. Ch.2007). The complaint fails to adequately allege facts that support an inference that the Viacom Director Defendants acted disloyally in authorizing the dissemination of the Prospectus. There are simply no well pleaded allegations of fact that those directors authorized the transaction at issue in order to further the interests of NAI or Redstone or that they knowingly and in bad faith approved false and misleading disclosures in connection therewith.

As discussed, in Count I the plaintiff alleges that the Prospectus contained numerous misstatements of fact and omits material information and that the Viacom Director Defendants breached their fiduciary duties by causing the Prospectus to be disseminated to the Viacom stockholders. While the plaintiff initially made seven disclosure allegations in the complaint, she abandoned all but four of them in her answering brief and only those allegations will be addressed.[FN35]

FN35.*Seagraves v. Urstact Prop. Co., Inc.,* 1996 WL 159626, at *5 (Del. Ch. Apr. 1, 1996); *see also Weiss v. Rockwell Int'l Corp.,* 1989 WL 80345, at *4 (Del. Ch. July 19, 1989) (the plaintiff alleged six disclosure claims in his complaint, but only relied on two in his brief, thus, the court deemed the remaining five claims abandoned). Regardless of this finding, the discussion of the remaining disclosure allegations addresses and dismisses the abandoned allegations as unfounded. Either the Prospectus addressed each allegation, or, with respect to the claim that the Exchange Offer was engineered to allow NAI and Redstone to solidify control of Viacom, the allegation was without merit.

***8** The duty of disclosure is not an independent duty, but derives from the duties of care and loyalty.[FN36]"Corporate fiduciaries can breach their duty of disclosure under Delaware law ... by making a materially false statement, by omitting a material fact, or by making a partial disclosure that is materially misleading."[FN37]"Material facts are those facts for which 'there is a substantial likelihood that a reasonable person would consider [them] important in deciding how to vote.' " [FN38] The plaintiff alleges that the Prospectus contained all three sorts of potential disclosure violations.

FN36.*See* Malpiede v. Townson, 780 A.2d 1075, 1086 (Del.2001).

FN37.*O'Reilly v. Transworld Healthcare, Inc.,* 745 A.2d 902, 916 (Del. Ch.1999) (quoting Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del.1985)).

FN38.*Id.*

1. *The Plaintiff's Claim Of A False Statement*

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"To state a claim for breach of the fiduciary duty of disclosure on the basis of a false statement or representation, a plaintiff must identify (1) a material statement or representation in a communication contemplating stockholder action (2) that is false."FN39

FN39.*Id.* at 920.

The plaintiff contends that the Prospectus misrepresented Blockbuster's operating cash flow and asserts that the March 2006 restatement is alone sufficient to demonstrate materiality, citing *In re First Energy Securities Litigation.*FN40The defendants respond that the restatement was merely the result of a "misclassification" that is immaterial because it had no effect on reported revenues, net income, total assets, shareholder's equity, total cash flow, current cash or liquidity positions, or compliance with financial covenants under Blockbuster's debt facilities.

FN40.316 F.Supp.2d 581 (N.D.Ohio 2004).

First Energy, a case involving securities fraud, is of little help to the plaintiff because it stands for the proposition that a restatement, by definition, means the prior statement was in error, not that it was materially false or misleading. As the Delaware Supreme Court stated in *Loudon v. Archer-Daniels-Midland Co.,*"[a] claim based on disclosure violations must provide some basis for a court to infer that the alleged violations were material."FN41While there is no dispute that some of the cash flow numbers in the Prospectus were later restated, the plaintiff must sufficiently demonstrate materiality. In this case, there is nothing in the complaint to suggest that the misstatement of cash flows was material to a Viacom stockholder in deciding whether or not to accept the Exchange Offer.

FN41.700 A.2d at 141.

Blockbuster had certified financial statements throughout the time of the alleged misstatements and correctly disclosed the accounting principles that it relied on to report cash flows. Therefore, anyone examining Blockbuster's cash flow statements could discern its treatment of new releases and that treatment's effect on operating and investment cash flows.FN42The restatement involved a mere reclassification of certain cash flows that did not affect total cash flows, net income, or any other reported accounting figure. The complaint also does not allege that news of the reclassification affected the Blockbuster stock price, which is itself a strong indication of immateriality. In sum, the plaintiff fails to advance well pleaded allegations of fact that a reasonable person, in deciding how to vote, would consider important the reclassification of operational and investing cash flows in this case.

FN42. Indeed, it was conceded at oral argument that the complaint does not allege that anyone detrimentally relied on the accounting principle that led to the reclassification.

***9** Moreover, the complaint does not contain well pleaded allegations of fact to support an inference that any of the Viacom Defendants engaged in a breach of fiduciary duty by authorizing the publication of the Prospectus containing the certified Blockbuster financial statements, including the cash flow statements, in their original, non-restated form. There is simply no factual basis alleged that could support a reasonable inference that the Viacom Defendants knew or should have known that Blockbuster's cash flow statements relied on a misapplication of GAAP in classifying new releases as non-current, rather than current, assets.

2. *The Plaintiff's Claim Of Omission*

"To state a claim for breach by omission of any duty to disclose, a plaintiff must plead facts identifying (1) material, (2) reasonably available (3) information that (4) was omitted from the proxy materials."FN43"Omitted information is *material* if a reasonable stockholder would consider it important in deciding whether to tender his shares or would find that the information has altered the 'total mix' of information available."FN44

FN43.*O'Reilly,* 745 A.2d at 926.

FN44.*Frank,* 1998 WL 668649, at *3 (emphasis in original).

The centerpiece of the claimed omissions set forth in

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the complaint is found in a series of allegations relating to Blockbuster's cash flow and future profitability. In addition to the claim relating to the misclassification of cash flows already discussed, the plaintiff alleges that the Prospectus failed to disclose the existence of a cash flow analysis prepared by a treasury department manager at Blockbuster in "February or March of 2004"-some six or seven months before the date of the Prospectus. According to the complaint, this analysis concluded that the proposed special dividend would prevent Blockbuster from funding its planned initiatives.[FN45] Allegedly, this report also concluded that some of Blockbuster's strategic plans, such as its online subscription program and the elimination of late fees, would be unprofitable.[FN46] The plaintiff alleges that when the cash flow analysis was distributed to senior management at Blockbuster, the Senior Vice President of Investor Relations and Treasurer of Blockbuster told employees to disregard it.[FN47]

FN45. Compl. ¶ 62.

FN46. *Id.*

FN47. *Id.* ¶ 63.

The plaintiff also alleges that "Blockbuster maintained inadequate controls to determine its cash flows at any time"[FN48] and cites to a former systems analyst who severely criticized Blockbuster's revenue accounting systems.[FN49] Finally, the plaintiff alleges that, when confronted with "forecasting models showing that Blockbuster's proposed subscription service would not be profitable for the company ... Blockbuster executives altered the models to fraudulently show that the new initiative would be profitable."[FN50]

FN48. *Id.* ¶ 64.

FN49. *Id.* ¶ 65.

FN50. *Id.* ¶ 67.

As for knowledge of these facts by any of the Viacom Defendants, the plaintiff alleges in the complaint, without elaboration, that Redstone was aware of the cash flow analysis and the related cash flow and profitability issues. The complaint also states generally that "other members of Viacom's and Blockbuster's board of directors knew or should have known that the Prospectus contained omissions and false statements."[FN51]

FN51. *Id.* ¶ 68.

***10** Before addressing the significance of these allegations, the court notes that at oral argument counsel for the plaintiff, whose name appears in the signature block of the complaint, admitted that he had never read or even seen the alleged cash flow analysis that sits at the core of most of these claims. Not surprisingly, this concession substantially undermined the court's confidence in the allegations about this document and the related matters. Perhaps to restore credibility, the plaintiff's counsel twice stated at oral argument that he would, that same afternoon, submit the document for the court's examination. Remarkably, he both failed to do so and failed to explain the omission. In the circumstance, the court cannot help but wonder whether-if it exists-any of the plaintiff's counsel have seen the alleged report or whether it or the claims related to it are accurately described in the complaint.

Also at oral argument, the court questioned the plaintiff's counsel about the basis for the allegations that Redstone and the other Viacom directors knew about any of these matters. The response was striking. According to the plaintiff's counsel, Redstone is alleged to have knowledge merely because Antioco (allegedly) knew about this information and would have told Redstone .[FN52] The other Viacom Defendants supposedly "knew or should have known that the Prospectus contained omissions and false statements" because Redstone (allegedly) knew and would have shared that information with his fellow Viacom directors.

FN52. First, while the plaintiff in her complaint does generally allege that "the cash flow analysis was distributed to senior management of Blockbuster ...," the only allegation that directly identifies Antioco is the previously mentioned quote that states "Blockbuster financial analysts presented Antioco and other members of Blockbuster's senior management with forecasting models showing that Blockbuster's proposed subscription service would not be profitable

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for the company."Compl. ¶ 67. At oral argument, counsel for the plaintiff attempted to expand the complaint with a more particularized allegation that the cash flow report "was given to, and read by, Mr. Antioco."Tr. 37. Relying on this allegation, the plaintiff's counsel further argued that "[b]y virtue of [Redstone's] position on the board, and by virtue of the fact that Mr. Antioco was on the board, it's a reasonable inference that Mr. Redstone knew about the cash flow problems and knew about the reports and knew about ... the other problems identified in the complaint...."*Id.* 38.

This response, based entirely on a daisy chain of surmise and illogic, suggests that the plaintiff and her counsel have no basis to support the far-reaching allegations of knowledge made in the complaint. They simply do not have a factual basis from which to allege that Antioco ever saw the cash flow analysis, that he ever showed it to Redstone, or that Redstone ever disclosed it to the other Viacom directors. Lacking such knowledge and based only on a series of suppositions, they nevertheless expect the court to credit their general allegations that the Viacom Director Defendants knew or, in some cases, should have known about some internal Blockbuster treasury department report written months before the Exchange Offer and the other unflattering characterizations of Blockbuster's accounting systems.

There are, of course, many situations where bare allegations of knowledge are so grounded in common experience as to suffice. For example, it is generally fair to allege that a director knew as fact something either known (or reasonably assumed) to have been disclosed to or discussed with the board as a whole or otherwise known publicly. For example, the court assumes that the boards of directors of both Viacom and Blockbuster received and reviewed reports and information concerning the transactions involved in this litigation. Many of these are identified in the Prospectus.

By contrast, directors are not as a matter of general experience presumed to know business operational information that is not of a kind routinely disclosed to boards of directors. For example, it would be at odds with what is known of how large public corporations run their affairs to expect directors to have knowledge of studies prepared by staff that are not presented to them for some purpose. As this court said in *IOTEX Communications, Inc. v. Defries:*

> ***11** [W]here pleading a claim of fraud or breach of fiduciary duty that has at its core the charge that the defendant knew something, there must, at least, be sufficient well-pleaded facts from which it can reasonably be inferred that this "something" was knowable and that the defendant was in a position to know it.[FN53]

FN53.1998 WL 914265, at *4 (Del Ch. Dec. 21, 1998); *See also* *Metro Commc'ns Corp. BVI v. Advanced Mobilecomm Techs. Inc.,* 854 A .2d 121, 145 (Del. Ch.2004) (the complaint failed, under Court of Chancery Rule 9(b), to allege that the defendants had knowledge of the misleading nature of statements distributed to stockholders because the complaint only created an inference of contemporaneous knowledge on the part of the defendants); *Alex v. Alex Brown Mgmt. Servs., Inc.,* 2005 WL 2130607, at *11 (Del. Ch. Aug. 25, 2005) (a bare allegation that knowledge of the purported wrongful acts should be imputed to an employer, where the court found no agency relation to exist, was insufficient to support a fraud claim and breach of fiduciary duty claim); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.,* 906 A.2d 168, 207-8 (Del. Ch.2006) (in a fraud claim based on allegedly improper disclosures, the plaintiffs' general and cursory allegations that the parent and subsidiary acted together to commit the improper disclosures failed to adequately plead knowledge).

In this case, in particular, common experience is very much at odds with the plaintiff's contention that any of the Viacom directors, including Redstone, somehow must have known about the February-March 2007 cash flow study prepared by an analyst in the Blockbuster treasury department or about the other operational infirmities she alleges. In fact, the plaintiff alleges that Blockbuster's Senior Vice President of Investor Relations and Treasurer told her subordinates not to worry about the cash flow

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analysis, strongly suggesting that she did not transmit that study to even the Blockbuster board of directors, much less that of Viacom.

When faced with substantially similar allegations regarding the same cash flow study and related information, the federal district judge in *Congregation of Ezrasholom v. Blockbuster* determined, albeit under a different standard, that the plaintiffs in that case failed to plead scienter under the Private Securities Litigation Reform Act ("PSLRA").[FN54] More specifically, the court stated,

> FN54.504 F.Supp.2d 151.Under the PSLRA, a plaintiff must "plead with particularity facts giving rise to a strong inference that defendants acted with scienter, which is 'a mental state embracing intent to deceive, manipulate, or defraud.' " *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 263 (5th Cir.2005) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976)).

According to the Confidential Sources, Defendants Antioco and Zine were presented with financial models showing that the "No Late Fees" initiative would lose money, which Antioco refused to acknowledge. What is missing from the Complaint, however, is any indication that Antioco or Zine accepted the models and proceeded nonetheless. To the contrary, the Confidential Source indicated that Antioco rejected the assumptions underlying the models. This is more consistent with an inference that Antioco and Zine disagreed with the pessimistic models, and that is why they went forward with the "No Late Fees" initiative. It is illogical and contrary to common sense to infer that two executives would believe that a new program would be disastrous, and nonetheless proceed.[FN55]

> FN55.*Congregation Ezrashalom*, 504 F.Supp.2d at 165-66.

This analysis serves to further erode the plaintiff's blithe assertion that Redstone and the other Viacom Director Defendants received the report. Even assuming arguendo that Antioco reviewed the report, the well pleaded allegations in the complaint strongly suggest that he dismissed its findings. Thus, there is no well pleaded basis in fact to support an inference Antioco gave the report, or conveyed its contents, to Redstone or any of the other Director Defendants.[FN56]

> FN56. It is also worth noting that the plaintiff waited nine months from the filing of the federal court action and almost two years after the Exchange Offer to file her complaint in this court. Presumably, if the plaintiff felt that she had a well founded Delaware state law claim, she would have sought relief in this court much sooner.

It is also a fact that the Prospectus contained numerous robust disclosures and warnings that directly addressed Blockbuster's cash flow issues, its new business initiatives, the increased leverage and other effects of the special dividend and related borrowings, and its ability to service its increased debt payments.[FN57]These clearly disclosed cautionary statements put anyone reading the Prospectus on notice that Blockbuster faced significant challenges in servicing the debt incurred from the special dividend and in funding the ambitious strategy critical to reviving its business. Those Viacom stockholders considering tendering into the Exchange Offer should have been particularly conscious of these risks given the well known deterioration of Blockbuster's business and its inability to challenge Internet-based companies, such as Netflix.com.

> FN57. Those disclosures included the following:
>
> • "As a Result of the Payment of the Special Distribution Blockbuster's Leverage Will Increase and Blockbuster's Ability to Make Payments on its Bank Debt and Senior Subordinated Notes will Depend on Blockbuster's Future Operating Performance Which Will Depend on a Number of Factors That are Outside of Blockbuster's Control."Abramczyk Aff. Ex. B 42.
>
> • "Blockbuster's indebtedness may make it more difficult for Blockbuster to pay its debts as they become due during negative economic and market industry conditions because if its revenues decrease due to general economic or industry conditions, it may not have sufficient cash flow from

operations to make its scheduled debt payments. *Id.* at 43.

• "Blockbuster may not be able to effectively upgrade and expand its systems, or add new systems, in a timely manner or to integrate smoothly any newly developed or purchased technologies with its existing technologies."*Id.* at 40.

• "[F]inancial results, including cash flows, will ... be adversely impacted by the investment for approximately $90 million of incremental operating expenses and approximately $100 million of additional capital investments associated with the development and launch of its key growth initiatives, as well as the anticipated continued weakness in the rental industry."*Id.*

3. *The Plaintiff's Claims Of Partial, Misleading Disclosures*

***12** "To state a claim of partial, misleading disclosure, a plaintiff must plead facts identifying a(1) perhaps voluntary, but (2) materially incomplete (3) statement (4) made in conjunction with solicitation of stockholder action that (5) requires supplementation or clarification through (6) corrective disclosure of perhaps otherwise material, but reasonably available information."[FN58]

FN58.*O'Reilly,* 745 A.2d at 927.

a. *Pricing Methodology*

The plaintiff asserts that the "Viacom shareholders were entitled to know precisely how the [e]xchange [r]atio was calculated ."[FN59]In response, the defendants argue that the disclosure of such information is not required in connection with a voluntary Exchange Offer. The Prospectus contained the following explanation of the derivation of the exchange ratio:

FN59. Compl. ¶ 70.

In determining the exchange ratio, Viacom considered among other things:

• recent historical market prices on the New York Stock Exchange for shares of Viacom class A and class B commons stock and Blockbuster class A common stock; and

• discussions with the co-dealer managers as to what exchange ratio might induce Viacom stockholders to tender Viacom class A or class B common stock in this exchange offer so that all (or the greatest percentage) of the shares of Blockbuster class B common stock and converted class A common stock that Viacom holds will be distributed.[FN60]

FN60. Abramczyk Aff. Ex. B 71.

Generally, Delaware courts, in non-coercive self-tender offers, do not require the disclosure of specific pricing methodologies. The defendants here cite the Chancellor's decision in *Frank v. Arnelle*[FN61] to support their position that further disclosure was not required. In *Frank,* this court, faced with similar circumstances, found that disclosure of a pricing methodology prepared in connection with a Dutch auction was unnecessary, since it was a non-coercive self-tender offer.[FN62]The holding in *Frank* did note that such disclosure would be necessary to ensure a balanced presentation where "the board has made a partial disclosure that implies that the offered price is fair."[FN63]

FN61.1998 WL 668649.

FN62.*Id.* at *5.

FN63.*Id.*

In this case, the Prospectus did not state that the offered price was fair. For example, it did not contain language suggesting that the price was based on the company's intrinsic value.[FN64]On the contrary, it candidly disclosed that one of the primary reasons behind the price was to induce stockholders to tender.

FN64.*See id.*

The plaintiff here, similar to the plaintiff in *Frank,* asserts that the offer of a premium suggests that the

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price is fair, thus, requiring further explanation. This argument is entirely unpersuasive. As discussed, the description of the derivation of the exchange ratio makes clear that the price was not represented to stockholders as fair.

b. *Composition Of The Viacom Committee*

Finally, the plaintiff asserts that the members of the Viacom board committee that approved the Exchange Offer should have been disclosed in the Prospectus. The plaintiff claims that the composition of this committee is important to determine if its members had conflicting ties to NAI or Redstone. The analysis in *Frank* is also instructive on this point. The defendants argue that such disclosure was not required, citing the language in *Frank* that "the fact that a special committee, as opposed to the full Board, set the price range and other terms [is not] material...."[FN65] But, here, unlike *in Frank,* the Prospectus contained a reference to a Viacom board committee that approved the transaction. Thus, the issue is whether the disclosure made about the Viacom board committee was materially incomplete.

FN65.*Id.*

***13** Specifically, the Prospectus stated:

> On June 17, 2004 a committee of Viacom's board of directors delegated with authority to approve the final form of the divestiture of Blockbuster from Viacom approved the divestiture by means of the split-off contemplated by this Prospectus-Offer to Exchange. The committee also approved Viacom's entry into the various separation agreements described on the section entitled "Agreements Between Viacom and Blockbuster and Other Related Party transactions."[FN66]

FN66. Compl. ¶ 71.

As noted, "when fiduciaries undertake to describe events, they must do so in a balanced and accurate fashion, which does not create a materially misleading impression."[FN67]This singular and brief reference to the Viacom board committee did not create a materially misleading impression for stockholders, necessitating further disclosure. There is no indication that the committee was independent of management or NAI, nor does the language in the Prospectus induce stockholders to rely on the committee's decision to validate the transaction. In short, this passing reference to the committee did not materially mislead stockholders because nothing in the Prospectus suggests that its decision carried any greater significance than that of the full board of directors.

FN67.*Clements v. Rogers,* 790 A.2d 1222, 1240 (Del. Ch.2001).

B. *Count III*

In Count III, the plaintiff seeks to void the Exchange Offer as an interested transaction under Section 144 of the DGCL.[FN68] According to the complaint, the transaction unfairly benefitted NAI and Redstone and was approved by the other Viacom directors in breach of their fiduciary duties in order to promote the interests of NAI over those of the other Viacom stockholders. As the complaint conclusorily states: "[e]ach of the Viacom Director Defendants breached their fiduciary duties of loyalty and care in approving and/or acquiescing in the Exchange Offer on terms that were unfair to Viacom's minority shareholders and unfairly [benefitted] Viacom's controlling shareholder, NAI, and Redstone."[FN69]

FN68.8 *Del. C.* § 144(a) provides: (a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if: (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even

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though the disinterested directors be less than a quorum; or (2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

FN69. Compl. ¶ 106.

The provisions of Section 144 apply to interested transactions, but neither NAI nor any of the Viacom Director Defendants stood on both sides of the Exchange Offer. Thus, Section 144 has no bearing on this case and cannot serve as a means to invalidate the Exchange Offer. Mere allegations that the Exchange Offer benefitted NAI to the detriment of Viacom's other stockholders do not suffice to overcome this obvious conclusion.

C. *Count IV*

Count IV is the sole claim brought against NAI and it alleges that NAI breached its fiduciary duties of loyalty and good faith "by causing the Viacom Director Defendants to approve and recommend the Exchange Offer to Viacom's minority stockholders."[FN70]Count IV also alleges that the Exchange Offer was designed to unfairly benefit NAI and Redstone through the reduction of Viacom's public float, the solidification of control by NAI and Redstone over Viacom, and the termination of Viacom's relationship with Blockbuster, which allegedly had "undisclosed problems that were known to NAI."[FN71]

FN70. Compl. ¶ 110.

FN71.*Id.*

***14** NAI was not a party to either the special dividend or the Exchange Offer, and the complaint fails to state any well pleaded facts that NAI did anything in connection with either transaction. As would be required to sustain her claim, the plaintiff makes no allegation that NAI directed the actions of Viacom.[FN72]Since there are no well pleaded allegations supporting the plaintiff's conclusions, this claim will be dismissed. In addition, in light of the obviously *de minimis* effect of the Exchange Offer on the capitalization of Viacom,[FN73] the claim that the Exchange Offer "consolidated" NAI's control over Viacom will be dismissed as frivolous.

FN72. As noted in *Cinerama, Inc. v. Technicolor, Inc.,*"when a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of a corporation. When, on the other hand, a majority shareholder takes no such action, generally no special duty will be imposed."1991 WL 111134, at *19 (Del Ch. June 24, 1991), *aff'd in part, rev'd on other grounds sub nom.*

FN73.*See* note 17, *supra.*

D. *Counts v. and VI*

The plaintiff brings Counts V and VI as direct claims. Count V alleges that the Blockbuster Director Defendants breached their duties of loyalty and good faith in declaring the special dividend. Count VI alleges that Viacom breached its fiduciary duties of loyalty and good faith by causing the Blockbuster Director Defendants to declare the special dividend.

As the defendants correctly point out, these are derivative claims that require the plaintiff to comply with Rule 23.1. The Supreme Court stated in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.* that the test for distinguishing direct and derivative claims hinged on "(1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)."[FN74]"The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation."[FN75]

FN74.845 A.2d 1031, 1033 (Del.2004).

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FN75.*Id.* at 1039.

Since Blockbuster suffered the alleged harm, the plaintiff's claim is derivative. Indeed, claims of excessive dividends, such as Count V, have been held to be derivative.[FN76] Having failed to present either board of directors with her claim or allege why demand should be excused under Rule 23.1, both of these claims will be dismissed.

FN76.*In re Rexene Corp. S'holder Litig.*, 1991 WL 77529, at *3 (Del. Ch. May 8, 1991).

V.

In conclusion, the plaintiff fails to sustain her disclosure claim due to her conclusory allegations that are wholly dependent on an unsupported and illogical understanding of the Viacom Director Defendants' oversight of Blockbuster. In addition, the plaintiff's other disclosure allegations are clearly not material and did not warrant further disclosure. Her claim against NAI is also unfounded, given she does not sufficiently allege that NAI directed the actions of Viacom in connection with the Exchange Offer. Lastly, the claims against the Blockbuster Director Defendants and Viacom, challenging the special distribution, are improperly raised as direct, as opposed to derivative, claims and fail to comply with Court of Chancery Rule 23.1.

For the foregoing reasons, the defendants' motion to dismiss for failure to state a claim upon which relief may be granted is GRANTED with prejudice. IT IS SO ORDERED.

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Not Reported in A.2d, 2008 WL 308450 (Del.Ch.)

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