Madison Sullivan Partners LLC v PMG Sullivan St. LLC
2018 NY Slip Op 30047(U)
January 11, 2018
Supreme Court, New York County
Docket Number: 650930/2017
Judge: Shirley Werner Kornreich

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 54

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MADISON SULLIVAN PARTNERS LLC, on behalf of Itself and derivatively on behalf of PMG-MADISON SULLIVAN DEVELOPMENT LLC, PMG-MADISON DEVELOPER LLC, SULLIVAN MEMBER LLC, and SULLIVAN CONDO LLC,

Plaintiffs,

-against-

PMG SULLIVAN STREET LLC, KM SULLIVAN LLC, PMG SULLIVAN CONSTRUCTION LLC, and KEVIN MALONEY,

Defendants,

-and-

PMG-MADISON SULLIVAN DEVELOPMENT LLC, PMG-MADISON DEVELOPER LLC, SULLIVAN MEMBER LLC, and SULLIVAN CONDO LLC,

Nominal Defendants.

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Index No.: 650930/2017

DECISION & ORDER

SHIRLEY WERNER KORNREICH, J.:

Defendants PMG Sullivan Street LLC (PMG), KM Sullivan LLC (KMS), PMG Sullivan Construction LLC (Construction), and Kevin Maloney, along with nominal defendants PMG-Madison Sullivan Development LLC (Development), PMG-Madison Developer LLC (Developer), Sullivan Member LLC (Member), and Sullivan Condo LLC (Condo), move, pursuant to CPLR 3211, to dismiss the amended complaint (the AC). Plaintiff Madison Sullivan Partners LLC (Madison) opposes the motion. For the reasons that follow, defendants' motion is granted.

I. Factual Background & Procedural History

As this is a motion to dismiss, the facts recited are from the documentary evidence submitted by the parties and the AC (Dkt. 100).[1]

This action concerns a joint venture between Madison and PMG to develop property located at 10 Sullivan Street in Manhattan (the Property). The joint venture was structured using the parties' membership interests in various LLCs. That said, the undisputed economic reality of the parties' investment is that Madison and PMG each had a 50% stake in the Project's profits. In this action, Madison claims that PMG – who was responsible for the construction – did a shoddy job that caused delays and resulted in the Project generating $30 million less profit than expected (e.g., through added interest expenses owed to the lender due to the extra time needed to repay the Project's debt).

Madison's claims are governed by the parties' operating agreements, which contain classic exculpatory clauses for alleged malfeasance that amounts to mere negligence (as opposed, for instance, to gross negligence or intentional misconduct). These exculpatory clauses bar all of Madison's claims for monetary damages. As discussed herein, Madison's factual allegations and the documentary evidence refute Madison's theory of the case – that PMG had an incentive to cause delay to generate more fees. No such excess fees were obtained. In fact, the scheme posited by Madison would reduce PMG's own profit – the amount of which was identical to Madison's share. The obvious alignment of the parties' incentives, along with the clear documentary evidence, leaves Madison with nothing other than allegations of ordinary construction negligence. While such allegations might normally state a claim on which relief could be granted, the governing operating agreements' exculpatory clause mandates dismissal.

[1] References to "Dkt." followed by a number refer to documents filed in this action on the New York State Courts Electronic Filing system (NYSCEF).

The parties, with the exception of Construction (a New York LLC) and Maloney (a natural person and PMG's principal), are Delaware LLCs. "In 2012, Madison entered into a real estate joint venture with PMG to acquire and develop [the Property]. The purpose of the joint venture was to [complete the Project, which entailed replacing] a car wash and gas station at the intersection of Sixth Avenue and Sullivan Street and to develop a new 16-story flat-iron shaped residential building, with 22 condominium apartments, four adjoining 25 foot-wide townhouses, amenities, ground floor retail and a parking garage." AC ¶ 17. "To facilitate the joint venture, Madison and PMG formed [Development and Developer]." ¶ 22. Both of these Delaware LLCs are governed by operating agreements, respectively dated as of June 15, 2012 and June 14, 2013. *See* Dkt. 111 (the Development Agreement) & Dkt. 114 (the Developer Agreement) (collectively, the Operating Agreements).[2] The purpose of these LLCs is set forth in section 1.6 of the Operating Agreements. Development's role was to invest in, develop, and obtain financing for the Project. *See id.* at 8; *see also* AC ¶ 22 n.2 (Development "was formed to effectuate the acquisition of the Property from a prior venture owned and controlled by Madison and an institutional investor."). Development owns a 75% membership interest in Member and serves as its managing member.[3] *See* Dkt. 111 at 8. Member is the sole member of Condo. Condo holds title to the Property. Madison and PMG each own a 50% membership interest in Development, which means they each effectively own half of a 75% interest in the Property. *See id.* at 22. Developer, in which Madison and PMC each own 50% membership interests, "was formed to effectuate the development of the Project." AC ¶ 22 n.3; *see* Dkt. 114 at 5-6, 20.

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[2] The amendments to the Operating Agreements that are in the record did not alter the relevant contractual provisions.

[3] The other 25% member of Member is non-party Atlantic Investors LLC, which was the Project's lender.

Madison and PMG are co-managing members of both Development and Developer. *See* Dkt. 114 at 7. In accordance with section 2.1(b)(ii) of the Operating Agreements, Madison was in charge of tasks such as design, sales, and marketing, while PMG was in charge of construction. *See* Dkt. 114 at 7-8.[4] Section 2.3 provides:

> A Member exercising management powers or responsibilities for or on behalf of the Company **shall not have personal liability to the Company or its members for damages for any breach of duty in such capacity**, provided that nothing in this Section 2.3 shall eliminate or limit (a) the liability of any such Member if a judgment or other final adjudication adverse to him or her establishes that his or her **acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law, or that he or she acted without the unanimous consent of all Members, or that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled** ... .

Dkt. 114. at 9 (emphasis added). In other words, for Madison to hold PMG liable for acts related to PMG's construction responsibilities, Madison must establish that PMG either: (1) acted in bad faith; (2) engaged in intentional misconduct or intentionally broke the law; or (3) engaged in an ultra vires act (i.e. an act that required Madison's consent under the Operating Agreement).

PMG's construction work was performed by its wholly owned affiliate, Construction, and is governed by a Construction Management Agreement, dated March 13, 2014, between Construction and Condo (the CMA). *See* Dkt. 123. Madison's claims for breach of the CMA can only be asserted as a triple derivative claim on behalf of Condo by way of Madison's interest in Member and Development.[5]

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[4] Section 2.1(b)(iv) provides a dispute resolution mechanism that Madison and PMG were to follow if they had disagreements (this section, indisputably, was never invoked during the course of the Project). *See id.* at 8.

[5] *See Sagarra Inversiones, S.L. v Cementos Portland Valderrivas, S.A.*, 34 A3d 1074, 1078 (Del 2011). Such a claim, which is viable under Delaware law [*see id.* at 1079 n.7], is similar to the more commonly asserted double derivative claim, where "a derivative action [is] maintained by the shareholders of a parent corporation or holding company on behalf of a subsidiary company." *Sternberg v O'Neil*, 550 A2d 1105, 1107 n.1 (Del 1988); *see Pokoik v 575 Realties, Inc.*, 143

Article 2 of the CMA sets forth Construction's responsibilities. *See id.* at 1-4. Madison claims that "Construction exhibited bad faith, intentional misconduct, and gross mismanagement throughout the duration of the Project in breach of the [CMA]." AC ¶ 48. Allegedly, "Construction ignored each of its contractual requirements at the Project by failing to adhere to the Project budget, failing to coordinate trades and consultants at the Project, causing significant delays at the Project, and failing to adhere to the Project schedule." *Id.* Specifically, Construction allegedly "refused to comply with its notice obligations ... by failing to provide Madison with ... updated budgets, updated schedules, and monthly cost projections or forecasts," "failed to notify [Madison] of infractions at the Project," "failed to maintain sufficient personnel and staffing at the Project," "diverted personnel and resources to his other projects to the detriment of the Project," and did not "cause the Work to be performed consistent with all applicable laws," the latter of which resulted in "stop work orders causing over 350 days of delays at the Project." ¶¶ 49-53. Supposedly, Construction did this because the longer the Project took to complete, the greater the "financial windfall" for Construction and Maloney's other companies. *See* AC ¶ 54. However, as Madison itself appears to recognize, and as the documentary evidence establishes, such a theory of scienter is not plausible since Construction was only contractually entitled to and only received reimbursement of its out-of-pocket costs.[6]

AD3d 487, 489 (1st Dept 2016) ("where the parent controls the subsidiary, a shareholder may bring a 'double' derivative action not only for wrongs inflicted directly on the corporation in which he holds stock, but for wrongs done to that corporation's subsidiaries which make indirect, but nonetheless real, impact upon the parent corporation and its stockholders.") (citation and quotation marks omitted). While, as discussed herein, Madison's derivative claims are governed by Delaware law, it should be noted that the First Department appears to recognize the viability of triple derivative actions. *See Kaufman v Wolfson*, 1 AD2d 555, 558 (1st Dept 1956).

[6] Except for one $10,000 payment that, in any event, was never paid (and is miniscule relative to the tens of millions of dollars in controversy, i.e., it could not have plausibly altered PMG's incentives). *See* Dkt. 106 at 11.

See id. Then too, Maloney, through his indirect ownership interest in the Project, like Madison, would have lost profits were the Project delayed.

The AC sets forth a litany of alleged breaches of the CMA, described in conclusory fashion as a product of "bad faith, intentional misconduct, and gross mismanagement" due to defendants' "act[ing] in a self-serving manner by advancing their own interests in attending to his personal ventures at the expense of the [Project]." *See* AC ¶¶ 57-58. As discussed herein, to the extent the documentary evidence does not utterly refute these allegations, at most, defendants' alleged malfeasance amounts to ordinary negligence for which they are exculpated under section 2.3 of the Operating Agreements. Indeed, at no point until the commencement of this action did Madison formally complain (under section Section 2.1(b)(iv) or otherwise). Nor did the lender, who had oversight rights and an interest in completing the Project in an efficient, cost-effective manner, complain about these purported problems.

After the work was substantially completed, there were three remaining unsold units at the Project (the profit from the others was properly split between the parties). "In November 2016, the parties agreed in principal to split the unsold units." AC ¶ 136. "Madison was entitled to the sale proceeds of Unit PH[,] and PMG was entitled to the sale proceeds of Unit TH1 and Unit 15A." *Id.* This agreement was memorialized in a January 11, 2017 amendment to the Development Agreement. *See* Dkt. 113 (the Amendment).[7] Section 7 of the Amendment

[7] Defendants refer to the Amendment as a "Separation Agreement" despite that nomenclature not being found in the Amendment. It does not contain a release of Madison's claims.

provides that in an action for breach of the Development Agreement or the Amendment, the prevailing party in such action shall be entitled to its reasonable attorneys' fees. *See id.* at 7.[8]

On February 22, 2017, Madison commenced this action by filing its original complaint. *See* Dkt. 1. On March 20, 2017, after Madison had sold Unit PH, it moved by order to show cause for an attachment of the sale proceeds of the unit PMG was to sell in accordance with the Amendment. The court denied that motion by order dated April 26, 2017. *See* Dkt. 96. While the court formally ruled on statutory grounds, the court identified serious deficiencies in the complaint, most notably the conclusory nature of its allegations and remarked that Madison could not demonstrate a likelihood of success on the merits, let alone standing to prosecute its derivative claims. *See* Dkt. 94 (4/26/17 Tr. at 18). This impelled Madison to amend its complaint.

On May 10, 2017, Madison filed the AC, which asserts the following direct and derivative causes of action (though they are not so labeled): (1) breach of fiduciary duty against all defendants; (2) aiding and abetting breach of fiduciary duty against Maloney (PMG's principal) and KMS (PMG's managing member); (3) aiding and abetting breach of fiduciary duty against Maloney, KMS, and Construction; (4) breach of contract (the Operating Agreements) against PMG, KMS, and Maloney;[9] (5) breach of contract (the CMA) against Construction; and (6) an equitable accounting, asserted against all defendants. *See* Dkt. 100.

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[8] Since the court is dismissing the AC with prejudice, defendants are the prevailing parties. Hence, in the ordering language below, the court refers a hearing on their reasonable attorneys' fees to a Special Referee.

[9] Madison now concedes that it should not have named non-contracting parties KMS and Maloney on this cause of action. Absent a valid basis to impose liability on a non-contracting party (e.g., veil piercing), it is frivolous to assert a breach of contract claim absent privity.

Defendants filed the instant motion to dismiss on May 31, 2017. They principally argue that the Operating Agreements' exculpatory clause (section 2.3) mandates dismissal because the failure to plead malfeasance within the scope of such clause is a failure to state a claim upon which relief may be granted and, likewise, defeats Madison's claim of demand futility on its derivative claims (i.e., allegations of mere negligence in the face of the exculpatory clauses means that the substantial likelihood of liability test is not satisfied). The court reserved on the motion after oral argument. *See* Dkt. 148 (10/11/17 Tr.).

II. Discussion

On a motion to dismiss, the court must accept as true the facts alleged in the complaint as well as all reasonable inferences that may be gleaned from those facts. *Amaro v Gani Realty Corp.*, 60 AD3d 491 (1st Dept 2009); *Skillgames, LLC v Brody*, 1 AD3d 247, 250 (1st Dept 2003), citing *McGill v Parker*, 179 AD2d 98, 105 (1st Dept 1992); *see also Cron v Hargro Fabrics, Inc.*, 91 NY2d 362, 366 (1998). The court is not permitted to assess the merits of the complaint or any of its factual allegations, but may only determine if, assuming the truth of the facts alleged and the inferences that can be drawn from them, the complaint states the elements of a legally cognizable cause of action. *Skillgames*, *id.*, citing *Guggenheimer v Ginzburg*, 43 NY2d 268, 275 (1977). Deficiencies in the complaint may be remedied by affidavits submitted by the plaintiff. *Amaro*, 60 NY3d at 491. "However, factual allegations that do not state a viable cause of action, that consist of bare legal conclusions, or that are inherently incredible or clearly contradicted by documentary evidence are not entitled to such consideration." *Skillgames*, 1 AD3d at 250, citing *Caniglia v Chicago Tribune-New York News Syndicate*, 204 AD2d 233 (1st Dept 1994). Further, where the defendant seeks to dismiss the complaint based upon documentary evidence, the motion will succeed if "the documentary evidence utterly refutes

plaintiff's factual allegations, conclusively establishing a defense as a matter of law." *Goshen v Mutual Life Ins. Co. of N.Y.*, 98 NY2d 314, 326 (2002) (citation omitted); *Leon v Martinez*, 84 NY2d 83, 88 (1994).

As an initial matter, all of Madison's breach of fiduciary duty claims are derivative because the harm Madison suffered is the diminished profit on the Project (allegedly $30 million), which is a loss Madison realized by virtue of its membership interests in the nominal defendant LLCs. Under Delaware law, which must be applied here,[10] to determine whether a claim is direct or derivative, the court must focus on "the nature of the wrong and to whom the relief should go." *Tooley v Donaldson, Lufkin & Jenrette, Inc.*, 845 A2d 1031, 1033 (Del 2004). For a claim to be direct, "[t]he stockholder's claimed direct injury **must be independent of any alleged injury to the corporation**. The stockholder must demonstrate that the duty breached was owed to the stockholder **and that he or she can prevail without showing an injury to the corporation**." *Id.* (emphasis added). "Thus, under *Tooley*, a court should consider '(1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually).'" *Id.*; *see NAF Holdings, LLC v Li & Fung (Trading) Ltd.*, 118 A3d 175, 180 (Del 2015) ("important

[10] It is undisputed that Delaware law applies to all of Madison's claims that concern the internal affairs of the defendant LLCs (i.e., all of the claims for breach of the Operating Agreements and for breach of fiduciary duty). *See New Greenwich Lit. Trustee., LLC v Citco Fund Servs. (Europe) B.V.*, 145 AD3d 16, 22 (1st Dept 2016); *Lerner v Prince*, 119 AD3d 122, 128-29 (1st Dept 2014). While Construction is the sole defendant that is not a Delaware LLC, its internal affairs are not at issue. Consequently, New York's LLC laws do not apply. That said, the CMA is governed by New York law. *See* Dkt. 123 at 22. Therefore, New York law applies to the fifth cause of action for breach of the CMA (but not on the question of whether Madison has derivative standing to sue for breach of the CMA). It also should be noted that Madison's claims for breach of the Operating Agreements and for breach of fiduciary duty are duplicative because they concern the exact same subject matter and would give rise to duplicative relief. *See AM General Holdings LLC v Renco Group, Inc.*, 2013 WL 5863010, at *10 (Del Ch 2013), citing *Nemec v Shrader*, 991 A2d 1120, 1129 (Del 2010). Regardless, both claims are subject to the Operating Agreements' exculpatory clause and fail on the merits.

initial question has to be answered: does the plaintiff seek to bring a claim belonging to her personally or one belonging to the corporation itself?"); *see also Serino v Lipper*, 123 AD3d 34, 41 (1st Dept 2014) ("The lost value of an investment in a corporation is quintessentially a derivative claim by a shareholder.").

Moreover, just because it is necessary "to look to [an] entity's foundational agreement rather than to default principles of equity law for protection does not mean that every claim for breach of those foundational agreements is direct. Rather, to determine if a claim is derivative or direct requires the usual examination of who owns the claim." *El Paso Pipeline GP Co., v Brinckerhoff*, 152 A3d 1248, 1251 (Del 2016). Hence, that Madison's claims arise from its rights under the Operating Agreements does not make its claims direct. Rather, that Madison seeks recovery of the Project's lost profits renders its claims derivative. Additionally, as noted earlier, Madison's claims for breach of the CMA are necessarily derivative because it is not a party to that contract. It is suing triple derivatively on behalf of the LLCs in which it has an interest (i.e., Member and Development.).

Further, derivative claims belong to the company, and, consequently, stockholders lack standing to prosecute derivative claims absent demand or demand futility. *Ironworkers Dist. Council of Philadelphia & Vicinity Ret. & Pension Plan v Andreotti*, 2015 WL 2270673, at *25 (Del Ch 2015) (*Ironworkers*), *aff'd sub nom. Ironworkers Dist. Council of Philadelphia v Andreotti*, 132 A3d 748 (Del 2016). Ordinarily, where the court is faced with derivative claims on a motion to dismiss, as a threshold issue, the court will assess whether demand was made on the board or if the complaint adequately pleads demand futility. *See Shawe v Elting*, 2017 WL 2882221, at *12 (Sup Ct, NY County 2017) (Delaware law derivative claims); *Vasbinder v*

Hung, 2017 WL 2537054, at *7 (Sup Ct, NY County 2017) (New York law derivative claims).[11] Here, the threshold derivative standing inquiry turns on the same dispositive fact as the underlying merits – that all of Madison's allegations concerning PMG's construction work, at most, amount to negligence claims for which defendants are exculpated from liability under the Operating Agreements. Ergo, defendants' demand futility and failure to state a claim arguments are predicated on virtually identical inquiries.

To explain, the enforceability of a provision in an operating agreement, such as section 2.3, that disclaims a managing member's liability for ordinary negligence, is well settled under Delaware law. *See Capone v Castelton Commodities Int'l LLC*, 148 AD3d 506, 506 (1st Dept 2017) ("the relevant agreement contains a clear exculpatory provision that, standing alone, supports the motion court's dismissal of the claims alleged against defendants."), citing *Elf Atochem N. Am., Inc. v Jaffari*, 727 A2d 286, 291 (Del 1999), *accord* 6 *Del C* § 18-1101(e).[12] LLC members are free to disclaim most forms of liability, including breaches of fiduciary duty. *See Auriga Capital Corp. v Gatz Props.*, 40 A3d 839, 851 (Del Ch 2012), *aff'd* 59 A3d 1206 (Del 2012). And while certain types of liability cannot be disclaimed (e.g., the duty of good faith

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[11] Even where, as here, the action is commenced in a New York court, Delaware's demand futility pleading standard applies. *See Wandel v Dimon*, 135 AD3d 515, 516 (1st Dept 2016) ("The issue whether a pre-suit demand is required or excused is governed by the law of Delaware, the state of incorporation of [defendant].").

[12] 6 *Del C* § 18-1101(e) states that an LLC's operating agreement:

> may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

Wood v Baum, 953 A2d 136, 141 (Del 2008).

and fair dealing and gross negligence) [*see id.*], the negligence disclaimer in section 2.3 of the Operating Agreements is an example of a classic, enforceable exculpatory provision. Indeed, even under New York law applicable to construction contracts (such as the CMA), contractual negligence waivers are generally enforceable. *Colnaghi, U.S.A., Ltd. v Jewelers Protection Servs., Ltd.*, 81 NY2d 821, 823 (1993); *see Pacnet Network Ltd. v KDDI Corp.*, 78 AD3d 478, 480 (1st Dept 2010) ("Contractual limitation of liability provisions are generally enforceable unless the party seeking to avoid liability has engaged in grossly negligent conduct"). Hence, to state a claim against defendants for breach of their construction obligations, Madison must allege facts that amount to more than mere negligence.

Additionally, Madison is subject to a heightened pleading standard both in regard to the alleged breaches[13] and in regard to standing. *See Cent. Laborers' Pension Fund v Blankfein*, 111 AD3d 40, 45 (1st Dept 2013) ("plaintiffs have not taken issue with Supreme Court's determination that they failed to plead particularized facts that would have established the futility of demanding action by the board so as to excuse the demand prerequisite to a derivative suit under Delaware law."). Here, where Madison challenges the ability of its co-managing member to impartially decide whether to authorize the suit, the applicable standards are those set forth in *Rales v Blasband*, 634 A2d 927 (1993) and *Aronson v Lewis*, 473 A2d 805 (Del 1984). "To plead demand futility under *Rales*, the plaintiff must plead ***particularized factual allegations*** that 'create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding

[13] This would be true regardless of whether Madison's claims are derivative and even if the claims were governing by New York law. *See Parker Waichman LLP v Squier, Knapp & Dunn Commc'ns, Inc.*, 138 AD3d 570, 571 (1st Dept 2016) ("Dismissal of the cause of action alleging breach of fiduciary duty was also warranted since plaintiff failed to plead it with particularity, as required by CPLR 3016(b).").

to a demand." *Sandys v Pincus*, 152 A3d 124, 128 (Del 2016), quoting *Rales*, 634 A2d at 934 (emphasis added). "To successfully plead demand futility under [*Aronson*], a plaintiff must allege ***particularized facts*** sufficient to raise a reasonable doubt that (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. *Aronson* applies when the plaintiff challenges an action taken by the board that would consider demand." *Lenois v Lawal*, 2017 WL 5289611, at *9 (Del Ch 2017), quoting *Rales*, 634 A2d at 933-34 (emphasis added).[14]

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[14] While the parties quibble about whether *Rales* or the slightly different standard under *Aronson* applies, it should be noted that the "[t]he analyses in both *Rales* and *Aronson* drive at the same point; they seek to assess whether the individual directors of the board are capable of exercising their business judgment on behalf of the corporation." *Park Employees' & Ret. Bd. Employees' Annuity & Benefit Fund of Chicago v Smith*, 2017 WL 1382597, at *5 (Del Ch 2017). "The point of this inquiry is to assess whether plaintiff has 'create[d] a reasonable doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand,' had one been made." *Id.*, quoting *Rales*, 634 A2d at 934. That said, in *Wood*, the Supreme Court of Delaware explained:

> Two tests are available to determine whether demand is futile. The *Aronson* test applies to claims involving a contested transaction i.e., where it is alleged that the directors made a conscious business decision in breach of their fiduciary duties. That test requires that the plaintiff allege particularized facts creating a reason to doubt that "(1) the directors are disinterested and independent [or that] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." ... The [*Rales*] test applies where the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board's oversight duties. The Rales test requires that the plaintiff allege particularized facts establishing a reason to doubt that "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

Wood, 953 A2d at 140 (citations omitted). Here, the question of whether *Rales* or *Aronson* applies is academic by virtue of Madison's proffered basis for demand futility – PMG's lack of disinterestedness, thereby triggering the "substantial likelihood of personal liability" test discussed herein. It should be noted that while Madison's opposition brief challenges PMG's business judgment, Madison's discussion of business judgment frames the issue in the very manner that implicates the "substantial likelihood of personal liability" test issue. *See* Dkt. 146 at 21 ("PMG would face financial liability if it authorized an action against the other Defendants, and, therefore, there is reasonable doubt that PMG could exercise disinterested business

"At the pleading stage, a lack of independence turns on whether the plaintiffs have pled facts from which the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party." *Sandys*, 152 A3d at 128 (citation and quotation marks omitted). Where, as here, there allegedly is a 50-50 split, demand futility exists if the "board is evenly divided between compromised and non-compromised directors." *Frederick Hsu Living Tr. v ODN Holding Corp.*, 2017 WL 1437308, at *26 (Del Ch 2017), citing *Beneville v York*, 769 A2d 80, 82 (Del Ch 2000) ("an equally divided vote on a motion to bring suit has the same effect as a vote in which the motion is defeated by a one vote majority.").

Madison's demand futility allegations are premised on PMG's interestedness due to its allegedly wrongful conduct. Madison avers that PMG faces "personal consequences from the outcome of the litigation." *See Beam v Stewart*, 845 A2d 1040, 1049 (Del 2004). Madison, therefore, must allege particularized facts indicating that PMG's actions exposes it to a "**substantial likelihood** of personal liability." *In re Qualcomm Inc. FCPA Stockholder Deriv. Lit.*, 2017 WL 2608723, at *2 (Del Ch 2017) (emphasis added). As one Vice Chancellor recently explained, this is no easy task when a defendant, such as PMG, is cloaked with the protections of an exculpatory clause:

> As the Supreme Court explained in *Aronson*, a "substantial likelihood of director liability" exists only "in rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment." Similarly, *Aronson* teaches that "the **mere threat** of personal liability for approving a

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judgment when responding to such a demand."). The allegations in the AC all concern activities within the purview of PMG's authority under the Operating Agreements. The issues raised are either negligence allegations (i.e., the sort of oversight claims that ordinarily implicate *Rales*) or the inability to impartially consider a demand (which implicates the "substantial likelihood of personal liability" test). Madison's self-dealing allegations, which also implicate *Aronson*, are limited to its conclusory claims of intentional delay to procure fees and do not raise the requisite reasonable doubt.

> questioned transaction, standing alone, is insufficient ..." in the absence of "egregious" or "rare cases." Additionally, **"[w]here directors are contractually or otherwise exculpated from liability for certain conduct, 'then a serious threat of liability may only be found to exist if the plaintiff pleads a non-exculpated claim against the directors based on particularized facts.**

Ryan v Armstrong, 2017 WL 2062902, at *15 (Del Ch 2017) (emphasis added; internal citations omitted). Thus, Madison must make "particularized allegations" that permit the conclusion that defendants face a "credible threat of the imposition of liability." *See id.* at *2;[15] *Wood*, 953 A2d at 140 (plaintiff "must comply with **stringent requirements of factual particularity.**"); *see also id.* at 141 n.11 (reiterating "substantial likelihood of personal liability" standard). Since PMG cannot be held liable for ordinary negligence, it would only face a credible threat of liability if Madison pleads a claim, pursuant to section 2.3, for bad faith, gross negligence, or intentional wrongdoing.

The upshot, as noted at the outset, is that the dispositive question on this motion to dismiss is whether Madison's allegations amount to mere negligence, or something more.[16]

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[15] Defendants' opposition brief appears to advocate for a lesser burden, relying on *Miller v Schreyer,* 200 AD2d 492, 494 (1st Dept 1994). Leaving aside the fact that Delaware (and not New York) law applies, the New York Court of Appeals expressly rejected the standard set forth by the Appellate Division in *Miller*. *See Marx v Akers*, 88 NY2d 189, 200 (1996). Hence, the mere fact that Madison asserts claims on which PMG might theoretically be held liable is not sufficient to establish demand futility under Delaware law. Such a "mere threat" of liability is not the threshold. *See Lenois*, 2017 WL 5289611, at *19 ("Without any substantial likelihood of liability, the Board retains the right to manage this litigation under the second prong of *Aronson*.").

[16] The line between ordinary and gross negligence is well settled. "'[G]ross negligence' differs in kind, not only degree, from claims of ordinary negligence. It is conduct that evinces a reckless disregard for the rights of others or 'smacks' of intentional wrongdoing." *Colnaghi,* 81 NY2d at 823-24, quoting *Sommer v Fed. Signal Corp.*, 79 NY2d 540, 554 (1992); *see Pegasus Aviation I, Inc. v Varig Logistica S.A.*, 118 AD3d 428, 433 (1st Dept 2014), citing *Hartford Ins. Co. v Holmes Protection Group*, 250 AD2d 526, 527 (1st Dept 1998) (same); *see also Brown v United Water Delaware, Inc.*, 3 A3d 272, 276 (Del 2010), citing *Browne v Robb*, 583 A2d 949, 953 (Del 1990) ("Gross negligence is a higher level of negligence representing 'an extreme departure from the ordinary standard of care.'") (citation omitted). Given this definition, and since the other

Absent something more (e.g., the bad faith, gross negligence, or intentional wrongdoing carveouts in section 2.3), Madison would have simultaneously failed to state a claim and would lack standing (i.e., for failure to allege that PMG faces a credible threat of the imposition of liability). Ergo, whether Madison pleaded a non-exculpated claim under section 2.3 is the dispositive inquiry.

The facts pleaded by Madison in the AC are no more than allegations of ordinary negligence. No intentional wrongdoing is alleged. First, Madison complains that "[d]uring the

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applicable carveouts in the exculpatory clause require intentional conduct, the relevant inquiry is whether Madison's allegations suggest intentional wrongdoing, as opposed to conduct that merely breaches a duty of "reasonable care." *See Pasternack v Lab. Corp. of Am. Holdings*, 27 NY3d 817, 825 (2016); *Elmaliach v Bank of China Ltd.*, 110 AD3d 192, 199 (1st Dept 2013). Indeed, though not addressed by the parties, there are Delaware cases that explain that the applicable pleading standard where there is an exculpatory clause requires the plaintiff to establish bad faith, gross negligence, or intentional wrongdoing. In *Lenois*, 2017 WL 5289611, the court explained:

> In order to raise a reason to doubt good faith, **the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests and was essentially inexplicable on any ground other than bad faith**. This requires a **pleading of particularized facts** that demonstrate that the directors acted with scienter; i.e., there was an intentional dereliction of duty or a conscious disregard for their responsibilities. This is a high burden, **requiring an extreme set of facts**. The most salient examples include (1) where the fiduciary intentionally breaks the law; (2) where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation; or (3) where the fiduciary intentionally fails to act in the face of a known duty to act. While aspirational goals of ideal corporate governance practices may be highly desirable, to the extent they go beyond the minimal legal requirements of the corporation law, they do not define standards of liability.

Id. at *10 (emphasis added; citations and quotation marks omitted). Simply put, where there is an applicable exculpatory provision (e.g., in corporate charter or operating agreement), "demand is excused as futile under the second prong of *Aronson* with a showing that a majority of the board **faces a substantial likelihood of liability for non-exculpated claims**." *Id.* at *14 (emphasis added); *see also id.* at *15-19 (discussing types of bad faith). Notwithstanding the parties' failure to address this Delaware law, at bottom, the issue is whether Madison has pleaded bad intent, as opposed to mere negligence.

course of the Project, the New York City Department of Buildings stopped work at the Project no less than 17 times, resulting in more than 350 days of full or partial work stoppages at the Project." AC ¶ 76. Madison claims that the violations committed by defendants breached "Article 2.01.1 of the [CMS], which required [Construction] to cause all work at the Project to be performed consistent with all applicable laws. ¶ 78; *see* ¶ 79 (listing stop work orders). Madison does not, however, explain why the stop work orders were the product of a willful intention to break the law or gross negligence, as opposed to the ordinary negligence found at a New York City construction site (e.g., someone overlooked a regulatory requirement). Madison focuses only on the frequency of the oversights to infer intent. It cites no authority under the applicable Delaware particularity standard that permits the court to infer willfulness merely based on the number of violations. Madison, in conclusory fashion, merely recites the words of the exculpatory clause. *See* AC ¶ 77.[17] Likewise, Madison complains that "[d]efendants failed to obtain the necessary licenses or permits prior to the point when the townhouse portion of the Project was ready to accept construction work and be completed." ¶ 80. Madison does not plead any facts suggesting this oversight was more than the product of negligence.

Next, Madison complains that, "in early 2014, [defendants] unilaterally decided to move the elevator locations to the middle of each townhouse," and that this resulted in delay when Madison informed defendants of logistical problems with such a design. *See* AC ¶¶ 85-87. Again, Madison does not plead any facts to suggest that defendants' proposed elevator location was the product of more than mere negligence. In fact, the documentary evidence establishes that Madison actually approved these design changes in 2014. *See* Dkt. 106 at 30.

[17] In this court's experience, large construction projects in Manhattan often are affected by stop work orders due to violations. Rarely does such a large project get completed without any delay. Madison posits no basis for the court not to assume, absent specific well-pleaded facts to the contrary, that the problems were caused by ordinary negligence.

Madison also complains about delays that allegedly resulted from its acquiescence to defendants' suggestion that the Project switch real estate brokers from Corcoran (a broker which employed the wife of Madison's principal) to Douglas Elliman, and such brokers' inability to market the residential units' great views because units on the higher floors had not been completed due to the construction delays. Neither allegation is supported with any facts to infer intentional misconduct. Madison appears to suggest that defendants should be held responsible for Douglas Elliman's alleged poor performance. While Madison plausibly contends that demand for the apartments would be hindered by the inability to be awed by the units' views, that result is simply the product of the overall construction delays for which, as discussed herein, Madison has failed to allege any facts demonstrating anything other than ordinary negligence.

Likewise, Madison alleges that defendants' staffing changes and allocation of personnel prolonged the construction work and resulted in problems. Once more, Madison does not plead any facts to support its argument that these staffing issues were the product of anything nefarious. At best, Madison has plausibly alleged that poor personnel management caused delays.[18] That is simply a claim of ordinary negligence. Madison's claim of self-dealing (the diversion of workers to other projects) are conclusory and implausible given the parties' equal stake in the Project.

Finally, Madison makes much of the fact that it belatedly was given a final budget that included costs in excess of what was original projected. However, the expenses in that budget, at best, were the product of delays caused by ordinary negligence, which cannot give rise to

[18] *See infra* n.21.

liability. That costs were greater than projected (a common phenomenon with construction) is not evidence of intentional wrongdoing.[19]

In the absence of any non-conclusory factual allegation that PMG engaged in conduct that smacks of intentional wrongdoing, the court cannot draw a plausible inference that PMG acted to benefit itself to Madison's detriment by intentionally causing delay to reap higher fees on the Project. PMG simply had no incentive to do so. Any added fees that it procured for itself (and, to be clear, PMG only was entitled to and only received at-cost reimbursement)[20] would have reduced its profit in an amount commensurate with Madison's stake. Hence, PMG did not profit from delay. As defendants explain:

> The theory of plaintiff's case is that PMG "intentionally" and "in bad faith" caused the parties' *coequally*-owned Project to suffer $30 million in cost overruns and lost sales so that Construction could collect **one-seventeenth of that amount** ($1.7 million) in "general conditions." But under the governing documents, "general conditions" payments did not and could not ever exceed the expenses Construction actually incurred in connection with the Project. Plaintiff's claim thus require[s] the Court to believe that PMG – a 50/50 owner whose principal was the *sole* guarantor of the Project's debt – deliberately caused the Project to suffer $30 million in damage (half of which would fall on PMG) so that its affiliate could incur $1.7 million in expenses and be reimbursed from *joint* funds (half of which would come from PMG).

Dkt. 147 at 5 (italics in original; bold added for emphasis; internal citations omitted). Nonetheless, Madison believes it would have made a greater profit on the Project but for PMG's alleged negligence. However, as discussed, Madison, a counseled, sophisticated business entity contracted away the right to disgorge such unrealized profits from PMG for ordinary negligence and did not contract for a cap on costs.

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[19] It should be noted that Madison does not actually allege that PMG's projections were fraudulent.

[20] *See* Dkt. 123 at 5-8 (CMA § 4.02).

That said, even if Madison pleaded demand futility on its claim for breach of the CMA, the claim would still fail because the damages it seeks are expressly precluded by section 19.09 of the CMA. *See* Dkt. 123 at 23 (wavier of "consequential damages", including damages for "income and profit"). The damages Madison seeks in this action concern its lost profit. To be sure, section 15.01 of the CMA does permit Construction's termination for some of the malfeasance alleged by Madison. *See id.* at 17. Section 19.09, however, does not permit recovery of lost profits. Consequently, if Madison had issues with how Construction was performing, it should have raised them before all of the work was completed and the units were sold. Madison never sought to terminate Construction; its first formal complaints were made in this lawsuit.

As should be evident from the foregoing, the overarching theme of Madison's complaints is delay. Yet, there is no question that some of that delay was a product of its own belated production of architectural drawings, which delayed the commencement of the construction work.[21] Regardless, even assuming the truth of all of the AC's allegations, Madison has not alleged conduct within the scope of the exculpatory clause, and, therefore, has failed to state a claim for relief under the Operating Agreements. In short, Madison has not pleaded any facts that suggest PMG faces a credible threat of liability.[22] That failing also renders Madison without standing to assert its derivative claims, as the exculpatory clause's applicability defeats Madison's assertion of demand futility.

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[21] *See* Dkt. 148 (10/11/17 Tr. at 39-40). Based on the extensive factual record previously reviewed by the court in connection with the prior attachment motion, it is clear that much of what Madison alleges is simply false. *See* Dkt. 106 at 30-31.

[22] That Madison has not obtained discovery in this action is of no moment. *See Lerner*, 119 AD3d at 130 ("the purpose of discovery is to find out additional facts about a well-pleaded claim, not to find out whether such a claim exists.") (citation omitted).

Madison's remaining cause of action is for an equitable accounting, which it seeks by virtue of the parties' fiduciary relationship as members in the defendant-Delaware LLCs. Under settled Delaware law, a plaintiff may not maintain an independent cause of action for an accounting. *Stevanov v O'Connor*, 2009 WL 1059640, at *15 (Del Ch 2009) ("A claim for an accounting in the Court of Chancery generally reflects a request for a particular type of remedy, rather than an equitable claim in and of itself."). Rather, if and when the plaintiff prevails on a claim for breach of fiduciary duty, it may seek an accounting as a remedy for such breach. *See Gallagher v Long*, 2013 WL 718773, at *4 (Del Ch 2013) ("any request for an accounting must be based on a successful claim for breach of fiduciary duty"), *aff'd* 65 A3d 616 (Del 2013). That said, the First Department recently held that the law of the forum (here, New York) governs the remedy of an equitable accounting. *See Estate of Calderwood v ACE Group Int'l LLC*, 2017 WL 6375543, at *5 (1st Dept Dec. 14, 2017). New York law is somewhat more liberal than Delaware on the issue of when a fiduciary must account. *See Barry v Clermont York Assocs. LLC*, 50 Misc3d 1203(A), at *13 (Sup Ct, NY County 2015), *aff'd as mod. on other grounds*, 144 AD3d 607 (1st Dept 2016) (*Barry II*). Regardless, here, where the parties are extremely sophisticated and where the parties' fiduciary relationship derives from their membership in LLCs, the First Department has held that it may be inequitable to compel an accounting in the absence of any real need and where doing so is burdensome. *See Barry II*, 144 AD3d at 608. Here, Madison does not have any viable non-exculpated cause of action against defendants relating to the Project, which has been completed. There simply is no need for an accounting at this juncture that could justify the burden of providing one. Accordingly, it is

ORDERED that defendants' motion to dismiss the AC is granted, and the Clerk is directed to enter judgment dismissing the AC with prejudice; and it is further

ORDERED that defendants' claim for the reasonable attorneys' fees they expended in this action pursuant to section 7 of the Amendment is hereby severed, shall continue, and is referred to a Special Referee to hear and report; and it is further

ORDERED that within one week of the entry of this order on NYSCEF, defendants shall serve a copy of this order with notice of entry, as well as a completed information sheet, on the Special Referee Clerk at spref-nyef@nycourts.gov, who is respectfully directed to place this matter on the calendar of the Special Referee's part for the earliest convenient date and notify all parties of the hearing date.

Dated: January 11, 2018

ENTER:

J.S.C.

SHIRLEY WERNER KORNREICH
J.S.C.