

STATE OF NEW YORK
SUPREME COURT
COMMERCIAL DIVISION

COUNTY OF ALBANY

THOMAS P. DiNAPOLI, Comptroller of the
State of New York, as Administrative Head of
the New York State and Local Employees'
Retirement System and the New York State
and Local Police and Fire Retirement System
and as Trustee of the New York State
Common Retirement Fund,

Plaintiff,

-against-

STRATEGIC CO-INVESTMENT
PARTNERS, GP, L.P. and GEORGE E.
HALL,

Defendants.

DECISION
AND
ORDER

Index No. 2064-10

RJI No.: 01-10-100458

(Judge Richard M. Platkin, Presiding)

APPEARANCES:

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Hon. Richard M. Platkin, A.J.S.C.

Plaintiff Thomas P. DiNapoli, Comptroller of the State of New York (“Comptroller”), brings this commercial action in his capacity as administrative head of the New York State and Local Employees’ Retirement System and the New York State and Local Police and Fire Retirement System and as the sole trustee of the New York State Common Retirement Fund to recover for breach of contract and breach of fiduciary duty. Defendants Strategic Co-Investment Partners, GP, L.P. (“SCIP-GP”) and George E. Hall now move pursuant to CPLR 3211 (a) (7) to dismiss the complaint for failure to state a cause of action.

BACKGROUND

1. Overview

This action arises out of an investment by the New York State Common Retirement Fund (“CRF”) in a private equity fund called Strategic Co-Investment Partners, L.P. (“the Partnership”). The Partnership was launched pursuant to the Amended and Restated Limited Partnership Agreement (“LPA”) of October 3, 2006. The Partnership invested primarily in private equities for which there was no regular, established market.

Defendant SCIP-GP was the general partner and had the power to, among other things, formulate and execute the investment strategies of the Partnership, acquire, hold and dispose of securities, enter into agreements on behalf of the Partnership, and value the Partnership’s investments. In exchange for these efforts, SCIP-GP was compensated through incentive distributions.

CRF was the sole, unaffiliated limited partner, and it invested approximately \$400 million in the Partnership. Commensurate with its controlling interest, CRF had the right to,

among other things, remove the general partner and thereafter determine whether to continue the Partnership or wind it down.

2. Distributions Under the LPA

Section 4.2 of the LPA governs how base distributions from realized investments are made. Under what the parties refer to as a “waterfall” provision, distributions are first made to the limited partner, CRF, until its capital contribution has been repaid, it has been reimbursed for specified fees, expenses and costs, it has been compensated for the net writedowns (*i.e.* losses) on unrealized investments, and it has received a 10% preferred return (LPA § 4.2 [i], [ii]). At that point, any remaining funds flow to SCIP-GP until it has received 8% of the preferred distributions made to CRF (*id.* [iii]). Thereafter, CRF and SCIP-GP share the remaining funds in a prescribed ratio (*id.* [iv], [v]). It is the incentive distributions made to SCIP-GP pursuant to LPA § 4.2 (iii), (iv) and (v) that comprise the “Carried Interest Distributions” at issue in this action.

In addition to CRF’s right to receive distributions in accordance with the foregoing “waterfall” provisions, the LPA also provides CRF with the right to receive “interim clawback” payments and a “final clawback” payment under certain conditions (LPA §§ 4.7, 4.8). The “clawback” provisions were intended to recapture some or all of the Carried Interest Distributions paid to SCIP-GP if gains on investments realized early in the life of the Partnership were later offset by realized or unrealized losses. When the Partnership was launched, defendant Hall executed a guarantee (“the Guarantee”) that made him personally liable for SCIP-GP’s payment of the final clawback.

The obligation to make an interim clawback payment is triggered when, as of the relevant determination date, Carried Interest Distributions have been made to SCIP-GP and the aggregate distributions made to CRF do not equal or exceed the “Interim LP Share Amount”. The Interim LP Share Amount is defined as the aggregate amount of distributions that CRF would have received if distributions under LPA § 4.2 had been made on the determination date (*id.* [c]). If triggered, the interim clawback requires SCIP-GP to return the after-tax amount of Carried Interest Dividends, or so much thereof as is necessary to bring CRF’s distributions up to the Interim LP Share Amount, for redistribution to CRF (LPA § 4.7 [a], [b]). The parties agree that the relevant determination date for the interim clawback is December 31, 2008.

The final clawback, which is triggered upon the termination of the Partnership, operates in a similar manner. If, as of the termination date, Carried Interest Distributions were made to SCIP-GP and the aggregate distributions to CRF do not equal or exceed the “LP Share Amount”, SCIP-GP must contribute the after-tax amount of the Carried Interest Dividends (or such lesser amount thereof as is necessary to bring CRF’s distributions up to the LP Share Amount) back to the Partnership for distribution to CRF (LPA § 4.8 [a], [b]). The LP Share Amount is defined as the aggregate amount of distributions that CRF would have received if all distributions under LPA § 4.2 had been made on the termination date (*id.* [c]). It is undisputed that the termination date is December 18, 2009.

3. This Action

In his complaint, the Comptroller alleges that the Partnership successfully liquidated one of its investments in or about September 2008 (¶ 15). On September 30, 2008, SCIP-GP

paid itself a Carried Interest Distribution of approximately \$1.8 million. In January 2009, the Partnership obtained the gains from a second, realized investment. On February 6, 2009, SCIP-GP paid itself a second Carried Interest Distribution of \$1,068,010.

The complaint alleges that these payments, made in the midst of a near-collapse of the U.S. financial markets, were improper. The Comptroller claims that SCIP-GP knew or should have known of substantial unrealized losses associated with other Partnership investments as a result of this “extraordinary market collapse”. The Comptroller asserts that SCIP-GP’s payment of Carried Interest Distributions under such circumstances constituted a breach of the fiduciary duties owed by the general partner to CRF and that Hall aided and abetted this breach of duty.

The Comptroller’s complaint further alleges that SCIP-GP failed to make clawback payments pursuant to Sections 4.7 and 4.8 of the LPA. Specifically, the complaint alleges that CRF was due an interim clawback as of December 31, 2008 and a final clawback as of December 18, 2009. Relatedly, the Comptroller seeks to recover against Hall based on his personal guarantee of SCIP-GP’s obligation to make the final clawback payment.

Oral argument was held on October 22, 2010. This Decision & Order follows.

ANALYSIS

The LPA provides that it shall be governed by the substantive law of the State of Delaware (§ 17.8). However, the law of New York governs procedural matters, including the standard for a motion to dismiss (*see Ground to Air Catering Inc. v Dobbs Int’l Servs. Inc.*, 285 AD2d 931, 932 [3d Dept 2001]).

Under the well-established principles of New York law governing a motion to dismiss made pursuant to CPLR 3211 (a) (7), “the Court must afford the pleadings a liberal construction, take the allegations of the complaint as true and provide plaintiff the benefit of every possible inference” (*EBC I, Inc. v Goldman, Sachs & Co.*, 5 NY3d 11, 19 [2005]). The Court’s “sole criterion is whether the pleading states a cause of action, and if from its four corners factual allegations are discerned which taken together manifest any cause of action cognizable at law a motion for dismissal will fail” (*Polonetsky v Better Homes Depot, Inc.*, 97 NY2d 46, 54 [2001] [internal quotations omitted]). The test is whether the plaintiff “has a cause of action, not whether he has stated one” (*Leon v Martinez*, 84 NY2d 83, 88 [1994]; *see also Matter of Niagara Mohawk Power Corp. v State of New York*, 300 AD2d 949, 954 [3d Dept 2002]). However, the Court need not “accept as true legal conclusions or factual allegations that are either inherently incredible or flatly contradicted by documentary evidence” (*1455 Washington Ave. Assocs. v Rose & Kiernan, Inc.*, 260 AD2d 770, 771 [3d Dept 1999]).

A. Breach of Final Clawback Provision

Defendants begin with the argument that the Comptroller has failed to adequately state a claim for breach of the final clawback provision. According to defendants, the complaint fails to allege facts as to the net amount of writedowns on the Partnership’s unrealized investments as of December 18, 2009, much less that the substantial gains realized from the liquidation of successful investments in September 2008 and January 2009 were offset by writedowns on the Partnership’s unrealized investments as of the final determination date.

As an initial matter, the Court observes that the parties' dispute over whether the complaint states a claim for a final clawback payment arises, at least in part, from the different ways that they have attempted to articulate in words the mathematical calculations required by the LPA's intricate waterfall and clawback provisions. And both sides acknowledged at oral argument that their verbal descriptions of these provisions present the Court with only a simplified version of the test for whether a clawback payment is due.¹

These difficulties in verbally articulating the mathematical test for a final clawback payment can be seen in reviewing defendants' objection to the first sentence of paragraph 34 of the complaint, which alleges that "[a]s of December 18, 2009, there remain substantial writedowns in the [Partnership's] investment portfolio that greatly exceed the amount of the Carried Interest Distributions" (¶ 34). Clearly, this falls short of directly alleging that net writedowns as of December 18, 2009 exceeded the gains from the Partnership's two realized investments. Moreover, the formula for determining whether a final clawback payment is due does not call for a direct comparison of the Partnership's net unrealized losses with the incentive distributions received by SCIP-LP.

Nonetheless, it may be inferred from this allegation that when the gains from the realized investments were made and SCIP-GP received Carried Interest Distributions pursuant to LPA § 4.2 (iii), CRF had already received its higher priority distributions set forth in § 4.2 (i) and (ii). Thus, additional net writedowns between the dates of distribution and December 18, 2009 would cause Carried Interest Distributions previously made to SCIP-

¹ For example, the parties do not give serious consideration to the scope of the 10% preferred return (LPA § 4.2 [ii]), which necessarily is implicated in the clawback calculation.

LP to be “clawed back” on a dollar for dollar basis. Accordingly, insofar as the amount of these additional net writedowns equals or exceeds the amount of Carried Interest Distributions paid to SCIP-IP, the general partner would be obliged to return the full after-tax amount of such distributions. As such, this allegation can be construed as alleging facts giving rise to a final clawback payment.

More fundamentally, paragraph 35 of the complaint sets forth a purely factual allegation that as of December 18, 2009, the LP Share Amount was \$166,268,403 and CRF’s aggregate distributions total only \$163,404,597. Under the plain language of LPA § 4.8, this clearly alleges an obligation on the part of SCIP-LP to make a final clawback payment of \$2,863,706. And at least implicitly, it alleges that no less than \$2,863,706 in additional net unrealized losses accrued between the distribution dates and the final determination date.

Defendants take issue with these allegations, arguing that the complaint does not allege that CRF obtained an appraisal of the Partnership’s investment as of December 18, 2009 to determine whether any funds are due under the final clawback. However, a pleading is not required to contain such evidentiary detail (Siegel, N.Y. Prac § 207, at 343 [4th ed]). Defendants further argue that the second sentence of paragraph 34, which relies upon the value of the Partnership’s investments as of March 31, 2009, is insufficient to state a claim to a final clawback. However, the inclusion of unnecessary or irrelevant allegations is not fatal to a pleading.

Defendants also argue that insofar as the Comptroller has alleged an LP Share Amount as of December 18, 2009, it is it is inherently incredible, maintaining that such a determination could not be made without a valuation of the Partnership’s investments as of

December 18, 2009. Thus, defendants claim that plaintiff is inappropriately relying upon the March 31, 2009 valuation referred to in paragraph 34 of the complaint.

However, at this stage of the litigation, plaintiff is not required to prove the allegations of its complaint. The Comptroller's allegations in paragraph 35 are factual, refer only to a valuation date of December 18, 2009 and, if proven, would support a cause of action for recovery of a final clawback payment. While defendants submit documentary evidence indicating that at least one of the Partnership's unrealized investments may have increased in value during the period at issue, such proof does not speak to the remainder of the portfolio or otherwise conclusively establish that plaintiff's allegations of additional net writedowns during such period are inherently incredible.

Liberalizingly construing the complaint, taking its allegations as true, and giving plaintiff the benefit of every favorable inference, the Court concludes that plaintiff has stated a claim for breach of the final clawback provision.

B. Claim for Breach of Interim Clawback Provision

Next, defendants raise similar contentions with respect to the interim clawback, claiming that the complaint lacks allegations that the substantial gains realized from the liquidation of a successful investment in September 2008 were offset by net writedowns on the Partnership's unrealized investments as of December 31, 2008.

As with the final clawback payment, the complaint contains a specific allegation regarding the Interim LP Share Amount as of December 31, 2008 and alleges that such amount exceeded the aggregate distributions to CRF on such date (¶ 23). For the reasons

stated above, these allegations are sufficient to support a cause of action for recovery of an interim clawback.

Defendants also contend that since a final clawback payment would encompass any missed interim clawback payments, plaintiff's cause of action for breach of the interim clawback is subsumed in its cause of action to recover the final clawback payment. The Court cannot agree. There is nothing the text of the LPA to support the contention that plaintiff's accrued rights under interim clawback provision are extinguished upon termination of the Partnership. Further, depending on what valuations ultimately are established, it is possible that an interim clawback payment may be due based on the net unrealized losses as of December 31, 2008, even where subsequent gains in the Partnership's portfolio left CRF without a right to recover a final clawback based December 18, 2009 valuations. Moreover, the interim clawback was due on December 31, 2008, while the final clawback was not due until December 18, 2009 – almost a full year later. If plaintiff establishes a breach of the interim clawback, it would have a claim to interest from the date of such breach.

Accordingly, the Court concludes that complaint also states a cause of action for recovery of an interim clawback.

C. Breach of Fiduciary Duty

The third cause of action asserts a claim for breach of fiduciary duty. The Comptroller alleges that SCIP-GP made incentive distributions when the general partner knew or should have known “that no Carried Interest Distributions were due or should have been made to the General Partner” (§ 41). Thus, rather than alleging that incentive distributions were due and authorized by the LPA but that SCIP-LP knew or should have

known that the distributions would have to be returned because of foreseeable future losses, the complaint specifically alleges that Carried Interest Distributions were not due and payable when made. While the former might allege a breach of duty independent of the contract, the latter merely alleges that SCIP-LP breached a contractual obligation to the plaintiff:

[T]he principal inquiry by Delaware courts is whether the fiduciary duty in the complaint arises from general fiduciary principles or from specific contractual obligations agreed upon by the parties. Because of the primacy of contract law over fiduciary law, if the duty sought to be enforced arises from the parties' contractual relationship, a contractual claim will preclude a fiduciary claim. This is because a breach of fiduciary duty claim generally only survives where it may be maintained independently of the breach of contract claim. Where those rights arise from a contract that specifically addresses the matter at issue, the court evaluates the parties' conduct within the framework they themselves crafted, instead of imposing more broadly defined equitable duties.

(*Grunstein v Silva*, 2009 Del Ch LEXIS 206 [internal quotations omitted]; *accord*

Clark-Fitzpatrick, Inc. v Long Is. R.R. Co., 70 NY2d 382, 389 [1987] [New York law]).

In this connection, the Court rejects the Comptroller's reliance on *RJ Assocs., Inc. V. Health Payors' Org. Ltd. P'ship, HPA, Inc.* (1999 Del Ch LEXIS 161). The breach of fiduciary claim upheld by the Delaware Chancery Court in that case was based upon allegations that defendant "wrongfully amend[ed] the Partnership Agreement formula for calculating distributions at an unfairly noticed directors meeting." Here, plaintiff merely alleges that SCIP-LP made payments that were not authorized by LPA § 4.2. As such, the third cause of action fails to state a cause of action for breach of a fiduciary duty.²

² The Court further notes that plaintiff cannot evade the consequences of the rule articulated in *Grunstein* by declining to pursue contractual recovery for such a breach.

This does not necessarily require dismissal of the third cause of action, however. If the facts support any cognizable cause of action – that is, if plaintiff has a viable cause of action under *any* available legal theory –the cause of action should not be dismissed. As noted above, the factual allegations relied upon in the third cause of action allege that SCIP-LP violated the “waterfall” provisions of LPA § 4.2 in making Carried Interest Distributions. While similar to the claims for clawback payments under LPA §§ 4.7 and 4.8, separate breaches of the LPA are alleged. Moreover, it is possible that the remedies for a breach of LPA § 4.2 may differ from those provided by LPA §§ 4.7 and 4.8, which are limited to the after-tax amounts of Carried Interest Distributions. Further, the breaches occurred at different times, potentially giving rise to additional liability for interest.

Accordingly, it is determined that the third cause of action states a cause of action for breach of contract separate and distinct from the first two causes of action.

D. Aiding and Abetting

The fourth cause of action of the complaint seeks to recover from Hall for allegedly aiding and abetting SCIP-GP in its breach of fiduciary duties. As an aiding and abetting claim necessarily depends on a viable breach of fiduciary claim and no such claim has been stated, the fourth cause of action must be dismissed.

E. Guarantee by Defendant Hall

The fifth cause of action alleges that Hall guaranteed the final clawback payment. It already has been determined that the first cause of action alleges a valid cause of action against SCIP-LP for breach of that obligation. As such, the fifth cause of action states a valid cause of action to recover on Hall’s guarantee.

CONCLUSION

Based on the foregoing, the Court concludes that the first, second, third and fifth causes of action of plaintiff's complaint state valid causes of action against the defendants. The fourth cause of action fails to state a cause of action. Accordingly, it is

ORDERED that defendant's motion to dismiss the complaint for failure to state a cause of action is granted to the extent that the fourth cause of action and the claim of breach of fiduciary duty are dismissed and is otherwise denied; and it is further

ORDERED that parties shall confer regarding a schedule for disclosure in this action and, within thirty (30) days from the date of this Decision & Order, shall either: (i) stipulate to a discovery order, which shall be submitted to the Court for approval; or (ii) request a conference with the Court after complying with the consultation requirements of Rule 8 of the Commercial Division.

This constitutes the Decision & Order of the Court. The original Decision & Order is being transmitted to defendants' local counsel. All other papers are being transmitted to the Albany County Clerk for filing. The signing of this Decision and Order shall not constitute entry or filing under CPLR Rule 2220. Counsel is not relieved from the applicable provisions of that Rule respecting filing, entry and Notice of Entry.

Dated: Albany, New York
November 8, 2010

RICHARD M. PLATKIN
A.J.S.C.

Papers Considered:

Notice of Motion dated May 27, 2010; Affirmation of Hermes Fernandez, Esq. dated May 27, 2010, with Exhibits 1-4 annexed;
Affirmation of Hermes Fernandez, Esq. dated August 30, 2010, with Exhibit 1 annexed.