

AP Servs., LLP v Lobell
2015 NY Slip Op 31115(U)
June 19, 2015
Supreme Court, New York County
Docket Number: 651613/12
Judge: Marcy S. Friedman
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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: MARCY S. FRIEDMANPART 60*Justice*AP SERVICES, LLP, in its capacity as Trustee of the
CRC Litigation Trust,INDEX NO. 651613/2012

-against-

MOTION DATE _____

J. JAY LOBELL, LINDSAY A. ROSENWALD, I.
KEITH MAHER, ISAAC KIER, MICHAEL WEISER
and ARIE BELLDEGRUNMOTION SEQ. NO. 004The following papers, numbered 1 to _____ were read on this motion to dismiss

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

No (s). _____

Answering Affidavits — Exhibits _____

No (s). _____

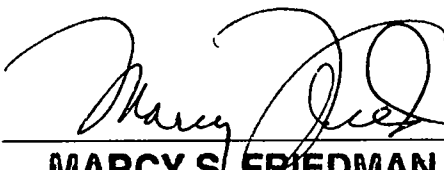
Replying Affidavits _____

No (s). _____

Cross-Motion: ☐ Yes ☒ No

Upon the foregoing papers, it is ordered that

Upon the foregoing papers, it is ORDERED that the motion of defendants J. Jay Lobell and Lindsay A. Rosenwald to dismiss the First Amended Complaint is decided in accordance with the attached decision/order, dated June 19, 2015.

Dated: 6-19-15

 MARCY S. FRIEDMAN, J.S.C.

J.S.C.

1. Check one: ☐ CASE DISPOSED ☒ NON-FINAL DISPOSITION
2. Check as appropriate:.....Motion is: ☐ GRANTED ☐ DENIED ☐ GRANTED IN PART ☐ OTHER
3. Check if appropriate:..... ☐ SETTLE ORDER ☐ SUBMIT ORDER
- ☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE
FOR THE FOLLOWING REASON(S):

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COM. DIV. PART 60

-----X
AP SERVICES, LLP, in its capacity as
Trustee of the CRC Litigation Trust,

Plaintiff,

Index No. 651613/12

- against -

J. JAY LOBELL, LINDSAY A. ROSENWALD,
I. KEITH MAHER, ISAAC KIER, MICHAEL WEISER
and ARIE BELLDEGRUN,

Defendants.
-----X

MARCY S. FRIEDMAN, J.:

Plaintiff AP Services, LLP, as trustee for the CRC Litigation Trust (CRC), brings this action on behalf of Chem Rx Corporation (the Company) against the former directors of Paramount Acquisition Corp. (Paramount), a blank-check or special purpose acquisition company that was the Company's predecessor. CRC claims that the directors breached their fiduciary duties to Paramount by causing Paramount to enter into a leveraged buy-out transaction in which Paramount acquired an existing private company doing business as "Chem Rx" for \$133 million in cash (the LBO Transaction). According to CRC, in approving the transaction, the directors were self-interested or controlled by an interested director. CRC also alleges that in their rush to approve the LBO Transaction, the directors ignored key red flags that should have alerted them to the fact that Chem Rx's audited financial statements were untrustworthy. CRC further claims that the LBO Transaction saddled the Company with massive debt that it was unable to service or repay, and resulted in bankruptcy and liquidation.

Defendants Lindsay A. Rosenwald and J. Jay Lobell move, in motion sequence 003, to dismiss the First Amended Complaint, pursuant to CPLR 3211 (a) (1) and (7). Defendants I. Keith Maher, Isaac Kier, Michael Weiser and Arie Belldegrün, move, in motion sequence number 004, for the same relief. The motions are consolidated for disposition.

FACTUAL ALLEGATIONS

The following factual allegations are taken from the First Amended Complaint (FAC) and the October 2, 2007 Proxy Statement for the LBO Transaction, which CRC's pleading incorporates. (See FAC, ¶ 47; see also Transcript of Oral Argument [OA Tr.] at 47.)

Paramount was incorporated in Delaware in 2005 as a "blank-check acquisition company." (FAC, ¶ 20; Engel Aff., Ex. F: Proxy Statement at 10.) The parent company of Paramount is Paramount BioSciences LLC (Paramount BioSciences), a company founded by defendant Rosenwald in 1991 as a venture capital firm specializing in the healthcare industry. (FAC, ¶¶ 21-22.) Paramount was formed for the sole purpose of effecting a merger or other similar business combination with an operating business in the healthcare industry. (Id., ¶ 2.) If the company did not execute a term sheet with a potential merger candidate by April 27, 2007, and consummate the transaction six months later, by October 27, 2007, it would be forced to liquidate. (FAC, ¶ 20; Proxy Statement at 10.) Paramount consummated an initial public offering (IPO) of units consisting of one share of common stock and two warrants on October 21, 2005. (FAC, ¶ 26.) The IPO netted the company approximately \$53,473,000, of which \$52,164,500 was placed in a trust account to be released upon the consummation of a merger transaction. (Id.)

The six defendants in this lawsuit were the members of Paramount's board of directors. (FAC, ¶¶ 8-13.) Rosenwald was the chairman of the board. (Id., ¶ 22.) Defendants were the initial stockholders of Paramount. (Proxy Statement at 159.) Before the IPO, defendants acquired 2,125,000 shares out of a total of 11,900,00 issued shares or approximately 20% of Paramount's common stock, with a value of \$12,006,250 as of October 1, 2007. (FAC, ¶ 27.) Between 2005 and 2007, defendants increased their investment in Paramount, collectively purchasing nearly 2,000,000 warrants, with a value of approximately \$1.3 million. (Id., ¶¶ 27-29). Under the terms of the IPO, defendants were not entitled to receive any of the net proceeds of the IPO held in trust to be distributed upon liquidation, and their shares and warrants would become "worthless" if Paramount failed to enter into a merger by the October 27, 2007 deadline. (FAC, ¶ 30; Proxy Statement at 43.)

Shortly after the IPO, Paramount began shopping for a merger target. (FAC, ¶ 35.) After a deal with a company called BioValve Technologies, Inc. fell through on January 22, 2007, CRC alleges that "Paramount began frantically searching for a new merger target." (Id., ¶ 37.) Between that date and October 26, 2007, when the LBO Transaction closed, Paramount allegedly signed more than 20 non-disclosure agreements with potential acquisition candidates, including B.J.K., Inc. doing business as Chem Rx, then the third largest long-term care institutional pharmacy in the United States (Id., ¶¶ 16, 38.) Chem Rx was owned and operated by Jerry Silva, and his son, Steven Silva. (Id., ¶ 17.)

On March 8, 2007, representatives of 25 Highland Partners, LLC and Alinian Capital Group, LLC (the Intermediaries) met with two employees of Paramount BioSciences for the purpose of introducing Chem Rx on a "no-names" basis as a potential merger candidate under

terms consistent with a letter of intent the Intermediaries had executed with Chem Rx on January 31, 2007. (FAC, ¶ 39; Proxy Statement at 50). Further meetings were held in March 2007, and on March 27 Paramount sent the Intermediaries a draft term sheet which contemplated Paramount's acquisition of Chem Rx. (FAC, ¶ 40; Proxy Statement at 51.)

On April 6, 2007, a meeting was held between Paramount representatives, the Intermediaries, Jerry and Steven Silva, and Stephen Feldman from the accounting firm Marcum & Kliegman LLC (M&K). (FAC, ¶ 41; Proxy Statement at 51.) M&K had served as Chem Rx's independent auditor until February 2007, at which time the firm began providing financial advisory services to the Silvas. (FAC, ¶ 42.) CRC alleges that "[a]t the meeting, Chem Rx rejected the terms set forth in the Term Sheet and the Intermediaries pulled out . . . because of issues surrounding Chem Rx's management. Defendants, however, were desperate for a deal and forged ahead, undeterred by the fact that those who had first suggested Chem Rx as a business partner for Paramount," had withdrawn due to "significant issues with Chem Rx and its management. . . ." (*Id.*, ¶ 43.)

On April 24, 2007, three days prior to the April 27, 2007 liquidation deadline, Paramount executed non-binding term sheets with Chem Rx and two other acquisition targets. (Proxy Statement at 52.) By doing so, Paramount gained an extra six months to consummate a merger (*See* FAC, ¶ 44; Proxy Statement at 10, 52.) Paramount's board of directors met on June 1, 2007 to vote on the proposed transaction. (FAC, ¶ 45; Proxy Statement at 53.) CRC alleges that "[t]he entire meeting, which included presentations from Lobell, outside counsel, and a financial advisor, lasted less than two hours. At the end, the board signed off and voted to recommend the

deal to Paramount's stockholders." (FAC, ¶ 45.) A Stock Purchase Agreement (the SPA) was executed on June 1, 2007. (Id., ¶ 64.)

The deal approved by the board was a leveraged buy-out transaction in which Paramount acquired Chem Rx for \$133 million in cash, including a separate \$11 million payment to Steven Silva prior to the LBO Transaction. (FAC, ¶ 3.) The LBO Transaction consisted of two interrelated parts: (1) the SPA, by which Paramount acquired 100% of the stock of Chem Rx in exchange for a payment of \$133 million, including approximately \$106 million to the Silva family directly; and (2) \$162 million in financing for the stock purchase, pursuant to certain credit facilities provided by CIBC World Markets Corp. (CIBC). (Id., ¶¶ 64-67; Proxy Statement at 1.) After the merger of Paramount and Chem Rx, the combined company changed its name to Chem Rx Corporation (the Company). (FAC, ¶ 65.)

After voting to recommend the deal to Paramount's stockholders, the board mailed the Proxy Statement to Paramount's stockholders on October 3, 2007. (FAC, ¶ 47.) Under the terms of the IPO documents, at least 80% of Paramount's stockholders were required to approve the LBO Transaction. (Proxy Statement at 4.) CRC alleges that a number of Paramount's institutional investors threatened to block the LBO Transaction unless they were given substantial put options, which allowed these stockholders to sell their interests in the Company for a set price following the LBO Transaction. (FAC, ¶ 62.) According to a document entitled the "Funds Flow Memorandum," over \$30 million – which CRC alleges is a disproportionately large sum in relation to the size of the transaction – was placed in escrow for the benefit of major stockholders. (Id.; Kleinman Aff., Ex. 8.) Paramount's stockholders voted to approve the LBO

Transaction at a special meeting held on October 22, 2007, and the transaction closed on October 26, 2007. (Engel Aff., Ex. I at 1; FAC, ¶ 64.)

CRC alleges that the \$133 million purchase price for Chem Rx was more than double the \$65 million implied valuation of Chem Rx reflected by its stock repurchase less than one year earlier. (FAC, ¶ 46.) CRC also alleges that the \$162 million the Company borrowed “increased the Company’s debt to unprecedented – and untenable – levels.” (Id., ¶ 67.) “Prior to the LBO Transaction, [Chem Rx] had a positive tangible net worth, positive Total Liability to Equity Ratio, and positive Bank Debt to Equity Ratio.” (Id., ¶ 70.) However, following the LBO Transaction, at the end of October 2007, the Company was insolvent, and in 2008 and 2009, the Company lost an aggregate sum of over \$100 million, “much of it being the massive interest expense incurred as a result of the LBO Transaction.” (Id., ¶ 71.) In April 2009, the Company publicly announced that, as of December 31, 2008, it was in violation of financial covenants under the credit agreements with CIBC. (Id., ¶ 73.) In May and June of 2009, the Company was able to enter into forbearance agreements with its lenders, and in doing so, “the Company admitted that the historical financial statements on which the LBO Transaction was based were false.” (Id., ¶¶ 76-77.)

The Company filed for bankruptcy in Delaware on May 11, 2010. (FAC, ¶¶ 1, 83.) The bankruptcy ultimately led to a distressed sale of the Company as a going concern and a Chapter 11 plan liquidation. (Id., ¶ 84.) CRC was created and approved by the bankruptcy court as a litigation trust for the purpose of prosecuting causes of action on behalf of the bankruptcy estate, and the proceeds of any successful claims are the only source of recovery for the general unsecured creditors of the Company. (Id., ¶¶ 1, 84.)

DISCUSSION

On a pre-answer motion to dismiss pursuant to CPLR 3211, the court must “accept the facts as alleged in the complaint as true, accord plaintiffs the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory.” (Leon v Martinez, 84 NY2d 83, 87–88 [1994]; see also 511 W. 232nd Owners Corp. v Jennifer Realty Co., 98 NY2d 144, 151–152 [2002].) However, “the court is not required to accept factual allegations that are plainly contradicted by the documentary evidence or legal conclusions that are unsupportable based upon the undisputed facts.” (Robinson v Robinson, 303 AD2d 234, 235 [1st Dept 2003]; see also Erich Fuchs Enters. v American Civ. Liberties Union Found., Inc., 95 AD3d 558 [1st Dept 2012].) When documentary evidence under CPLR 3211 (a) (1) is considered, “a dismissal is warranted only if the documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law.” (Leon v Martinez, 84 NY2d at 88.)

The complaint alleges a first cause of action against all defendants for breach of fiduciary duty; a second cause of action against all defendants for aiding and abetting breach of fiduciary duty; and third and fourth causes of action against defendant Lobell for breach of fiduciary duty and aiding and abetting such breach, respectively.

The first cause of action alleges that defendants breached their fiduciary duties of loyalty and due care to the Company. CRC alleges that defendants were self-interested in approving the LBO transaction. In particular, they were motivated by the desire to avoid having their \$13 million dollar investment in Paramount “rendered worthless” by a liquidation. (FAC, ¶¶ 90–91.) According to CRC, in their “rush to avoid liquidation,” defendants “closed their eyes” and “willfully ignored” several “red flags” evident from the face of the transaction documents

themselves. (FAC, ¶¶ 48, 91-92). These red flags allegedly should have alerted defendants: (1) to the fact that M&K's audited financial statements for Chem Rx "were both untrustworthy and incomplete"; and (2) that the LBO Transaction was not in the best interests of the Company. (*Id.*, ¶¶ 91, 93.) CRC alleges that defendants' failure to investigate these red flags rises to the level of gross negligence and constitutes an intentional dereliction of their fiduciary duties. (*Id.*, ¶¶ 4, 92.)

Breach of Fiduciary Duty Cause of Action

Under Delaware law,¹ corporate directors owe fiduciary duties of loyalty and care to the corporation and to its shareholders. (*North Am. Catholic Educ. Programming Found., Inc. v Gheewalla*, 930 A2d 92, 99 [Del 2007]; *In re Walt Disney Co. Derivative Litig.*, 907 A2d 693, 745 [Del Ch 2005], *affd* 906 A2d 27 [Del 2006]; *Paramount Communications Inc. v QVC Network Inc.*, 637 A2d 34, 43 [Del 1994]; *compare Cede & Co. v Technicolor, Inc.*, 634 A2d 345, 361 [Del 1993], *modified on other grounds* 636 A2d 956 [1994] [referring to "triads" of fiduciary duty – good faith, loyalty, and due care] *with Stone ex rel. AmSouth Bancorporation v Ritter*, 911 A2d 362, 370 [Del 2006] [clarifying that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly"].)

Duty of Loyalty

¹ Paramount is a Delaware corporation, and all parties agree that Delaware law applies to the first cause of action. (See *Finkelstein v Warner Music Group Inc.*, 32 AD3d 344, 345 [1st Dept 2006]; *Simon v Becherer*, 7 AD3d 66, 72 [1st Dept 2004].)

The duty of loyalty requires that a director act in a manner in which “the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.” (Cede & Co., 634 A2d at 361.)

Defendants argue that the duty of loyalty is not implicated in this case, and that their acts in recommending approval of the LBO Transaction are protected by the business judgment rule. The business judgment rule “is an acknowledgment of the managerial prerogatives” of directors under Delaware law. “It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” (Aronson v Lewis, 473 A2d 805, 812 [Del 1984], overruled by Brehm v Eisner, 746 A2d 244, 253–254 [Del 2000] in part on other grounds relating to the standard of review of Chancery Court; accord Cede & Co., 634 A2d at 360; Trenwick Am. Litig. Trust v Ernst & Young, L.L.P., 906 A2d 168, 194 [Del Ch 2006], affd sub nom Trenwick Am. Litig. Trust v Billet, 931 A2d 438 [Del 2007].) Where the business judgment rule is applicable, it requires a “deferential” standard of review of the directors’ acts. (MM Cos., Inc. v Liquid Audio, Inc., 813 A2d 1118, 1128 [Del 2003].) Under the rule, “a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be attributed to any rational business purpose.” (Cede & Co., 634 A2d at 361 [internal quotation marks and citation omitted]; accord MM Cos., 813 A2d at 1128.)

A party challenging the decision of the board bears the ultimate burden of establishing facts sufficient to rebut the presumption that the board exercised sound business judgment. (Aronson, 473 A2d at 812.) On a motion to dismiss, the plaintiff “must allege particularized facts that raise doubt about whether the challenged transaction is entitled to the protection of the

business judgment rule.” (In re Walt Disney Co. Derivative Litig., 825 A2d 275, 286 [Del Ch 2003]; Aronson, 473 A2d at 817 [in demand futility case, holding that “particularized facts” must be alleged to support a breach of fiduciary duty claim]; Wayne County Empls.’ Retirement Sys. v Corti, 2009 WL 2219260, *10 [Del Ch, July 24, 2009, No. 3534-CC], affd no opinion 996 A2d 795 [Del 2010]; Orman v Cullman, 794 A2d 5, 28-29 [Del Ch 2002]:) Specifically, the plaintiff “must allege facts that raise a reasonable doubt as to whether the Board breached either its duty of care or its duty of loyalty to the corporation.” (Orman, 794 A2d at 22.) As further explained:

“As a general matter, the business judgment rule presumption that a board acted loyally can be rebutted by alleging facts which, if accepted as true, establish that the board was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders. To establish that a board was interested or lacked independence, a plaintiff must allege facts as to the interest and lack of independence of the individual members of that board. To rebut successfully business judgment presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating that a majority of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director.”

(Id. [emphasis in original] [internal quotation marks and citations omitted].) The business judgment rule can also be rebutted “where the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.” (Parnes v Bally Entertainment Corp., 722 A2d 1243, 1246 [1999] [internal quotation marks and citation omitted]; accord In re Alloy, Inc. Shareholder Litig., 2011 WL 4863716, * 10 [Del Ch, Oct. 13, 2011, C.A. No. 5626 (VCP)]; Crescent/Mach I Partners, L.P. v Turner, 846 A2d 963, 981 [2000].) “If the presumption of the business judgment rule is rebutted, however, the burden shifts to the director defendants to prove to the trier of fact that the challenged transaction was

‘entirely fair’.” (Emerald Partners v Berlin, 787 A2d 85, 91 [Del 2001] [emphasis in original]; Cede & Co., 634 A2d at 361.)

A director may be deemed interested in a transaction if he “appear[s] on both sides of a transaction or a director receiv[es] a personal benefit from a transaction not received by the shareholders generally.” (Cede & Co., 634 A2d at 362.) “Directorial interest . . . exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders.” (Rales v Blasband, 634 A2d 927, 936 [Del 1993].) However, “in the absence of self-dealing, it is not enough to establish the interest of a director by alleging that he received any benefit not equally shared by the stockholders. Such benefit must be alleged to be material to that director.” (Orman, 794 A2d at 23 [emphasis in original]; Cede & Co., 634 A2d at 363.)

Here, there is no claim that any of the Paramount directors appeared on both sides of the Chem Rx acquisition. Nor is there any claim that any Paramount director had a prior connection to Chem Rx. Rather, CRC alleges that the directors identified Chem Rx as a promising target after considering two dozen alternatives. (FAC, ¶¶ 35, 38.) CRC’s claims of directorial interest are based on two alleged factual predicates. First, CRC maintains that “[l]iquidation would have rendered all of [the directors’] shares and warrants [of Paramount stock] worthless,” and that the directors “stood to make substantial profits on their personal investments if the LBO Transaction closed.” (FAC, ¶ 30.) Second, CRC argues that Rosenwald was interested in the LBO Transaction and that defendants Lobell, Maher and Weiser were controlled by, or beholden to, Rosenwald.

In response to CRC’s first assertion, defendants contend that their ownership of Paramount common stock and warrants did not create a disabling conflict. As defendants

correctly argue, “Delaware courts recognize that stock ownership by decision-makers aligns those decision-makers’ interests with stockholder interests; maximizing price. [Delaware] Courts have therefore routinely held that an interest in options vesting does not violate the duty of loyalty.” (In re BioClinica, Inc. Shareholder Litig., 2013 WL 5631233, *5 [Del Ch, Oct. 16, 2013, C.A. No. 8272 [VCG)]; see also In re OPENLANE, Inc., 2011 WL 4599662, * 5 [Del Ch, Sept. 30, 2011, C.A. No. 6849 (VCN)] [accelerated vesting of stock options as a result of a merger, “without more, does not suffice to impugn the disinterestedness” of the board]; Krim v ProNet, Inc., 744 A2d 523, 528 [Del Ch 1999] [holding that “neither the vesting of the options nor the fact some ProNet directors retained board seats in the merged entity created a ‘substantial conflict’”].)

In this case, however, CRC does not allege merely that defendants owned Paramount stock and warrants, in which event their interests would be aligned with those of the IPO stockholders in entering into a business transaction that would maximize both the directors’ and the stockholders’ investment. Rather, CRC alleges that under the terms of the IPO, defendants would not have been entitled to receive any of the net proceeds of the IPO that were held in trust to be distributed to the stockholders upon a liquidation. The Proxy Statement itself cites these facts as demonstrating that the directors “have interests in the Transaction that may be different from [the shareholders] because if the Transaction is not approved the securities held by them may become worthless.” (Proxy Statement at 35). The Registration Statement for the August 2005 IPO goes a step farther and identifies the directors’ risk of loss of their investment as a “potential conflict of interest.” (Engel Aff., Ex. E at 40). CRC thus adequately alleges that the directors had a financial interest, which was not aligned with the stockholders’ interest, in

entering into the LBO Transaction by the looming merger deadline, notwithstanding the alleged red flags as to the soundness of Chem Rx and the transaction itself.

Moreover, according to the Form S-1 registration statement for the IPO, defendants' \$12,006,250 investment in Paramount common stock was owned as follows: Rosenwald – 55%; Lobell – 15%; Maher – 15%; Weiser – 5%; Belldegrin – 5%; and Kier – 5%. (Engel Aff., Ex. E at 42.) Thus, the minimum investment of any Paramount director was allegedly worth as much as \$600,312.

The court holds that CRC pleads sufficiently particularized facts to support its claims that each member of the Paramount board owned Paramount stock and warrants that would be rendered worthless in the event of a liquidation; that the amounts owned were significant and the directors would therefore receive a material benefit from entering into the LBO Transaction and avoiding liquidation; that the board was therefore interested in the outcome of the LBO Transaction; and that its interest deviated from that of the stockholders. (See generally Orman, 794 A2d at 22.)¹ The First Amended Complaint accordingly pleads a breach of the duty of loyalty based on the self-interest of the majority of the directors in the LBO Transaction. On the

¹ In so holding, the court notes that the parties do not cite legal authority specifically addressing the interest of directors of a special purpose acquisition company (SPAC) in approving a business combination, where the directors will not have a right to distribution of funds from a trust account and their stocks and warrants will be rendered worthless in the event of a liquidation. The argument that such directors' interests were misaligned with the stockholders' interest was made in Opportunity Partners L.P. v Transtech Serv. Partners Inc. (2009 WL 997334 [Del Ch, April 14, 2009, C.A. No. 4340 (VCP)]). But the issue was not decided in that case. Moreover, although defendants argue that the structure of the SPAC was such that the directors could not have approved the acquisition of Chem Rx without shareholder approval, they do not submit legal authority addressing the impact on directors' good faith decision-making of investor protections which may be adopted in connection with SPACS, including a requirement that a majority of IPO stockholders approve a business combination or that initial stockholders agree to a lock-up provision committing them to hold the stock for a fixed period. (See Castelli, Not Guilty By Association: Why The Taint of Their "Blank Check" Predecessors Should Not Stunt the Growth of Modern Special Purpose Acquisition Companies, 50 Boston Coll L Rev 237 [2009].) (In the instant case, a supermajority of stockholders was required to approve the business combination. The record is silent, however, as to whether the directors were subject to a lock-up provision). It is expected that these omissions will be addressed at a future stage of the litigation.

authority discussed above (supra at 10-11), this pleading rebuts the presumption of the business judgment rule and shifts the burden to defendants to prove the entire fairness of the transaction to the trier of fact.

The court reaches a different result as to CRC's claim that the duty of loyalty was also breached based on the directors' lack of independence. As to the latter claim,² CRC adequately pleads that defendant Rosenwald was an interested director. In particular, it alleges that in the event of a liquidation, Rosenwald's personal investment of over \$6 million in Paramount stock and warrants would have been rendered worthless, and he would also have faced personal liability for over \$1.6 million in potential claims against Paramount. (FAC, ¶¶ 4 [a], 31-32.) CRC fails, however, to plead facts which, if proved, would establish that at least three of the other directors, and thus a majority of Paramount's board, were controlled by Rosenwald. (See FAC, ¶¶ 23-24.)

A lack of independence is pleaded when a plaintiff alleges facts which, if proved, would establish that the directors are "beholden to the controlling person or so under their influence that their discretion would be sterilized." (Orman, 794 A2d at 24.)

"A director can be controlled by another if in fact he is dominated by that other party, whether through close personal or familial relationship or through force of will. A director can also be controlled by another if the challenged director is beholden to the allegedly controlling entity. A director may be considered beholden to (and thus controlled by) another when the allegedly controlling entity has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively."

² (See generally Orman, 794 A2d at 25 n 50 ["Interest and independence are two separate and distinct issues . . ."].)

(Id. at 25 n 50 [emphasis in original].)

CRC alleges that defendant Lobell was the President and CEO of both Paramount BioSciences, the parent entity of the Paramount family of companies, and of Paramount BioCapital Asset Management (FAC, ¶¶ 21, 23); was a registered representative of Paramount BioCapital Inc. (FAC, ¶ 23); and was appointed by Paramount to serve as one of four directors of the Company after the merger – a position he held until January 12, 2010. (FAC, ¶¶ 4 [a].)

Defendant Lobell's appointment by Paramount to serve on its post-LBO Transaction board is not, without more, a disqualifying interest. (Orman, 794 A2d at 28-29; Krim v ProNet, Inc., 744 A2d at 528 n 16.) Even assuming arguendo that Lobell might be considered to have been beholden to Rosenwald as a result of his executive positions with Paramount's parent company, there are insufficient particularized factual allegations to support the claim that any of the four remaining directors was beholden to Rosenwald. Indeed, CRC makes no claim that defendants Kier and Belldgrun were beholden to or controlled by Rosenwald. Defendant Maher was allegedly a senior managing director of Paramount BioCapital Asset Management and a registered representative of Paramount BioCapital Inc., but only until July 2007, a few months before the LBO Transaction closed. (FAC, ¶¶ 23, 24 n 1.) Defendant Weiser is alleged to have "previously" served as the Director of Research at Paramount BioCapital Inc. (Id., ¶ 23.) The fact that defendants Maher and Weiser previously worked for other companies in the Paramount corporate family does not raise a reasonable doubt that they could not exercise their independent business judgment as directors of Paramount. (See Crescent/Mach I Partners, 846 A2d at 980-981 [allegations of a "long-standing 15-year professional and personal relationship" between a director and the CEO of the company were not sufficient to support finding that the director was controlled by the CEO]; see also Zimmerman v Crothall, 2012 WL 707238, *13 [Del Ch, Mar.

27, 2012, C.A. No. 6001 (VCP)] [extensive shared work experience was not sufficient to show lack of independence].) The allegations of the First Amended Complaint as to Maher and Weiser's lack of independence from Rosenwald therefore fail as a matter of law.

In sum, the court holds that CRC pleads sufficient facts which, if proven, support its claim that defendants breached the duty of loyalty based on defendants' alleged self-interest in the LBO Transaction, as opposed to their lack of independence in approving the transaction.

Red Flags

The court turns to CRC's separate claim that defendants breached their fiduciary duties by ignoring red flags as to accounting and other improprieties in connection with the LBO Transaction. In opposing this claim, certain of the defendants first contend that a failure to investigate in the face of red flags implicates only the duty of care, and that the claim is barred because Paramount's articles of incorporation contain an exculpatory clause barring suit for breach of the duty of care. (Lobell/Rosenwald Memo. In Support at 15.)

Pursuant to the Delaware General Corporate Law, directors may not be sued for a mere breach of the duty of due care if the corporation has adopted an exculpatory provision. (8 Del C § 102 [b] [7].) Paramount's Certificate of Incorporation exculpates the directors from liability for ordinary negligence, as it provides, in pertinent part: "A director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for any breach of the director's duty of loyalty . . . , [and] (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. . . ." (Engel Aff., Ex. D at 4.) Although defendants therefore cannot be sued for mere negligence in ignoring the alleged red flags, CRC alleges that they "willfully ignored" and "closed their eyes" to red flags that were apparent from the face of the Proxy

Statement and other transaction documents, and that their failure to investigate in response to the red flags amounts to “gross negligence” and “intentional dereliction of their fiduciary duties.” (FAC, ¶¶ 4, 48, 91.) CRC also alleges that defendants hastily approved the LBO transaction after a meeting of less than two-hours. (Id., ¶ 45.)

There is substantial authority that a duty of loyalty claim may be premised on willful disregard of red flags, whereas a duty of care claim may be premised on gross negligence in failing to heed red flags where the certificate of incorporation exculpates the directors from ordinary negligence. Ash v. McCall (2000 WL 1370341, * 9-11 [Del Ch, Sept. 15, 2000, C.A. No. 17132 (VCC)]), on which defendants rely, does not support their contention that red flags are relevant only to a duty of care claim. In that case, the plaintiffs alleged that “the directors missed several ‘red flags’ that should have alerted them to the accounting problems, in the course of full-scale due diligence, before they approved the merger.” (Id., * 8.) Based on the pleaded allegations, the court concluded that “plaintiffs’ claims sound in negligence, at most.” (Id. * 9.)

The Delaware Courts have, however, repeatedly held that “directorial liability” may be predicated on the duty of oversight where the failure to exercise oversight rises to the level of failure to act in good faith. Such failure in turn may be found “where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” (Stone, 911 A2d at 369 [internal quotation marks omitted] [quoting In Re Walt Disney Co. Deriv. Litig., 906 A2d at 67.] The failure to act in good faith is “a subsidiary element” or “condition” of the duty of loyalty. (Stone, 911 A2d at 369-370.) Generally, “only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability.” (Id. at 369 [internal quotation marks omitted] [quoting In re Caremark Intl. Inc. Deriv. Litig., 698 A2d 959, 971 [Del Ch 1996]; Rattner v Bidzos, 2003 WL

22284323, * 12 [Del Ch, Oct. 7, 2003 C.A. No. 19700 (VCN)] [in typical Caremark case asserting claim against directors for failure to exercise proper oversight, the plaintiff must demonstrate that the directors were grossly negligent); Canadian Commercial Workers Indus. Pension Plan v Alden, 2006 WL 456786, * 6 [Del Ch, Feb. 22, 2006, C.A. 1184-N (VCP)] [“The duty of oversight implicates both the duty of care and the duty of loyalty”]; Buckley v O’Hanlon, 2007 WL 956947, * 5 [US Dist Ct D Del, Mar. 28, 2007] [holding under Delaware law that officers and directors may not “consciously disregard visible ‘red flags’” regarding accounting irregularities].)

In its brief in opposition to the motion to dismiss, CRC argued that the red flags support its claims for breach of both the duty of loyalty and the duty of care. (P.’s Memo. In Opp. at 15, 19.) At the oral argument, CRC appeared to concede that the red flags were relevant only to the duty of care. (OA Tr. at 39-40, 42-43.) The court need not determine the impact of CRC’s statements at the oral argument, as the court finds that the First Amended Complaint pleads grossly negligent disregard of the asserted red flags, as well as intentional or conscious disregard.

The court rejects defendants’ contention that CRC fails to allege any facts demonstrating that defendants knew or should have known that Chem Rx was inflating revenue figures in its audited financial statements. This is not a case in which the complaint fails to plead any facts showing that the directors knew of the alleged red flags. Rather, the First Amended Complaint pleads that the red flags were “visible from the face of key transaction documents,” including the Proxy Statement, Stock Purchase Agreement, and Funds Flow Memorandum. (FAC, ¶ 4.) Indeed, defendants acknowledge that all of the red flags were disclosed. (OA Tr. at 54.) CRC’s allegations are sufficiently specific to plead defendants’ notice and disregard of the red flags.

Defendants further contend that none of the alleged red flags was “suspicious.” (Lobell/Rosenwald Memo. In Support at 20.) As discussed further below, this claim cannot be determined as a matter of law on the face of the pleadings which, on this motion to dismiss, must be given the benefit of every favorable inference.

The first alleged red flag concerns the resignation of Chem Rx’s independent auditor, M&K, and its replacement. CRC alleges that M&K abruptly resigned on the eve of the LBO Transaction to become Chem Rx’s financial consultant, and that M&K was awarded an exorbitant \$4.63 million advisory fee upon consummation of the LBO Transaction, as opposed to the mere \$50,000 auditor’s fee that M&K would have earned if it had completed Chem Rx’s 2006 audit. As a last minute replacement, Chem Rx selected KGS LLP, a small, unsophisticated firm with no experience in public LBO transactions. (FAC, ¶¶ 3 [a], 49-52, 53-56.) CRC alleges that M&K’s resignation before signing off on the 2006 audit should have put defendants on notice that the Silvas “paid off M&K to whitewash” financial problems so that the LBO Transaction would close. (*Id.*, ¶ 52.) It further alleges that due to time pressures regarding the LBO transaction, this new firm completed the audit relying on “work conducted by the hopelessly-conflicted M&K.” (*Id.*, ¶ 42 n 5.)

A financial advisor’s receipt of a contingent fee, without more, does not support an inference that its work was “so flawed that the [] directors could not have relied upon it in good faith.” (*In re Alloy, Inc. Shareholder Litig.*, 2011 WL 4863716, * 11 [Del Ch, Oct. 13, 2011, C.A. No. 5626 [VCP].) Here, however, the First Amended Complaint alleges that M&K’s fee was exorbitant or excessive. (FAC, ¶ 51; *see In re Alloy, Inc.*, 2011 WL 4863716, at * 11; *Crescent/Mach I*, 846 A2d at 984.) Moreover, although the First Amended Complaint does not plead facts to support the claim that the Silvas “paid off” M&K to whitewash problems so that

the LBO Transaction would close, it pleads allegations as to the abruptness of M&K's resignation as Chem Rx's independent auditor in the midst of merger negotiations between Paramount and Chem Rx; M&K's conflict as Chem Rx's financial advisor, and the grossly disproportionate amount of its success fee as advisor in relation to the fee it would have earned if it had continued as Chem Rx's auditor; the importance of the 2006 audit to the directors' consideration of the pending LBO Transaction; and the fact that, due to time pressures, M&K's replacement auditor relied on M&K's work in completing the 2006 audit.² These allegations are sufficient – albeit, marginally so – to plead a red flag as to M&K's switch of roles and the trustworthiness of Chem Rx's financial statements.

The second alleged red flag was a pre-LBO payment to one of the Company's largest suppliers and trade creditors, AmeriSource Bergen (ASB). CRC alleges that due to concern about the enormous debt being loaded onto the Company, ASB demanded that the Company post \$8.5 million in security (later increased to \$11 million), and threatened to sever its relationship with the Company unless the security was posted. (*Id.*, FAC, ¶¶ 3 [c], 58.) According to CRC, in order to ensure that the LBO Transaction went forward and to avoid disclosing ASB's request to other creditors, the Silvas agreed, in separate side deals with ASB, to pay the requested security out of their personal funds. (*Id.*, ¶ 60.) CRC suggests that the security was paid by Paramount, alleging that, "[c]oincidentally," Steven Silva was awarded an \$11 million payment for his role in facilitating the LBO Transaction. (*Id.*, ¶ 61 n 9.) These allegations are – again marginally, sufficient to plead a red flag. Contrary to defendants' contention, moreover, the First

² It appears that M&K was also the independent auditor for Paramount. (*See* Proxy Statement at 116; Engel Aff., Ex. E at 54.)

Amended Complaint pleads defendants' notice of the transaction based on the inclusion of Paramount representatives, including Lobell, on emails regarding the negotiations with ASB. (*Id.*, ¶ 61.)

Another asserted red flag was that the "Intermediaries" – two financial firms that had proposed the LBO Transaction – backed out of the deal by April 6, 2007 "because of issues surrounding Chem Rx's management." (FAC, ¶ 43.) Defendants assert that the Intermediaries withdrew "because they could not agree on their management role in the post-merger company." (Lobell/Rosenwald Reply Memo. at 11.) However, the Proxy Statement, on which defendants rely for this assertion, recites only that the Intermediaries withdrew "because the Intermediaries and Chem Rx were unable to resolve issues surrounding the ongoing management of Chem Rx's business." (Proxy Statement at 51.) On this record, the court cannot credit defendants' claim that the Intermediaries' withdrawal did not involve, and serve to alert defendants to, potential problems with the Silvas' management of Chem Rx.

A final asserted red flag was that a number of Paramount stockholders obtained over \$30 million in put options in exchange for their agreement to approve the LBO Transaction, which they had threatened to block. (FAC, ¶¶ 3 [d], 99.) Defendants argue that the granting of the put options was not a red flag because it was the Silvas who agreed to the put options and who therefore had "an even greater financial incentive to maintain the company's performance." (Lobell/Rosenwald Memo. In Support at 22.) Plaintiff counters that Paramount or the third-party lender was the source of the funds for the put options. Again, this issue cannot be determined as a matter of law, as the evidence in the record is equivocal as to whether the source of the funds for the put escrow account was Paramount or its lender for LBO Transaction, as opposed to the Silvas themselves. (*See Funds Flow Memorandum, Kleinman Aff., Ex. 8.*)

In concluding that CRC alleges sufficient facts to plead a claim for breach of the duty of loyalty or a claim for breach of the duty of due care based on red flags, the court rejects defendants' argument that that CRC's claims are "foreclose[d]" by the fact that the third-party lenders that are the intended beneficiaries of this lawsuit engaged in the same due diligence as the directors, and agreed to loan more than \$160 million to Chem Rx in connection with the LBO Transaction. (Lobell/Rosenwald Memo. In Support at 22-23.) The willingness of Paramount's lenders to make this loan in the face of the alleged red flags, which were concededly publicly disclosed, will undoubtedly be relied upon by defendants in support of their defense that the alleged red flags were not in fact suspicious. However, the record lacks any evidence as to the lenders' due diligence or their assessment of the significance of the red flags, and the court cannot appropriately make findings on this record on these issues.

Nor are defendants entitled to dismissal of this action based on their claim that CRC admitted in pleadings that it filed in actions against the Silvas and M&K that the director defendants were victimized by an undetectable fraud perpetrated by Chem Rx and its auditors. In support of this claim, defendants cite the following allegations by CRC: "The Company's true financial condition was not known to the non-Silva participants in the LBO Transactions, and the Silvas used their positions within the Company to make sure that was the case." (Second Amended Complaint, CRC Litigation Trust v Silva, No. 11-CV-3005 [SD NY filed May 4, 2012], ¶ 5, Engel Aff., Ex. B.) "The Company relied on the accuracy of the financial statements in closing the LBO." (Complaint, CRC Litigation Trust v Marcum LLP et al., Index No. 600881/12 [Sup Court, Nassau County filed May 9, 2012], ¶ 56, Engel Aff., Ex. C.)

On a motion pursuant to CPLR 3211 (a) (1), the court may consider these allegations as constituting "informal judicial admissions" of CRC. (See Morgenthau & Latham v Bank of

N.Y. Co., 305 AD2d 74, 78-80 [1st Dept 2003], lv denied 100 NY2d 512.) Informal judicial admissions are “facts incidentally admitted during the trial or in some other judicial proceeding” and, although not conclusive, are “evidence” of the facts admitted. (Matter of Union Indem. Ins. Co., 89 NY2d 94, 103 [1996] [internal quotation marks and citations omitted]; GJF Constr., Inc. v Sirius Am. Ins. Co., 89 AD3d 622, 626 [1st Dept 2011] [Catterson, J.P. and Richter, J., concurring].)

CRC’s two allegations, while evidence of defendants’ lack of knowledge of the unreliability of Chem Rx’s financial statements, are not conclusive of CRC’s claims in this lawsuit. As stated earlier, CRC’s red flag claims are based not on defendants’ actual knowledge of the Silvas’ accounting fraud or even negligence, but rather on their intentional or conscious disregard of, or gross negligence in failing to investigate, the alleged red flags.

The court is also not persuaded that CRC’s breach of fiduciary duty claims are barred by the Company’s agreement to indemnify the defendants. Delaware law permits a corporation to indemnify a director against lawsuits “by or in the right of the corporation” so long as “the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.” (8 Del Code § 145 [b].) If the director is ultimately found liable to the corporation, however, indemnification is generally not permitted. (Id.) This action is premised on CRC’s claim that Paramount’s directors did not act in good faith and in the best interests of Paramount in approving the LBO Transaction – a claim which, if proved, would preclude any claim by the directors for indemnification.

Aiding and Abetting Causes of Action

CRC's second cause of action is based is based, in part, on the allegation that defendants aided and abetted "one another's" breaches of fiduciary duty. (FAC, ¶ 100.) To this extent, the aiding and abetting claim is duplicative of the first cause of action.

The second cause of action also alleges that defendants "knowingly participated in or induced the Silva's breaches of fiduciary duty by encouraging them to cause the approval of the LBO Transaction" (FAC, ¶ 102.) More specifically, CRC alleges that "Defendants knew or should have known of the Silva's collusion with M&K and their collusion with AmeriSource Bergen." (*Id.*) Prior to the closing of the LBO Transaction, however, the Silvas indisputably had no fiduciary duty to Paramount. Regardless of whether Delaware or New York law applies to the aiding and abetting claims – a subject of dispute between the parties – CRC also pleads no facts that would support the critical element of "knowing participation" in the breach – an element of an aiding and abetting claim under both Delaware and New York law. (*In re Transkaryotic Therapies, Inc.*, 954 A2d 346, 370 [Del Ch 2008]; *Kaufman v Cohen*, 307 AD2d 113, 125 [1st Dep't 2003].)³ In particular, CRC does not plead facts supporting the assertion that defendants encouraged the Silvas to cause the approval of the LBO Transaction. The second cause of action will therefore be dismissed for failure to state a claim.

The third and fourth causes of action are asserted solely against defendant Lobell, in his capacity as a post-merger director of Chem RX, for allegedly aiding and abetting the Silvas' fiduciary breaches.⁵ CRC pleads that Lobell permitted the Silvas to block any sale of the

³ Delaware law also expressly provides that the defendant in an aiding and abetting claim must not be a fiduciary. (*In re Transkaryotic Therapies, Inc.*, 954 A2d at 370.)

⁵ While CRC alleges that Lobell served as one of four members of the Company's board (see FAC ¶ 4 [a]), according to the Proxy Statement, the Company's board was to consist of between seven and nine individuals. (Proxy Statement at 88, 147-148.)

Company that did not include the repayment of the Silvas' subordinated debt and the \$11 million cash deposit that they allegedly posted with ASB. (FAC, ¶¶ 80, 106.) This conduct allegedly made any deal to save the Company impossible, and ultimately forced the Company to file for bankruptcy in May 2010. (Id.) CRC also alleges that Lobell permitted the Silvas to waste millions of dollars of Company assets through charitable gifts in 2008 and 2009. (Id., ¶¶ 81, 82, 107.)

In seeking recovery against Lobell, CRC in effect contends that, in his capacity as a member of the Company's board of directors, he failed to actively monitor corporate performance. This theory of recovery, a "Caremark claim," "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." (In re Caremark Intl. Inc., 698 A2d at 967.) Director liability for breach of a duty to exercise appropriate oversight "may, in theory, arise in two distinct contexts": (1) where a board decision that was "ill advised or 'negligent'" resulted in a corporate loss; and (2) where there was an "unconsidered failure of the board to act," in circumstances in which due attention would have prevented the loss. (Id. [emphasis omitted].) In the latter situation, "only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability." (Id. at 971.)

CRC's allegations against defendant Lobell do not support a claim that he breached a fiduciary duty to the Company. CRC does not plead any facts suggesting that a viable buyer for Chem Rx was ever identified to Lobell or the rest of the Company's board, or describing how or why he "permitted" the Silvas to block the sale of the Company. Nor does CRC allege that the charitable donations were ever disclosed to Lobell or subject to his approval, or that they were

unlawful in any manner. The third and fourth causes of action are dismissed for failure to state a claim.

In Pari Delicto

In their reply, defendants acknowledge that they did not move to dismiss this action based on the in pari delicto doctrine. However, they invite the court to consider such a dismissal based on a decision in another CRC action which dismissed CRC's claim against M&K on this ground. (See Lobell/Rosenwald Reply Memo. at 15 n 4; CRC Litig. Trust v Marcum LLP, Sup Ct, Nassau County, June 10, 2013, Driscoll, J., Index No. 600881/12.) It is not apparent to this court that the doctrine is applicable on the facts alleged. In any event, consideration of an in pari delicto defense is not appropriate at this juncture.

It is accordingly hereby ORDERED that defendants' motions to dismiss the First Amended Complaint are granted to the extent of dismissing the second, third and fourth causes of action; and it is further

ORDERED that defendants shall serve and file an answer to the First Amended Complaint within twenty (20) days of service of a copy of this order with notice of entry.

Dated: New York, New York
June 19, 2015


MARCY S. FRIEDMAN, J.S.C.