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

PRESENT: Hon. KARLA MOSKOWITZ PART 03
Justice

---x

MARK FINKELSTEIN, STRICTLY RHYTHM RECORDS, INC.,

Plaintiffs,

-against-

WARNER MUSIC GROUP INC., THE RHYTHM METHOD INC., WEA INTERNATIONAL INC. WARNER MUSIC UK LIMITED, and AOL TIME WARNER INC.,

Defendants.

---x

INDEX NO. 604332/2002

MOTION DATE _____

MOTION SEQ. NO. 002

MOTION CAL. NO. _____

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

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

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is

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

Dated: February 14, 2006

KARLA MOSKOWITZ J.S.C.

Check one: ☐ FINAL DISPOSITION ☒ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST REFERENCE

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

.....X

MARK FINKELSTEIN,
STRICTLY RHYTHM RECORDS, INC.,

Plaintiffs,

Index No. 604332/02

-against-

WARNER MUSIC GROUP INC.
THE RHYTHM METHOD INC.
WEA INTERNATIONAL INC.
WARNER MUSIC UK LIMITED, and
AOL TIME WARNER INC.,

Defendants.

DECISION and ORDER

.....X

MOSKOWITZ, J.:

The court previously set forth the facts of this case in a prior decision dated October 28, 2003 (the "prior decision") and therefore repeats only those facts as are necessary to this decision. By this motion (seq. no. 2), Warner Music Inc., (f/k/a/ Warner Music Group Inc.) (Warner); The Rhythm Method Inc. (Rhythm), WEA International Inc and Warner Music UK Limited (collectively "defendants") move for partial summary judgment dismissing Count I for fraudulent misrepresentation and Count IX for aiding and abetting fraudulent misrepresentation. Defendants also move to dismiss plaintiffs' claims for breach of fiduciary duty and negligence (Counts II, VII and VIII) because, defendants claim, the counts are derivative and barred.

On November 22, 2000, plaintiffs Mark Finkelstein (Finkelstein), Strictly Rhythm Records, Inc (SRR) and defendant Rhythm agreed to form a joint venture. Defendant Warner previously created Rhythm to hold its interest in the joint venture. Finkelstein and SRR created Strictly Rhythm Records, LLC (Company or SRR LLC) to serve as a vehicle for the joint

venture. Plaintiff SRR owned 95% of the membership interest in the Company while plaintiff Finkelstein owned 5%. The Membership Interest Purchase Agreement (Purchase Agreement) and the Amended and Restated Operating Agreement (Operating Agreement) (collectively "Agreements") memorialized the terms of the joint venture and the creation of the Company.

Pursuant to the Agreements, SRR transferred its rights and interests in its music recordings to SRR LLC. In return for a 50% equity interest in SRR LLC, Rhythm paid SRR $9 million in cash for a 45% membership interest in the Company and gave Finkelstein a $1 million promissory note, that Warner guaranteed, for Finkelstein's 5% membership interest. SRR retained ownership of the remaining 50% of the Company.

Section 8.1 of the Operating Agreement required the Company to:

> adhere to [Warner's] policies and procedures (as the same may change from time to time) applicable to the management and administration of [Warner] Labels. Current [Warner] policies and procedures include those set forth on Exhibit D attached hereto.

(See Operating Agreement attached as Exhibit 9 to the Affirmation of Jay Cohen, Esq. Dated July 11, 2005).

Section 8.3 of the Operating Agreement entitled "Form of Agreements" also provides that "Company-related agreements * * * [shall] be in standard form mutually agreed by the Members," and that these agreements "[shall] be negotiated within parameters mutually agreed by the Members and, in reaching mutual agreement, [Rhythm] will take into account [SRR's] business practices."

Plaintiffs have accused Warner and its subsidiaries and affiliates of maintaining a policy "of not licensing recordings to third-parties for use in compilations unless such third-parties

themselves owned and agreed to license recordings to Warner or its subsidiary or affiliate for use in its own compilations." (the "Undisclosed Compilation Policy" [Complaint ¶ 64]). The Operating Agreement fails to mention the Undisclosed Compilation Policy anywhere even though it attaches a list of Warner's "current" policies. According to plaintiffs, defendants remained silent about the Undisclosed Compilation Policy prior to plaintiff's entry into the joint venture.

According to plaintiffs, Warner caused its subsidiaries to follow the Undisclosed Compilation Policy because of "the dramatic disparity between the revenue and profits that Warner stood to earn from the sale and distribution of dance music albums * * * by its own subsidiaries and the licensing revenue and profits that it stood to earn from its fifty percent interest (through Rhythm) in the Company." (Complaint ¶ 92). The net result, according to plaintiffs, was that Warner used its interest in the Company to increase its ownership interest in the dance music market and maximize its revenues at the Company's expense. Plaintiffs claim that the Undisclosed Compilation Policy resulted in lost business opportunities, thereby depriving the Company "of substantial revenues and profits" *(Id.*, ¶ 82), that eventually resulted in the Company's filing a voluntary Chapter 7 bankruptcy petition.

Discussion

I. The Fraud Claims

On the prior motion to dismiss at the inception of this case, defendants moved to dismiss the fraud claims arguing that there was no justifiable reliance. I denied that part of defendants' motion because plaintiffs allegations were sufficient that defendants had a duty to disclose the Undisclosed Compilation Policy. (Prior decision pg. 10).

Now, on summary judgment, defendants again press the point that plaintiffs cannot demonstrate reasonable reliance because plaintiffs did not inquire about third-party licensing policies and because plaintiffs failed to conduct due diligence concerning those policies. That plaintiffs did not conduct due diligence is not in dispute.

To prevail on a claim for fraud, plaintiff must show justifiable reliance. (*See J.A.O. Acquisition Corp. v. Stavitsky*, 18 AD3d 389 [1st Dep't 2005]). In cases involving sophisticated business entities, plaintiff cannot claim justifiable reliance where plaintiff had access to critical information but failed to make use of that access. *(Abrahami v. UPC Construction Co.*, 224 AD2d 231 [1st Dep't 1996] [failure to exercise right to perform audit precluded claim of justifiable reliance where plaintiff had been "put on notice" of precarious financial condition of defendant]).

However, "whether a duty to inquire is triggered is a context-specific and fact-based inquiry." (*JP Morgan Chase Bank v. Winnick*, 350 FSupp2d 393, 408 [SDNY 2004]). For example, where the facts are peculiarly within the knowledge of the defendants, the law may not require the plaintiff to conduct due diligence. (*Id.* at 410). Also, where plaintiff has a right to perform an inspection or due diligence but does not so do, there can still be justifiable reliance. It is only where plaintiff had indisputable access to the truth or there was some suspicious event or information triggering the duty to inquire that a plaintiff will not have justifiably relied. (*Id.*)

In addition, "once a party has undertaken to mention a relevant fact to the other party it cannot give only half of the truth." (*Manley v. Ambase Corp.*, 126 FSupp2d 743, 756 [SDNY 2001] [citations omitted]); *cf. Junius Construction Corp., v. Cohen*, 257 NY 393 [1931] [in seeking to rescind contract for sale of real property, seller "having undertaken or professed to

mention [two projected street openings] . . .could not fairly stop half way, listing those that were unimportant and keeping silent as to the other"]).

Before entering into the joint venture with Warner, plaintiffs would have had no reason to ask about the Undisclosed Compilation Policy. First, the record provides no definitive evidence that plaintiffs knew such a policy existed. It is undisputed that the Operating Agreement mentions current Warner policies, but fails to mention the Undisclosed Compilation Policy. Once Warner disclosed other Warner policies, a jury might find that plaintiffs justifiably thought that there were no other pertinent policies. Further, as joint venture partners, plaintiffs may not have expected that Warner would allow its international affiliates to follow a policy that would have harmed the Company.

Moreover, as noted earlier, section 8.3 of the Operating Agreement required Rhythm to take into account SRR's business practices in connection with contracts for the licenses that Rhythm was responsible to arrange with affiliates of Warner. One of SRR's business practices apparently was to allow "non-exclusive third-party compilation licenses issued by and through its exclusive licensees and, in the absence of exclusive licensees, by SRR itself" (Pl. Opp. Mem at 16; see also Finkelstein Aff. ¶ 9), a practice that was apparently the opposite of Warner's Undisclosed Compilation Policy.

Finally, the record reflects that, before the joint venture formed, an international affiliate of Warner (LondonFFRR) licensed a SRR recording to several third-parties on a non-exclusive basis, including to at least one-third party compiler who had no repertoire to trade in return. (See Affidavit of Mark Finkelstein, sworn to August 19, 2005 at ¶ 41). That at least one prior dealing was to the contrary further bolsters plaintiffs' claim that there was no reason to ask

about third-party licensing policies.

Thus, under these circumstances, whether plaintiffs' reliance was justifiable is an issue for the fact-finder. The court therefore denies defendants' motion to dismiss plaintiffs' direct claim for fraud (Count I). Because defendants make no separate arguments in seeking to dismiss Court IX for aiding and abetting fraud, the court also declines to dismiss that claim.

II. Derivative Claims

Defendants argue that plaintiffs' breach of fiduciary duty claims are derivative claims that really belong to SRR LLC. The Chapter 7 Trustee of SRR LLC released SRR LLC's claims against Rhythm and its "affiliates," including Warner. (*See* Affidavit of Brian S. Hermann, sworn to July 12, 2005, Ex. F). Defendants reason that therefore the release has extinguished any derivative claims that plaintiffs might assert in this action.

In opposition, plaintiffs first argue that, in effect, defendants are asserting that plaintiffs lack standing to bring the breach of fiduciary duty claims and that defendants have waived this defense because they did not raise it by way of motion or in their answer. However, defendants do not really challenge plaintiffs' standing. They do not assert that plaintiffs could never have brought claims on behalf of SRR LLC. Instead, defendants assert that the court must dismiss plaintiffs' claims, to the extent they are derivative, because the Chapter 7 Trustee released all claims on behalf of SRR LLC during the bankruptcy. Thus, the court does not preclude defendants' argument on the basis of waiver. The court notes that there is also waiver of a defense based upon release unless a party asserts that defense either in a motion to dismiss or in a responsive pleading. (See CPLR 3211[a] [5]) and 3211 [e]). However, as plaintiffs did not make this argument, the court will not address it.

The court now turns to the issue of whether plaintiffs' claims are truly derivative. The parties agree that Delaware law applies to the analysis of the claims against Rhythm. (See Opp. Mem at 38) The parties do not agree whether Delaware or New York law applies to the claims against Warner. For the purpose of this analysis, the court gives plaintiffs the benefit of the doubt and applies New York law as there is no discernable difference anyway between applicable New York law and Delaware law.

A. Breach of Fiduciary Duty against Rhythm

Defendants argue that plaintiffs' manufacturing, licensing, royalty and failure to license claims are really derivative claims that belong to SRR LLC and plaintiffs cannot assert these claims derivatively anymore because SRR LLC released them in the bankruptcy. Apparently, plaintiffs had the opportunity to object to SRR LLC's release of claims during the bankruptcy, but did not do so.

In determining whether a claim is derivative or direct under Delaware law, courts examine: (1) who suffered the alleged harm, the corporation or the suing members individually (or stockholders in the case of a corporation); and (2) who would receive the benefit of any recovery or other remedy, the corporation or the stockholders, individually. (*See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1032 [Del. 2004]) Shared injury will not suffice for a direct claim. (*Id.* at 1039). "The stockholder's claimed direct injury must be independent of any alleged injury to the corporation." (*Id. See also Nemazee v. Premier Purchasing Partners, L.P.*, __ AD2d__, 806 NYS2d 22, 23 [1st Dep't 2005] [following *Tooley*]).

Plaintiffs concede that "[d]efendants have correctly cited and articulated the relevant

case law addressing the issue of whether claims asserted by shareholders of Delaware corporations are direct or derivative." (Opp. Mem. at 38). Plaintiffs claim, however, that the cases defendants cite do not apply because those cases involved shareholders of Delaware corporations while this case involves a limited liability company. This is incorrect. The test to determine whether a claim is derivative or direct applies to all business entities. (*See Litman v. Prudential-Bache Properties, Inc.*, 611 A2d 12, 14 [Del. Ch. Ct 1992] ["the determination of whether a fiduciary duty lawsuit is derivative or direct is substantially the same for corporate cases as it is for limited partnership cases"]; see also Harris, *Recent Case Law Developments Relating to Delaware's Alternative Entities*, 7 Del. L. Rev. 213, fn. 31 [2004] [noting that *Tooley* disapproved of the test in *Anglo American*, a case upon which Finkelstein and SRR rely, and stating that nothing in *Tooley* indicates that it would not apply in the limited partnership context]).

In opposition to this motion, plaintiffs do nothing to explain how the injury they claim to have suffered inures only to them. In fact, plaintiffs concedes that these claims against Rhythm"appear" to be derivative, but under the outdated Delaware case law plaintiffs cite, "the distinction between direct and derivative claims is, as a practical matter, irrelevant." (*See* Opp Mem at 41-42). As discussed above, plaintiffs could not be more wrong on the law.

Under *Tooley*, plaintiffs' claims are indeed derivative. (*See e.g. Weber v. King*, 110 FSupp3d 124, 132 [EDNY 2000] [applying Delaware law and holding that claims were derivative because plaintiffs' interest in sustaining the profits of the limited liability company was due solely to their two-thirds stake in that entity.]). Plaintiffs' alleged damages rely solely on the reduced profits of the Company because of defendants' breaches. Thus, any damage

plaintiffs experienced flows directly from their interest in the Company. As such, the claims are derivative. Accordingly, the court dismisses plaintiffs' breach of fiduciary duty claims against Rhythm.

B. Plaintiffs' Breach of Fiduciary Duty Claims against Warner

Plaintiffs claim that Warner owed them direct fiduciary duties as a joint venture partner. (Opp. Mem at 43). The court notes that Warner is not a signatory on the agreements and therefore questions whether Warner is a joint venture partner with a concomitant fiduciary duty in the first instance. However, assuming that Warner does owe plaintiffs fiduciary duties, the court still must dismiss the claim for reasons similar to the dismissal of plaintiffs' fiduciary duty claim against Rhythm. This is because again, plaintiff does nothing to argue against defendants' characterization of this breach of fiduciary duty claim as derivative.

The parties appear to disagree over which state's law applies to the breach of fiduciary duty claims against Warner: New York or Delaware. Regardless, under either New York or Delaware law, plaintiffs still have not provided any way for this court to view their claims as direct. Instead, under the heading "SRR's Fiduciary Duty Claims are Direct Claims under Applicable New York Partnership Law" plaintiffs only regale the court with a broad exegesis on New York Partnership law and cite the general rule that a shareholder may bring an individual suit if the defendant has violated an independent duty to the shareholder. (Opp. Mem. at 44-47). What plaintiffs do not explain is what that independent duty is. Again, plaintiffs have failed to demonstrate how the injury they have suffered does not flow from injury to SRR LLC.

For example, plaintiffs have asserted in their complaint that Warner (and Rhythm) violated their fiduciary duty by failing to ensure that Warner's worldwide affiliates "had

appropriate facilities and resources available for the timely and proper manufacture of both vinyl records and CDs of the Company's records." (Complaint ¶ 144[d]). This type of mismanagement claim is derivative. (*Broome Family Partners v. ML Media Opportunity Partners L.P.*, 273 AD2d 63, 64 [1st Dep't 2000] [allegations of mismanagement and diversion of assets did not implicate any injury to plaintiffs distinct from the harm to the partnership]; *Strain v. Seven Hills Assoc.*, 75 Ad2d 360, 371 [1st Dep't 1980] [claim for alleged mismanagement was derivative]).

Similarly, plaintiffs claim that defendants breached their fiduciary duties by "refusing to grant and issue. . . licenses to third parties to use Company Records." (Complaint ¶¶ 144[b], [c] and [i]). According to plaintiffs, defendants refused the third-party licenses because defendants stood to earn more from using Company records on their own compilations than they would by licensing Company records to others to use on third-party compilations. (Id. ¶¶ 91-92). Thus, defendants' refusal detrimentally effected SRR LLC's profits. Therefore, any harm to individual members flowed first through the Company and is therefore derivative. (*See Broome, supra*, 273 Ad2d at 64). The remainder of plaintiffs' claims suffer similar problems. That defendants breached their fiduciary duties "by failing and refusing to properly account. . to the Company" for royalties that the "exploitation and use of Company recordings by [defendants'] affiliates" generated (Complaint ¶ 144[g]) alleges injury only to SRR LLC. So does the claim that defendants breached their fiduciary duties by refusing to "license repertoire to the Company." (Complaint ¶ 144[e]) Indeed, plaintiffs claim that this refusal "hampered the Company's ability to generate revenue" (Complaint ¶ 83). This makes it all the more clear that plaintiffs are asserting a derivative claim.

SRR LLC released the claims it had against Rhythm and Warner in its bankruptcy proceeding. Plaintiffs do not deny that they were given an opportunity to object to that release and did not. Accordingly, plaintiffs' claims for breach of fiduciary duty as contained in Counts II, VII and VIII of the complaint are dismissed to the extent the claims are derivative.

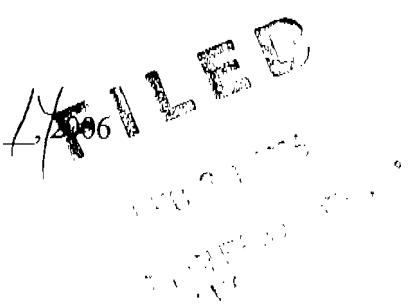
In so holding, the court notes that parties to a joint venture owe each other fiduciary duties. (*Meinhard v. Salmon*, 249 NY 458 [1928]; *Richbell Info. Serv. Inc., v. Jupiter*, 309 AD3d 288 [1st Dep't 2003]). To the extent that plaintiffs have asserted direct claims where the injury to them does not flow through SRR LLC, plaintiffs may maintain a claim for breach of fiduciary duty. However, plaintiffs have pointed out no direct claims to the court.

Accordingly, it is

ORDERED THAT defendants' Warner Music Group Inc., The Rhythm Method Inc., WEA International Inc. and Warner Music UK Limited motion for partial summary judgment is granted in part dismissing Counts II, VII and VIII of the complaint to the extent those counts assert derivative claims and is otherwise denied.

The parties are directed to attend a settlement conference on February 28, 2006 at 10 a.m. with principals in the courtroom, room 248, 60 Centre Street.

Dated: February 17, 2006



J.S.C.