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

PRESENT: Hon. KARLA MOSKOWITZ PART 03
Justice

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MARIETTA W. BREWSTER,

Plaintiff,

-against-

ALAN J. LACY, BRENDA C. BARNES, MICHAEL A. MJLES, DOROTHY A. TERRELL, RAUL H. YZAGUIRRE, WARREN L. BATTS, DONALD J. CARTY, HUGH B. PRICE, HALL ADAMS, JR, JAMES R. CANTALUPO W. and JAMES FARRELL,

Defendants,

-and-

SEARS, ROEBUCK AND CO.,

Nominal Defendant.

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INDEX NO. 603873/2002

MOTION DATE _____

MOTION SEQ. NO. 003

MOTION CAL. NO. _____

The following papers, numbered 1 to _____ *were* read on this motion to/fo

PAPERS NUMBERED

Notice of Motion/ Order to Show Cause — Affidavits — Exhibits _____

Answering Affidavits — Exhibits _____

Replying Affidavits _____

Cross-Motion: ☐ Yes ☐ No

FILED

JUN 22 2004

COUNTY CLERK'S OFFICE
NEW YORK

Upon the foregoing papers, It is

ORDERED that the motion is decided in accordance with the accompanying Decision and Order.

Dated: June 21, 2004

KARLA MOSKOWITZ J.S.C.

Check one: ☒ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 3

MARIETTA W. BREWSTER,

Plaintiff,

Index No. ***60387312002***

-against-

ALAN J. LACY, BRENDA C. BARNES, MICHAEL A, MILES, DOROTHY A. TERRELL, RAUL H. YZACUIRRE, WARREN L. BATTS, DONALD J. CARTY, HUGH B. PRICE, HALL ADAMS, JR., JAMES R. CANTALUPO and W. JAMES FARRELL,

DECISION and ORDER

Defendants,

-and-

SEARS, ROEBUCK AND CO.,

Nominal Defendant.

MOSKOWITZ, J.:

In this derivative action concerning various aspects of the Gold MasterCard program that nominal defendant Sears, Roebuck and Co. ("Sears") launched in *2000,* the individual defendants, who comprise the Board of Directors of Sears, move, together with Sears, pursuant to CPLR 3211(a)(1) and (a)(7), *to* dismiss the Amended Derivative Complaint of plaintiff Marietta W. Brewster, dated March 26, 2003 (the "Complaint").

For the reasons discussed in greater detail infra, defendants' motion is granted on the ground that plaintiff failed to make a pre-suit demand on the Board of Directors of Sears as Business Corporation Law ("BCL") §626(c) requires and has failed to

demonstrate why demand should be excused as futile.'

BACKGROUND

Sears is a New York corporation headquartered in Illinois. It is a multi-line retailer, offering a wide array of merchandise and related services. Additionally, through the credit business, Sears offers customers various credit and related financial products.

Since late-2000, Lacy has served as Sears' Chairman and Chief Executive Officer. Before then, he had served as president of Sears' credit division. All of the remaining individual defendants are "outside directors," including: Barnes, Miles, Terrell, Yzaguirre, Batts, Carty, Price, Adams, Cantalupo and Farrell. Seven of these directors serve on the Audit Committee, including Adams, Cantalupo, Farrell, Price, Yzaguirre, Terrell and Batts (retired in *2002).*

Prior to mid-2000, Sears offered a "proprietary" store credit card, that customers used to charge purchases at Sears stores, At the end of 1999, Sears had *$26.7* billion in proprietary card receivables. In July *2000,* while experiencing declining revenue from its retail operations , Sears introduced a credit card, called the Sears Cold MasterCard, with the goal of increasing revenue and earnings growth from Sears' credit business.

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[1] Because defendants' motion is granted on this ground, the court does not reach the additional grounds asserted by defendants, i.e., that: (a) the pleading of breach of fiduciary duty does not meet the particularity requirements of CPLR 3013 and 3016(b); and (b) plaintiffs claim is barred by Article 7 of Sears' Restated Certificate of Incorporation, adopted pursuant to BCL §402(b), that provides that directors shall not be liable for damages for any breach of duty not involving bad faith, intentional misconduct or a knowing violation of law.

The facts show that Sears offered the MasterCard as a "substitute" to certain existing Sears store credit cardholders, particularly those with good credit histories, who were not incurring finance charges. Other cardholders, approximately 15%, joined through pre-approved, direct-mail offers. Although plaintiff charges that the customers Sears targeted and acquired via direct mailings Sears considered less creditworthy/high risk customers, plaintiff furnishes no support for this claim.

Plaintiff alleges that the MasterCard program contributed to Sears' profitability. From late-2000 through mid-2002, a number of analyst and press reports commented positively about this venture, noting that Sears' credit business was "the third most profitable credit card operation anywhere," and that the strategy was "a giant step forward." While most of the reports were positive about Sears' credit business, there were a few that voiced words of concern.

From the third quarter of 2001 through the second quarter of 2002, Sears reported increased revenue from its credit business. In late 2001, however, the financial press began reporting that other bank card companies, particularly those known as "subprime" (i.e., high risk) lenders such as Providian, Capital One, Metris and NextCard, were encountering financial difficulties. Sears was quick to publically respond that, in its opinion, the quality of its MasterCard was far better than those of other bank card companies because Sears' cardholders had better credit ratings and lower risk than the subprime bank card companies' cardholders.

In July 2002, Sears adopted a change of policy relating to its allowance for

uncollectible accounts.[2] According to defendants, Sears' previous policy included an allowance for principal and finance charges on past due accounts, but not for current accounts or credit-card fees. The new policy added an allowance for those items, resulting in a cumulative **$191** million after-tax charge to net income for the quarter ending March 30, *2002.* On October **2,** 2002, **Sears** filed a Form 10-Q/A for the quarter ending March 30, 2002 (i.e., an amendment of its prior filing for this quarter) with the SEC reflecting Sears' reclassification *of* methodology with respect to its accounting for uncollectible accounts, that it now recorded as a charge against net income. Sears' Form 10-Q/A filed on July **18,** 2002 (and its September 30, *2002* Form **10-Q),** state the following:

> [Sears] periodically reviews its accounting practices to ensure that its adopted policies appropriately reflect changes in its business, the industries it operates in, and the regulatory and political environments. During the second quarter, [Sears] compared its methodology for computing the allowance for uncollectible accounts to the methodologies of participants in the bank card industry. [Sears] felt that a comparison to bank card issuers was appropriate given the growth of the Sears Cold Mastercard product (over $8 billion in balances at the end of the second quarter of 2002) and **the** recent changes to the Sears Card product that are meant to provide a wider range of services to the Sears Card holder (e.g., balance transfers, convenience checks, broader acceptance, etc.). [Sears] determined that practice in the industry was diverse and evolving, particularly in the areas of providing allowances for current accounts, finance charges and credit card fees. [Sears]'s previous policy for determining the allowance for uncollectible accounts provided an allowance for principal and finance charges on past due accounts but not for current accounts or credit card fees. Based on its comparison, [Sears] has changed its methodology to provide an allowance for principal and finance charge balances on current and past due accounts as well as for credit card fee balances. [Sears] believes that this new methodology for determining its allowance is preferable, as it is consistent with more conservative industry practices in this area.

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[2] According to defendants, the "allowance for uncollectible accounts" is **a** reserve that a credit business takes to reflect losses in its credit-card portfolio (see, defendants' memoranda of law, footnote 6).

Plaintiff claims that the above change in policy signified defendants' admission of their failures with respect to the MasterCard program. Defendants, however, maintain that the statement in its Form 10-Q did not imply or admit in any respect that the accounting standards Sears utilized were inappropriate. Defendants submit that this statement shows only that: (a) in the normal course of business, Sears reviews its practices to ensure that they appropriately reflect changes in its business; (b) because the Mastercard product became a relatively significant business, Sears felt a comparison to bank card issuers was appropriate; and (c) Sears, therefore, decided to change its methodology for determining the allowance to those that more conservative industries applied.

In the third quarter of 2002, the Sears credit business announced that it was suffering some setbacks, and, to this end, reduced its full-year outlook for comparable earnings per share from a 22% increase over the previous year to a 15% increase. Sears attributed this reduction to, among other things, an increase in receivables (including management's decision to add $189 million to the $1.4 billion allowance for uncollectible accounts), recent increases in charge-off trends and a cautious economic outlook for the remaining months of *2002.* According to Sears, notwithstanding this allowance increase, its credit business remained profitable and it reported a $284 million operating income for the third quarter of *2002.*

Plaintiff takes the above facts surrounding the third quarter *of* 2002 to mean that defendants must have recklessly overlooked information that should have come to their attention, that Sears must have had inadequate underwriting standards and that the troubles Sears encountered were a result of offering its MasterCard to customers who were

not creditworthy.

The 73 page complaint alleges that defendants breached the fiduciary duties of loyalty, good faith and due care that they owed to Sears and its shareholders by: (a) approving a reckless course of conduct with respect to Sears' Gold MasterCard business; (b) abdicating their responsibilities to prudently supervise the operations of Sears and the conduct of its senior management in connection with Sears' credit division; (c) failing to make a good faith effort to establish and maintain adequate systems that would allow them to effectively remain informed of and monitor the affairs of Sears, including its credit division, particularly inasmuch as Sears had no significant experience in the bankcard industry and the credit division had been the subject of related scandals within the past five years; and (d) failing to make a good faith effort to become informed of and remedy Sears' problems and senior management's imprudent conduct with respect to Sears' credit division.[3]

Soon after plaintiff commenced this action, Sears announced that it was putting its entire credit card loan portfolio, totaling $31 billion, up for sale. Plaintiff contends that this provides further evidence of Sears' reckless underwriting standards and the directors' reckless approval of the MasterCard strategy without any commensurate safeguards.

[3] It is useful to observe what is not alleged in the Complaint: (1) plaintiff does not allege any illegal conduct known to or participated in by any of the directors; (2) defendants are not charged with self-dealing, fraud, or any other typical "wrongdoing" generally alleged in shareholder derivative actions where futility of demand is asserted; and (3) plaintiff does not claim that any director had a personal interest or stood to gain personally in the MasterCard program or that any director was under the control or influence of someone who had such an interest.

DISCUSSION

The landmark case of Marx v Akers (88 NY2d 189) and its progeny teach us that the prerequisites to maintaining derivative actions, that minority shareholders bring to vindicate the corporation's rights, represent a balance between conflicting interests (see, Bansbach v Zinn, 1 NY3d 1, 8-9). Thus, "[o]n the one hand, derivative actions are not favored in the law because they ask courts to second-guess the business judgment of the individuals charged with managing the company," and, on the other hand, they "serve the important purpose of protecting corporations and minority shareholders against officers and directors, who, in discharging their official responsibilities, place other interests ahead of those of the corporation" (Id.).

BCL § 626, entitled "shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor," is the balance struck between these competing considerations. Pursuant to BCL § 626(c), "the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort." As explained by the Court of Appeals:

> A balance of these considerations is maintained by the requirement that a plaintiff shareholder set forth in the complaint–with particularity–an attempt to "secure the initiation of such action by the board or the reasons for not making such effort" (Business Corporation Law § 626 [c]). The demand requirement rests on "basic principles of corporate control– that the management *of* the corporation is entrusted to its board of directors, who have primary responsibility for acting in the name of the corporation and who are often in a position to correct **alleged** abuses without resort to the courts" (Barr v Wackman, 36 NY2D 371, 378 [1975] [citation omitted]; see also Auerbach v Bennett, 47 NY2d 619,630-631 [1979]).

(Id.).

Thus, the court must first determine whether plaintiff has pleaded with

sufficient particularity that a pre-litigation demand on Sears' board would have been futile. The test, under New York law, for determining whether a derivative complaint adequately pleads futility is set out in Marx v Akers , supra, reaffirmed just last year in Bansbach v Zinn, supra:

> Demand is futile, and excused, when the directors are incapable of making an impartial decision as to whether to bring suit. That occurs in three circumstances:
>
> > "(1) Demand is excused because of futility when a complaint alleges with particularity that a majority of the board of directors *is* interested in the challenged transaction. Director interest may either be self-interest in the transaction at issue, or a loss of independence because a director with no direct interest in a transaction is 'controlled' by a self-interested director. (2) Demand is excused because of futility when a complaint alleges with particularity that the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances. The 'long-standing rule' is that a director 'does not exempt himself from liability by failing to do more than passively rubber-stamp the decisions of the active managers'. (3) Demand is excused because of futility when a complaint alleges with particularity that the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors" (Marx v Akers, 88 NY2d, at 200-201[citations omitted).

(Id., at 9).

Although plaintiff admits that the first prong of the test enunciated in Marx v Akers, supra is inapplicable because none of the board members were "interested" in the Mastercard project, she takes the position that demand is excused under the second and third prongs insofar as defendants' "failures to act were so egregious on its face that it could not have been the product of sound business judgment of the directors," and that defendants did "not fully inform themselves about the challenged transaction to the extent

reasonably appropriate under the circumstances."

In this regard, plaintiff claims that she has sufficiently specified that defendants failed to follow industry practices, what the industry practice was and what defendants' practice was. She further contends that defendants, by taking charges and a restatement of one-half billion dollars in order to bring their practices in line with industry practice, and by thereafter deciding to put Sears' credit business up for sale, have virtually admitted their failures. This result is strengthened here, plaintiff submits, because seven of the defendants were members of the Audit Committee, and must have been aware of Sears' alleged credit card business problems. Plaintiff further asserts that various analyst reports and an article in Business Week suffice as "red flags" that defendants ignored or overlooked.

Defendants contend that dismissal is warranted because plaintiff failed to plead demand futility with sufficient particularity. Defendants maintain that, despite plaintiffs unsubstantiated declarations to the contrary (such as her assertion that Sears' entry into the credit card business was nothing more than a reckless foray into a completely new industry or that Sears targeted the MasterCard primarily to high risk, less creditworthy, borrowers than the Sears store card), the Sears MasterCard effort was neither a failure or a mistake, but rather a legitimate business undertaking which falls within the protected category of business judgment. Defendants claim that plaintiffs allegations show only that Sears expanded its credit card business in 2000 to include a Gold MasterCard; that the expansion was successful; that in 2002 Sears voluntarily adjusted its accounting methodology to conform to emerging practices in the bank card industry; and

that, in the third quarter of 2002, Sears increased its loss allowance, because of economic conditions. Accordingly, defendants assert that plaintiffs attempt to blame them for the losses allegedly resulting from the two accounting charges taken to Sears' earnings in 2002 - the first taken in the second quarter because of a change in methodology by which Sears calculates its allowance for losses in its portfolio of credit card receivables, and the second taken in the third quarter to reflect an increase in the allowance because of financial and economic developments that occurred during that quarter - is unfounded.

A review of the Complaint supports defendants' argument that plaintiff's real complaint is not that the program was a failure, but that it should have been introduced and implemented in a more fiscally conservative manner, by, among other things, increasing reserves earlier and/or utilizing a different accounting methodology. Defendants submit, however, that the change in accounting policy in the second quarter of 2002 and the increase in the allowance in the third quarter of 2002 were both precipitated by the events that occurred in *2002,* the growth of the Mastercard portfolio in relation to Sears' overall credit card portfolio and prolonged general economic adversity, and that neither *of* these "events" could have been known or predicted prior to that time.

Conclusory allegations of wrongdoing against board members are insufficient to excuse demand (see e.g., Lewis v Akers, 227 AD2d 595, 596; Bildstein v Atwater, *222* AD2d 545, 546; Lewis v Welch, 126 AD2d 51*9).* Notwithstanding plaintiff's abundant use of exaggerated phraseology and "buzz words" to describe defendants' actions, when stripped to its basics, plaintiffs characterizations are conclusory and rely on unsubstantiated allegations.

Additionally, unlike the facts in the vast majority of cases in which a court excused a pre-suit demand for futility, plaintiff makes no claims of any illegal conduct or suspect motivation on the part of Sears or any of its directors or officers. Simply put, the complaint contains no factual allegations to support the conclusion that the directors acted wrongfully, or recklessly disregarded any facts or circumstances known at the time of any relevant decisions, or ignored any warning signs or other "red flags," such as warnings of the financial press and analysts, that should have alerted the directors to the supposedly improper implementation of the MasterCard program or should have made the defendants question whether the accounting standards and methodology Sears utilized with respect to the MasterCards were in line with industry practice.

Plaintiff's reliance on cases such as In re Abbott Laboratories Derivative Shareholders Litigation (325 F 3d 795 [7th Cir 20031 [Illinois Law, following Delaware Law]), is misplaced. In Abbott, the Seventh Circuit determined that the members of the board were explicitly aware of the alleged practices complained of over a lengthy period of time and had consciously chosen not to act in response -- that the board's "inaction" was intentional and conscious and that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses (id., at 809). The facts alleged in the Abbott case are not remotely similar to the facts alleged in this case. Here, none of the supposed "red flags" plaintiff identified are sufficient to impute or suggest defendants' improper actions (Wilson v Tully, 243 AD2d 229, 237 [Delaware Law] ["despite all of plaintiffs conclusory allegations, there is no well-grounded

evidentiary showing that a reasonable doubt exists as to whether any of the defendant directors' alleged actions or inaction with regard to the so-called 'red flags' cited by plaintiffs were other than valid exercises of the directors' business judgment and fiduciary responsibility . . . "; In re Citigroup Inc. Shareholders Litigation, 2003 WL 21384599, at 2 [Del Ch 20031 [unpublished opinion] ["red flags are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer"], affd sub nom Rabinovitz v Shapiro, 839 A 2d 666 [Del 20031).

While it may be true, as plaintiff says, that defendants "approved" the MasterCard strategy, there is nothing to suggest that defendants' conduct is the sort of conduct for which a court would excuse the demand. At most, plaintiff has alleged that, in hindsight, perhaps Sears should have pursued its MasterCard strategy differently. That being said, the implementation of allegedly inadequate, but not illegal, accounting and underwriting standards in connection with a legitimate business strategy - is not the type of conduct that, without more, would furnish a basis for excusing demand.

In light of the lack *of* particularized allegations showing that defendants would not have been responsive to a demand, defendants are entitled to dismissal of the lawsuit (see, Wilson v Tully, supra, 243 AD2d, at 239; Teachers' Retirement System of Louisiana v Welch, 244 AD2d 231; In re Woolworth Core. Shareholders Derivative Litigation, NYLJ, April 22, 1996, at 28, col 5 [Sup Court, NY Co 1996], affd 240 AD2d 189; see also, Griffith v Medical Quadrangle. Inc., 5 AD3d 151; Simon v. Becherer, __ AD2d __, 775 NYS2d 313 [Delaware Law]).

CONCLUSION

It is ORDERED that defendants' motion to dismiss the complaint is granted, and the complaint is dismissed; and it is further

ORDERED that the clerk is directed to enter judgment accordingly.

Dated: June 24, **2004**

ENTER:

J.S.C.

J.S.C.