

SHORT FORM ORDER

**SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NASSAU : COMMERCIAL DIVISION**

P R E S E N T :

**HON. IRA B. WARSHAWSKY,
Justice.**

-----X

TRIAL/IAS PART 14

DELTA FINANCIAL CORPORATION, in its individual capacity and as Initial Member of DELTA FUNDING RESIDUAL EXCHANGE COMPANY, LLC.,

INDEX NO.: 011118/2003
MOTION DATE: 09/15/2006
MOTION SEQUENCE: 013

Plaintiff,

**DFC'S MOTION FOR
LEAVE TO AMEND
THE COMPLAINT**

-against-

JAMES E. MORRISON, DELTA FUNDING RESIDUAL MANAGEMENT, INC. and DELTA FUNDING RESIDUAL EXCHANGE COMPANY, Defendants.

**CONSOLIDATED
ACTIONS**

-----X

DELTA FUNDING RESIDUAL EXCHANGE COMPANY, LLC, and DELTA FUNDING RESIDUAL MANAGEMENT INC.,

Plaintiffs,

INDEX NO.: 003084/2004

-against-

DELTA FINANCIAL CORPORATION, SIDNEY A. MILLER, HUGH MILLER, MARC E. MILLER, RICHARD BLASS, and ARNOLD B. POLLARD,

Defendants.

-----X

-----X
DELTA FUNDING RESIDUAL EXCHANGE
COMPANY, LLC,

Plaintiff,

-against-

KPMG LLP,

Defendant.
-----X

INDEX NO.: 018599/2005

The following papers read on this motion:

Notice of Motion, Affidavit & Exhibits Annexed.....	1
Memorandum of Law in Support of Motion for Leave to Amend the Complaint.....	2
Memorandum of Law of Delta Funding Residual Exchange Company, LLC, Delta Funding Residual Management, Inc. and James E. Morrison in Opposition to Delta Financial Corporation's Motion for Leave to Amend its Complaint.....	3
Affidavit of James E. Morrison in Opposition to DFC's Motion for Leave to Amend its Complaint & Exhibits Annexed.....	4
Affirmation of Jonathan D. Perry in Opposition to Delta Financial Corporation's Motion for Leave to Amend its Complaint & Exhibits Annexed.....	5
Reply Memorandum of Law in Support of Delta Financial Corporation's Motion for Leave to Amend the Complaint.....	6

BACKGROUND

Delta Financial Corporation ("DFC") filed a lawsuit against defendants James Morrison, Delta Funding Residual Exchange Company, LLC ("LLC") and its management company, Delta Funding Residual Management, Inc. ("DFRM") (collectively sometimes hereinafter known as the "LLC"), after the LLC allegedly withheld certain monies allegedly due DFC. The LLC thereafter commenced an action for approximately \$110 million plus interest for, among other things, fraud with regard to an exchange of assets between the LLC and DFC in and about August, 2001 (the "2001 Exchange").

In July, 2004, the LLC commenced an action against the accounting firm of KPMG ("KPMG") for approximately \$110 million plus interest alleging misconduct in connection with

an audit of DFC that was related to the 2001 Exchange. All matters have been consolidated before this court. Familiarity with the facts is assumed and only relevant facts will be restated when necessary.

DFC's Motion For Leave To Amend Its Complaint

Currently before the Court is DFC's motion for leave to amend its complaint which was returnable on August 21, 2006 and argued before the court on August 25, 2006. It is important to note that DFC had previously been granted leave to move to amend its complaint and served its original notice of motion and supporting documents in or about December, 2005 (the "First Motion"). In response to the First Motion, the LLC cross-moved for an order pursuant to Section 3103(c) of the CPLR directing DFC to return or destroy all copies of a document that, according to the LLC, was inadvertently produced during pre-trial document discovery; to enjoin the use of the aforesaid document by DFC and KPMG to strike, and all references thereto from DFC's First Motion for leave to amend its complaint. Such document which was annexed to the Affidavit of Eugene Licker, Esq., counsel for DFC, was submitted in support of DFC's First Motion as an exhibit thereto. The inadvertently produced document was a string of e-mails dated April 21, 2003 between James Morrison and Ropes and Gray, counsel for DFREC and DFRM. In an Order dated May 9, 2006, this Court granted the LLC's motion and held that the string of e-mails dated April 21, 2003 was privileged, must be returned or destroyed, and cannot be used in any subsequent fashion. In addition, the Court dismissed DFC's First Motion with leave to renew without further request of the Court to allow DFC to modify its First Motion to remove all references to the inadvertently produced document.

On July 10, 2006, DFC moved, once again, pursuant to CPLR Rule 3025(b) for leave to amend its complaint. In that regard, DFC seeks to add claims both individually and derivatively in its capacity as a member of the LLC, seeking recovery for waste; for breach of fiduciary duty (beyond those already alleged in the complaint); and for material misrepresentation¹.

Specifically, DFC seeks to amend its complaint by modifying the existing Eleventh cause of action and adding a Twelfth, Thirteenth, and Fourteenth cause of action on an individual basis as well as derivatively to redress alleged injuries suffered, and to be suffered, by the LLC as a

¹ Although DFC discusses a claim for improper personal benefit in its supporting papers, a review of the proposed amended complaint does not reflect a separate cause of action against anyone for improper personal benefit.

direct result of the violations of law, including breaches of fiduciary duty, waste of corporate assets, and material misrepresentation by Mr. Morrison and DFRM.

**DFC's Argument With Regard To Its Motion
For Leave To Amend The Complaint**

DFC argues that CPLR Rule 3025(b) and the caselaw interpreting the rule make it clear that leave to amend should be freely given, and therefore, this Court should permit the amendment of the complaint to include the modification of the Eleventh cause of action and the addition of the Twelfth, Thirteenth and Fourteenth causes of action. DFC contends that leave should only be denied where the proposed amendment is shown to result in surprise or prejudice to the opposing party, and to be "palpably insufficient as a matter of law" or "totally devoid of merit". See Consolidated Payroll Services, Inc. v. Berk, 18 A.D.3d 415 (2nd Dep't 2005). DFC avers that the proposed amendment can hardly be said to surprise or prejudice Mr. Morrison or DFRM since the proposed additional causes of action, while distinct in the terms of legal recourse from those already set forth, are based upon factual averments set forth in the extant complaint.

With regard to DFC's proposed claims for waste and breach of fiduciary duty, DFC alleges that Mr. Morrison and DFRM are wasting the LLC's assets in pursuing this action against DFC and is doing so only for Mr. Morrison's personal benefit and gain. DFC avers that Mr. Morrison has kept important facts from the LLC members in an effort to ensure his personal gain from the action against DFC which is his sole motivation. Further, that Mr. Morrison and DFRM have breached their fiduciary duties to the LLC members and that Mr. Morrison has failed to disclose his interest in the conduct of the litigation and the inherent conflict of joint counsel. DFC seeks to assert the claims of waste and breach of fiduciary duty on its own behalf individually, as well as derivatively as a member of the LLC.

DFC contends that if allowed to amend its complaint, DFC will allege that Mr. Morrison has complete control and dominion over the LLC and has made decisions with regard to this lawsuit unilaterally with neither vote of the LLC nor input from the broad base of its members. DFC will allege that the LLC members have not been told crucial facts such as Mr. Morrison's prospects of reaping significant personal benefit from the lawsuit and that the entity employed

by Mr. Morrison to value the certificates at issue here initially determined a value of \$110 million and was allegedly convinced to lower that projection because of economic factor(s) post-dating the valuation date. DFC will also allege that Mr. Morrison's initial suspension of DFC and unilateral termination of payments to DFC was unlawful and puts the LLC at risk of liability to DFC. DFC will allege that all of these actions were undertaken to enrich Mr. Morrison at the expense of the LLC without full disclosure to the LLC members. Moreover, DFC claims that the financials that have been forwarded to the LLC members do not disclose the extent to which the funds expended have benefitted Mr. Morrison individually. DFC will allege that Mr. Morrison himself as well as entities in which he has interest have benefited mightily from this litigation.

With regard to DFC's request to amend the complaint to allege material misrepresentation, DFC alleges that although the LLC financial statements disclose to the LLC members the amounts that are being spent on the litigation by the LLC, they do not disclose how much is being paid to Mr. Morrison and his partners for prosecuting and defending these actions which DFC claims is actionable as a material misrepresentation. DFC argues that a fiduciary who makes a financial disclosure is obligated to include all information necessary to make the disclosure comprehensible.

DFC argues that in the current year's financial statements, all that is disclosed about the litigation is Mr. Morrison's success at motion practice. DFC contends that although the total amount paid by the LLC for legal fees is included, there is no specification as to what the legal fees paid for, and most importantly, how much of those fees were paid to Mr. Morrison directly or indirectly. If permitted, DFC will further allege that the LLC members were told that Mr. Morrison reserved a huge amount of cash to meet operating expenses but the LLC members are not told how much of that money is earmarked for payments of fees to the lawyers or to Mr. Morrison for prosecuting and defending the action. Therefore, DFC claims that disclosure is clearly incomplete, and therefore, false and misleading as there is no disclosure that the money is flowing into Mr. Morrison's pocket. DFC also contends in its brief that the LLC members relied on these disclosures in their tacit acceptance of the wasteful efforts against DFC that are quickly dissipating the LLC's assets and the LLC members voted to approve Mr. Morrison's employment contract based upon such nondisclosures.

The LLC argues that although DFC's proposed claims are nominally framed as a derivative action by a concerned LLC member, DFC's motion for leave to amend the complaint is actually nothing more than a self-interested attempt by DFC facing a substantial lawsuit to gain leverage against the company that is suing it. The LLC argues that DFC's motion flies in the face of well-established law and fails on three independent grounds, each of which alone would provide sufficient basis for rejecting all four of DFC's proposed amendments: (1) DFC lacks standing to assert the proposed claims derivatively on behalf of the LLC and cannot assert the claims directly on its own behalf; (2) even if DFC had standing, the proposed amended claims fail to state valid claims under Delaware law, and therefore, are palpably insufficient as a matter of law; and (3) DFC has failed to satisfy its burden of making a sufficient evidentiary showing that the proposed amended claims have merit.

LLC claims as a threshold issue, DFC's motion must be denied because DFC does not have standing to assert the proposed amended claims derivatively on behalf of LLC. The LLC argues that DFC cannot bring a derivative action under Delaware law because given its pending litigation with the LLC and its stated intention in pursuing these proposed claims as leverage in that pending litigation, DFC cannot be considered an "adequate and fair representative" of the LLC members. Moreover, that DFC's proposed claims, which are premised on injury to the LLC, not DFC, cannot be brought as direct causes of action as Delaware courts have uniformly rejected efforts to assert direct claims for waste and other fiduciary duty claims. Therefore, the LLC argues that DFC's lack of standing to bring the proposed amended claims is fully dispositive of DFC's motion.

Furthermore, the LLC argues that even if DFC had standing to pursue these claims, DFC's proposed claims all fail to state valid causes of action under Delaware law. For instance, the LLC argues that DFC's allegations cannot satisfy Delaware's onerous standard for pleading waste, which is met only by alleging that the challenged transactions serve no corporate purpose or that the corporation receives no consideration at all. Moreover, the LLC states that there is no precedent for DFC's claim that the commencement and prosecution of a lawsuit on behalf of the company, a lawsuit that has already survived a motion to dismiss, gives rise to a waste claim.

With regard to the proposed material misrepresentation claim, the LLC argues that DFC fails to state a valid cause of action because it fails to plead two essential elements of any claim premised on false disclosures: reasonable reliance and damages proximately caused by such reliance. Lastly, the LLC argues that DFC's proposed breach of fiduciary duty claims merely repeat the same allegations as those underlying the other proposed claims, and consequently, fails for the same reasons as those claims. In addition, the LLC claims that even if DFC's proposed amended claims did state claims as a matter of law, DFC's motion must be denied because DFC has not satisfied its affirmative burden to support its requested relief with sufficient evidence that could show that its proposed amended claims have merit.

DISCUSSION

Leave to amend the pleading is to be freely given where there is no showing of prejudice or surprise to the non-moving party and no showing that the proposed amendment is "palpably insufficient as a matter of law" or "totally devoid of merit." Consolidate Payroll Services, Inc. v. Berk, 18 A.D.3d 415, 794 N.Y.S.2d 410 (2nd Dep't 2005), quoting Ogilvie v. McDonald Corp., 294 A.D.2d 550, 551; McDermott v. Presbyterian Congregation of Bethlehem, 275 A.D.2d 305, 307 (2000). However, while leave to amend a pleading should be freely given, the decision whether to grant such leave is within the court's sound discretion to be determined on a case by case basis. See Lane v. Beard, 265 A.D.2d 382, 697 N.Y.S.2d 64 (2nd Dep't 1999); see also Mayers v. Dagostino, 58 N.Y.2d 696, 458 N.Y.S.2d 904, 444 N.E.2d 1323 (1982). Moreover, the movant must make some evidentiary showing that the proposed amendment has merit and a proposed amendment that is plainly lacking in merit will not be permitted. See Kurran v. Autoweb Service Center, 280 A.D.2d 636, 721 N.Y.S.2d 662 (2nd Dep't 2001); see also Heckler Electric Co. v. Matrix Exhibits - New York, 278 A.D.2d 279, 718 N.Y.S.2d 213 (2nd Dep't 2000); Bonnen v. Chin Hua Chiang, 272 A.D.2d 357, 707 N.Y.S.2d 365 (2d Dep't 2000); Westbranch Realty Corp. v. Exchange Insurance Co., 260 A.D.2d 473, 688 N.Y.S.2d 228 (2d Dep't 1999).

Does DFC Have Standing To Set Forth A Claim For Waste

As mentioned above, DFC asserts a claim for waste derivatively on behalf of LLC as well as on behalf of itself. Even before the legal merits of DFC's proposed amended claim for waste are reached, the Court must look into the threshold issue of standing with regard to asserting a derivative claim for waste. DFC's standing to the proposed amended claim for waste is governed by Delaware law. In a short form order dated May 9, 2005, this court held that because the LLC is an entity formed pursuant to the laws of the State of Delaware, issues pertaining to fiduciary duty [and waste] are governed by that law. See Delta Financial Corp. v. Morrison, 2006 WL 1233000, at 3 (N.Y. Sup. Ct. Nassau Co. May 9, 2006) (Warshawsky, J.); see also O'Donnell v. Ferro, 303 A.D.2d 567, 568, 756 N.Y.S.2d 485 (2nd Dep't 2003). (Applying Delaware law to waste and breach of fiduciary claims of corporation incorporated in Delaware). New York law provides that the law of the state of incorporation governs not only the substantive elements of such claims, but also whether such claims may be bought directly or derivatively, and whether the plaintiff has standing to assert a claim. See Nemazee v. Premiere Purchasing Partners, LP, 24 A.D.3d 196, 197, 806 N.Y.S.2d 22 (1st Dep't 2005).

The seminal Delaware case of Youngman v. Tahmouse, 457 A.2d 376 (Del. Ch. 1987) sets forth the standard on standing for a derivative action under Delaware law. The court in Youngman held that "while the only explicit standing requirement for maintaining a derivative suit is that the plaintiff be a stockholder of the corporation at the time of the transaction of which he complains, or that his stock thereafter devolves upon him by operation of law, this court [the Delaware Chancery Court] has recognized additional implicit requirements." Youngman, 457 A.2d at 379; see also 8 Del. C. Section 327; Ch. Ct Rule 231; Katz v. Plant Industries, Inc., Del. Ch., C.A. # 6407-N.C. (October 27, 1981). The court in Youngman went on to state that "the plaintiff in the derivative action must be qualified to serve in a fiduciary capacity as a representative of the class, whose interest is dependent upon the representative's adequate and fair prosecution." Youngman, 457 A.2d at 379; see also Katz v. Plant Industries, Inc., supra. According to the court in Youngman:

[t]he decisions in this area have interpreted the adequacy of representation required to mean that a Court can and should examine any extrinsic factors, that is, outside entanglements which make it likely that the interest of the other stockholders will be

disregarded in the prosecution of the suit. To this end, this Court has outlined the factors, although not exclusive, to be given consideration in determining the adequacy and fairness requirement within the context of the derivative suit.

Youngman, 457 A.2d at 379

In Youngman, citing Katz v. Plant Industries, the court listed the following criteria with approval:

[t]ypically, the elements are intertwined or interrelated, and it is frequently a combination of factors which lead a court to conclude that the plaintiff does not fulfill the requirements of 23.1 (although often a strong showing of one way in which the plaintiff's interests are actually inimical to those he is supposed to represent fairly and adequately, will suffice in reaching such a conclusion). Among the elements which the courts have evaluated in considering whether the derivative plaintiff meets Rule 23.1's representation requirement are: economic antagonisms between representative and class; the remedy sought by plaintiff in the derivative actions; indications that the named plaintiff was not the driving force behind the litigation; plaintiff's unfamiliarity with the litigation; other litigation pending between the plaintiff and defendants; the relative magnitude of plaintiff's personal interest as compared to its interest in the derivative action itself; plaintiff's vindictiveness toward the defendants; and finally the degree of support plaintiff is receiving from the shareholders he purported to represent.

Youngman, 457 A.2d at 379-380.

The court in Youngman went on to state that "a major type of antagonism requiring denial of certification is clear economic antagonism between representative and class." (emphasis supplied) Youngman at 457 A.2d at 380; see also Schnorback v. Fuqua, 70 F.R.D. 424, 433 (S.D. Ga. 1975); see also Roussel v. Tidelands Capital Corp., 428 F.Supp. 684, 688

(N.D. Ala. 1977) (typically these extrinsic factors involve competing business interests). Although these elements have been frequently combined to provide the basis for a court's decision to dismiss, often a strong showing of one factor which is actually inimical to the class will permit the same conclusion.

According to the LLC, DFC cannot possibly be considered an adequate and fair representative of the LLC members when it is pursuing these proposed claims to advance its own self-interest, which is diametrically opposed to the interests of the other LLC members. The LLC claims that because DFC is defending against substantial claims brought by the LLC and simultaneously seeking millions of dollars in damages for itself from the LLC for the breach of contract claims, DFC is precluded from representing the LLC members. The LLC contends that DFC cannot adequately represent the LLC's voting members in the lawsuit against Mr. Morrison and DFRM while it is simultaneously using that lawsuit to undermine those very same members' recovery from DFC.

Conversely, DFC claims that it has standing to assert the derivative claim for waste against Mr. Morrison and DFRM. DFC claims that there are no economic antagonisms between DFC and the other members of the LLC resulting from the litigation between the parties and DFC's pursuit of individual contract claims. Moreover, DFC contends that the LLC has not met their burden of making a strong showing that DFC's individual contract claims against the LLC are actually inimical to the class and the LLC's attempt to disqualify DFC on the basis of inadequate representation fails. According to DFC, the key is whether a nominal plaintiff's interests and issues are coextensive with those of the class he seeks to represent and whether he is able to ensure the trial court that as a representative, he will put up a real fight. In that light, DFC claims that it would put up a real fight on behalf of the LLC members and that DFC's interest in that regard are coextensive to those of the other members. DFC adamantly argues that it is not pursuing derivative claims that are diametrically opposed to the interest of the other LLC members just because DFC is simultaneously seeking to vindicate individual contract rights. Thus, according to DFC, its enforcement of its individual rights is not diametrically opposed to the interests of the members of the LLC and does not provide a basis to disqualify DFC as a fair and adequate representative of the LLC .

Court's Determination With Regard To Standing To Assert A Derivative Claim For Waste

This Court finds no basis to conclude that DFC is an inadequate representative for the LLC members with regard to its proposed derivative claim for waste. This Court has analyzed the factors set forth in Youngman, and finds that there is no specific economic antagonism between DFC and the other LLC members whose interest DFC purports to represent in prosecuting a derivative claim for waste. DFC seeks a remedy for the benefit for all LLC members not for DFC alone. Clearly, DFC would be the driving force behind the claim and is intimately familiar with the litigation as it has been involved in all events leading up to this point in the litigation. The Court finds that DFC will not be disqualified simply because it may have interests which go beyond interests of the class. See Emerald Partners v. Berlin, 564 A.2d 670, 675 (Del. Ch. 1989). The Court also holds that a finding for DFC on its individual claims would not preclude a recovery by DFC on the derivative claims. Thus, there is no structural conflict between DFC's individual claims and its derivative claims.

Moreover, the LLC claims that the vindictiveness by DFC toward Mr. Morrison and the LLC is so intense that it would impede DFC's ability to pursue adequately the interests of the other LLC members. This Court finds that DFC may have hostile feelings toward Mr. Morrison, however, those hostile feelings are not dispositive of the issue of whether DFC is a fair and adequate representative of the class. The fact that DFC may lack the affirmative support of all the other LLC members, is not dispositive either. There is no requirement that DFC must have full support of the other members. See Emerald Partners, 564 A.2d at 674. The true measure of adequacy of representation is not how many members the derivative plaintiff represents, but rather, how well DFC advances the interests of the other similarly situated members. Id. The Court finds that the LLC has failed to show that DFC is an inadequate member representative. Therefore, this Court holds that DFC has standing to set forth a derivative claim for waste.

Has DFC Stated A Derivative Claim For Waste Under Delaware Law

The Court now turns to the issue of whether DFC has stated a derivative claim for waste under Delaware law. DFC asserts that Mr. Morrison is wasting the LLC's assets in pursuing its

action against DFC and is doing so for an improper purpose, that is his own personal benefit and gain. DFC claims that the astronomical amount of money being spent, which DFC asserts is being paid to Mr. Morrison and his business partner for the most part, is a waste of corporate assets. Specifically, the claim for waste is premised on the allegation that Mr. Morrison and DFRM have improperly expended the LLC's resources by suspending distributions to DFC, investigating alleged misconduct of DFC, filing and pursuing litigation against DFC and paying Mr. Morrison and others to conduct litigation against DFC. On the other hand, the LLC claims that DFC has failed to satisfy the strict standard for waste under Delaware law, and therefore, the proposed derivative claim for waste does not state a valid claim under Delaware law.

In In re: Walt Disney Co., Derivative Litigation, 2006 WL1562466 at * 33 (Del. June 8, 2006) the court held that Delaware law establishes an "onerous standard for waste" that is satisfied "only in rare and unconscionable case where directors irrationally squander or give away corporate assets". Id. To state a claim for waste, DFC must plead facts and shoulder the burden of proving that the exchange was so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration. The court in In re: 3Com Corp., Shareholders Litigation 1999 WL 1009210 (Del. Ch. October 25, 1999) explained that the:

standard for a waste claim is high and the test is extreme ... very rarely satisfied by a shareholder plaintiff. . . . Further to find the plaintiff's claim sufficient I must be satisfied that the alleged facts establish a complete failure of consideration, and not merely the insufficiency of the consideration received. A complete failure of consideration is difficult to show since the acts alleged have to be so blatant that no ordinary business person would ever consider the transaction to be fair to the corporation. The company would literally would have to get nothing whatsoever for what it gave. Under this standard I am not to examine the allegations to see whether consideration, once received, was excessive or lopsided, was proportional or not, or even whether it was a bad deal from a business standpoint.

In re: 3Com, Shareholders Litigation, 1999 WL1009420 at * 4 (Del. Ch. October 25, 1999).

This Court holds that DFC fails to state a derivative cause of action for waste against the LLC. The Court finds that DFC's attempt to premise a derivative waste claim on the expenditure of money LLC continues to spend in connection with the ongoing litigation whether in pursuit of its affirmative claims or defense of claims against it, fundamentally and clearly misconstrues the concept of waste under Delaware law. See Highland Legacy Ltd. v. Singer, 2006 WL741939, at * 7 (Del. Ch. March 17, 2006) (complaining and alleging that firms were over compensated, but because plaintiff did not allege that they failed to perform the task for which they retained, the waste claims fall far short of the requirement for a claim for waste.) DFC's attempt to transform its defense against the LLC's lawsuit into an affirmative waste claim is without legal precedent. DFC has not cited a single case to support its position that a litigant may set forth a claim for waste against a plaintiff in an action based on the plaintiff's commencement and prosecution of that action.

The Court finds that no colorable derivative claim for waste arises from the LLC's payment of any legal expenses incurred by Mr. Morrison or DFRM or for investigations of alleged fraud. In fact, an indemnification provision in Mr. Morrison's employment agreement, which is consistent with Delaware's Limited Liability Act, permits the LLC to indemnify and hold harmless its members or managers. In addition, the Court finds that DFC cannot base its waste claim on LLC's suspension of distributions to DFC as that action did not expend any corporate funds.

Therefore, this Court finds that DFC's derivative claim for waste is devoid of merit.

DFC Has Not Set Forth The Requisite Evidentiary Showing That Its Derivative Waste Claim Has Merit

Even if DFC's allegations were sufficient to state a claim for waste which the Court has determined it has not, leave to amend the complaint would be denied notwithstanding because DFC has not made a sufficient evidentiary showing that its proposed derivative waste claim has merit. DFC bears the burden to make some evidentiary showing that the proposed claim can be

supported and cannot rest for purposes of this motion on facts alleged to be true in the complaint or facts summarized in an attorney affidavit. See Morgan v. Prospect Park Associates Holding L.P., 251 A.D.2d 306, 674 N.Y.S.2d 62 (2nd Dep't 1998); see also, Butt v. New York Medical College, 7 A.D.3d 744, 745, 776 N.Y.S.2d 897 (2nd Dep't 2004); E.N.V. Services, Inc. v. Alesia, 10 Misc. 3d 1054(A), 809 N.Y.S.2d 481 (N.Y. Sup. Ct. 2005). When considering a motion for leave to amend the complaint, a court must examine the underlying merits of the proposed claims, since to do otherwise would be wasteful of judicial resources. See Butt, 7 A.D.3d at 745; see also Morgan, 251 A.D.2d at 306. DFC has not met its obligation to present evidence that would establish no ordinary business person would ever consider the investigation of DFC and subsequent prosecution of LLC's lawsuit against DFC for fraud.

While DFC's moving and reply papers are replete with discussion with regard to the improper reasons for the action, it does not provide the necessary evidentiary showing that the proposed waste claim has merit. Accordingly, this Court finds that DFC fails to provide the evidentiary support that its derivative claim for waste has merit, and therefore, DFC shall not be permitted to amend its complaint to add a derivative claim for waste.

DFC Cannot Bring The Proposed Claim For Waste As A Direct Claim

In its proposed amended complaint DFC also attempts to assert a direct claim for waste on behalf of itself against DFRM and Mr. Morrison. The Supreme Court of the State of Delaware in Tooley v. Donaldson, Lefkind & Jenrette, Inc., 845 A.2d 1031 (2004) set forth the proper analysis that should be used to distinguish between direct and derivative claims. The court stated that "[t]he analysis must be based solely on the following questions: who suffered the alleged harm – the corporation or the suing stockholder individually – and who would receive the benefit of the recovery or other remedy? This simple analysis is well imbedded in our jurisprudence" Id. The court in Tooley specifically held that "the proper analysis has been and should remain as stated in Grimes v. Donald, 673 A.2d 1207 (Del. 1996), Kramer v. Western Pacific Industries, Inc., 546 A.2d 348 (Del. 1988), and Parnes v. Bally Entertainment Corp., 722 A.2d 1243 (Del. 1999). That is, a court should look to the nature of the wrong and to

whom the relief should go. The stockholders 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 injury to the corporation. Tooley, 845 A.2d at 1038. In fact, Delaware courts have rejected shareholders efforts to bring waste and breach of fiduciary claims directly. See In re J.P. Morgan Chase & Co. Shareholder Litigation -- A.2d --, 2006 WL 585 606, at *4 (Delaware. March 8, 2006) (holding that claims of waste are classically derivative); see also Kramer v. W. Pac. Industries, Inc., 546 A.2d 348, 353 (Del. 1988) (a claim of mismanagement resulting in corporate waste, if proven, represents a direct wrong to the corporation that is indirectly experienced by all shareholders, and thus must be brought derivative); Gentile v. Rossette, 2005 WL 3472361 at *1 (Del. Ch. Nov. 21, 2006) (holding that waste claims must be pursued by shareholders as derivative not direct claims because waste of corporate assets represents an injury to the corporation).

In the instant case, DFC's proposed direct claim for waste is improper as DFC has not and cannot identified any injury it purportedly suffered that is independent from the injury to the LLC. The only damages DFC could theoretically suffer is from the decreased distributions from the LLC to its members. However such an injury, which would be shared by all the LLC members, is, in fact, a classic example of indirect damages derivative of harm to the LLC. Therefore, this Court concludes that to the extent that DFC has set forth a proposed direct claim for waste, DFC is precluded from amending its complaint to reflect such a claim.

DFC's Proposed Claim For Material Misrepresentation

DFC argues that this Court should permit amendment of the complaint to allow the claim for material misrepresentation derivatively and on behalf of itself. DFC claims that the LLC's financial statements, which are annexed to the Licker Affidavit as Exhibit "A", disclose to the LLC members the amounts of money that were being spent on the prosecution and defense of litigation by the LLC. However, according to DFC, what the financials do not disclose is that a "king's ransom" is being paid to prosecute and defend these actions which in large part, according to DFC, is being paid to Mr. Morrison and his partners. DFC alleges that that failure is actionable as a material misstatement.

In addition, DFC contends that the LLC and Mr. Morrison have an on-going business relationship with regard to the conduct of the litigations and that, upon information and belief, the LLC has a similar relationship with entities that have a relationship with Mr. Morrison. According to DFC, Mr. Morrison has neglected to make that disclosure to the LLC members which constitutes a material misrepresentation. DFC argues that in the current year's financial statements, all that is disclosed about the litigation is Mr. Morrison's success at motion practice and the total amount paid by the LLC for legal fees. However, DFC argues that there is no specification of what the legal fees were paid for or, more importantly, how much of those fees were paid to Mr. Morrison, either directly or indirectly. Moreover, DFC claims that the LLC members were told that Mr. Morrison has reserved huge amounts of cash to meet operating expenses but has failed to tell the LLC members how much of that money is earmarked for payment of fees to the lawyers and to Mr. Morrison for prosecuting the action and defending Mr. Morrison. DFC contends that these omissions render the financial statements inaccurate and misleading.

DFC claims that the misstatements are material in nature as they affect the disclosure of legal expenses, which account for more than 70% of all expenses for 2005. DFC argues that when you add in "valuation asset management consulting expenses" which DFC believes is related to Boston Portfolio but may also include payments to Mr. Morrison, and "management member fees and expenses", these expenses exceed 94% of all LLC's expenses for the period.

DFC argues that disclosure is clearly incomplete, and is, therefore, false and misleading in that there is no disclosure that the money is flowing through Mr. Morrison. Finally, DFC claims that the LLC members have relied on these disclosures in their tacit acceptance of the wasteful efforts against DFC that are quickly dissipating LLC's assets.

On the other hand, the LLC contends that DFC does not have standing to assert a derivative claim for material misrepresentation. And, even if DFC had standing, which the LLC contends it does not, the LLC argues that DFC's proposed claim of material misrepresentation alleging that Mr. Morrison and DFRM breached their fiduciary duty by issuing financial statements that failed to disclose LLC's legal expenses were paid to Mr. Morrison, his associates, and upon information and belief, entities having a relationship with Mr. Morrison, falls far short

of stating a valid claim under Delaware law and as an evidentiary matter are contradicted by the disclosures themselves. The LLC claims that DFC must also plead reasonable reliance upon those misrepresentations and identify the damages proximately caused by such reliance. See Metro Commerce Corp., 850 4 A.2d at 157-158; see also A.R. DeMarco Enters. Inc. v. Ocean Spray Cranberries, Inc., 2002 WL31820970, at 410 (Del. Ch. November 26, 2002). The LLC contends that the proposed amendment fails to plead these required elements in that it does not allege that DFC or any other LLC member took any action whatsoever based upon the purportedly false financial statements let alone reasonably relied upon them. Moreover, the LLC avers that DFC does not identify any specific damages that were proximately caused by the purported material misrepresentation.

The LLC argues that DFC's proposed material misrepresentation claim also rests on the fundamental misconception about the scope of Delaware's duty of disclosure. According to the LLC, Delaware law does not require a fiduciary to disclose detailed information concerning an on-going litigation expenses and strategy, such as the particular entities to whom legal expenses have been paid, the specific litigation tasks being performed or the amount of money the company plans to spend on litigation in the future. To the contrary, the LLC contends that Delaware law expressly permits a fiduciary to balance his duty to disclose against its concomitant duty to protect the enterprise, in particular, by keeping certain financial information confidential. See Malone v. Brincat, 822 A.2d 512 (Del. 1998). For that reason the LLC states Delaware courts repeatedly have dismissed claims based on allegedly material misrepresentation regarding companies' pending litigation. See Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 144-145 (Del. 1997) (affirming dismissal of claim premised on failure to disclose information concerning activities of litigation committee); Bae Systems, N.A., Inc., 2004 WL 1739522 at *8N. 62 (fiduciary does not have to disclose each and every decision of litigation strategy as such a requirement would lead to perverse results).

**Does DFC Have Standing To Assert A Derivative Claim
On Behalf Of LLC For Material Misrepresentation?**

The Court finds that DFC does, in fact, have standing to assert a derivative claim on behalf of the LLC for material misrepresentation. In this Court's view, DFC can be an adequate and fair representative of the LLC members in pursuing a claim for material misrepresentation. As stated earlier, DFC is not precluded from representing LLC members necessarily because it is embroiled in litigations with the LLC. Based upon the reasoning set forth by the court above, this Court finds that DFC does have standing to bring a derivative claim against Mr. Morrison and DFRM for material representation.

Does DFC State A Valid Claim For Material Misrepresentation Under Delaware Law?

The Court of Chancery of Delaware in Metro Communications Corp. v. Advanced MobileCom Technologies, Inc., 854 A.2d 121 (Del. Ch. 2004) sets forth a test to determine whether or not a claim for material misrepresentation has been properly set forth. The court in Metro Communications Corp. stated:

[t]o prove its claim that a defendant committed fraud by overt misrepresentation, Metro must show: (1) a false representation, usually one of fact, made by the defendant; (2) defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or to refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance.

Metro Communications Corp., Inc., 854 A.2d at 143.

In the Court's view, DFC has not properly set forth a claim for material misrepresentation. DFC has failed to set forth, in its proposed amended complaint, *inter alia*, what action DFC has taken in justifiable reliance upon a representation or an allegation that no reliance is necessary. In its brief, DFC argues that LLC members have voted to renew Mr. Morrison's contract each year, and therefore, the alleged false disclosures effected the vote of shareholders, and thus there is no need for reliance. See Metro Communications Corp. v. Advance Mobile Comm., 645 A.2d 121, 156 (Del. 2004). But the proposed amended complaint is devoid of such allegations.

With regard to DFC's argument in its brief that no reliance is necessary, the court in Metro Communications Corp., stated that:

[t]hese, and other factors, have led the Delaware courts to articulate certain standards governing the disclosure-related duties of the fiduciaries of Delaware business entities.² Those standards operate differently depending upon the context in which the fiduciaries speak. When the fiduciaries communicate with the beneficiaries in the context of asking the beneficiary to make a discretionary decision – such as whether to grant a proxy, to vote yes or no on a particular matter, or to seek appraisal or accept merger consideration – the fiduciary has the duty to disclose all material facts bearing on the decision at issue. To prevail on a claim for a breach of this duty (traditionally described as a fiduciary duty of disclosure), a beneficiary, such as a stockholder, need not prove actual reliance on the disclosure, but simply that there was a material misdisclosure.

Metro Communications Corp., 854 A.2d at 156.

A review of the Thirteenth cause of action for material misrepresentation against Mr. Morrison and DFRM fails to include any allegation with regard to reliance or the lack of the requirement for reliance by the LLC members due to a vote. Paragraphs "133", "134", "135", and "136" of the proposed amended complaint allege certain fiduciary duties that were owed by Mr. Morrison and DFRM to the LLC and its members. Paragraph "137" contends that Mr. Morrison and DFRM have breached those fiduciary obligations. Paragraphs "138" and "139" allege that all the actions of Mr. Morrison and DFRM set forth in prior paragraph were unlawful and made in bad faith, that those actions were the direct and proximate result of conduct of Mr. Morrison and DFRM, and that DFC and the LLC have been damaged as a result thereof. Nowhere in the Thirteenth cause of action does DFC allege either reliance or the lack of the requirement for reliance by virtue of a vote to set forth a claim for material misrepresentation.

² These standards have been mostly articulated in the corporate context but the corporate standards often serve as the default rule in the alternative entity context unless they are preempted by valid contracting decisions.

Because DFC has failed to allege the necessary elements of the claim, DFC has failed to state a claim for material misrepresentation.

In addition, even if DFC alleged reliance or the lack of a requirement for reliance, DFC still could not plead a cause of action for material misrepresentation. Under Delaware law, fiduciaries are required to disclose relevant and pertinent information to its beneficiaries, in this case, the LLC members. But, this Court is unaware of any caselaw that requires a fiduciary to disclose extremely detailed information concerning on-going litigation expenses and strategy which failure to disclose would constitute material misrepresentation. Even DFC's papers do not set forth any caselaw that would suggest that fiduciaries must provide detailed disclosure so as to not create a situation in which he or she is materially misrepresenting relevant facts to its beneficiaries.

As set forth by the Supreme Court of Delaware in Malone v. Brincat, 722 A.2d 5 (1998):

[t]he directors' duty to disclose all available material information in connection with a request for shareholder action must be balanced against his concomitant duty to protect the corporate enterprise, in particular, by keeping certain financial information confidential. Directors are required to provide shareholders with all information that is material to the action being requested and to provide a balanced, truthful account of all matters disclosed in the communication with shareholders.

Malone v. Brincat, 722 A.2d at 12.

This Court agrees with the Supreme Court of Delaware in Malone and holds that failure to set forth a more detailed disclosure does not create a derivative or direct claim for material misrepresentation.

Does DFC State A Valid Claim For Breach of Fiduciary Duty?

DFC sets forth in its proposed amended complaint a Fourteenth cause of action for breach of fiduciary duty both on a derivative and individual basis against Mr. Morrison and DFRM. The Eleventh cause of action was an existing direct claim against Mr. Morrison and

DFRM for breach of fiduciary duty and DFC now asserts that claim on a derivative basis as well. A review of the allegations set forth in the Eleventh cause of action as well as the Fourteenth cause of action both for breach of fiduciary duty by Mr. Morrison and DFRM, shows factually similar contentions.

DFC contends in its moving brief that as a result of wasting the LLC's assets, the enrichment of Mr. Morrison from the on-going litigation, and his purported failure to disclose his interest in the conduct of that litigation and inherent conflict of joint counsel, gives rise to an action for breach of fiduciary duty. On the other hand, the LLC claims that the breach of fiduciary duty claim is duplicative of the proposed waste and material misrepresentation claims and fails for the same reasons that the other two proposed claims fail.

While this Court finds that DFC has standing to set forth a derivative claim for breach of fiduciary duty, the Court holds that the breach of fiduciary duty derivative claims as set forth in the Eleventh and Fourteenth causes of action are duplicative of the proposed claims for waste and material misrepresentation. While this Court agrees that in theory there may be situations in which a separate claim may be made based upon a different legal theory supported by the same set of facts, in this instance such is not the case.

A review of the Eleventh and Fourteenth causes of action list the fiduciary obligations that Mr. Morrison and DFRM purported breached. However, DFC does not set forth case law under Delaware law to establish that actions such as devoting LLC's resources' to investigations and the defense of Mr. Morrison, exposing the company to litigation by disregarding demands made upon it, devoting company resources to litigations, and compensation for Mr. Morrison create a valid claim for breach of fiduciary duty. In fact, the LLC has a contractual obligation to indemnify Mr. Morrison pursuant to agreements between Mr. Morrison and LLC. This Court has been unable to find any support for such a claim based upon the facts as DFC has proclaimed them. As such, DFC has failed to set forth a cause of action for breach of fiduciary duty on a derivative basis as set forth in the Eleventh and Fourteenth causes of action.

**DFC Cannot Bring A Cause
Of Action For Breach Of
Fiduciary Duty On Behalf Of Itself.**

As discussed at length above, Delaware Courts have routinely held that any attempt by shareholder (or members) to bring a cause of action for breach of fiduciary duty directly will be dismissed. See, In re J.P. Morgan Chase & Co. Shareholder Litigation, 2006 WL 585606, at * 4 (Del. March 8, 2006), see also Kramer v. W. Pac, Inc., 546 S.2d 348, 353 (Del. 1988). Therefore, DFC has failed to set forth a direct cause of action for breach of fiduciary duty.

In conclusion, based upon the foregoing, DFC's motion for leave to amend the complaint is denied in all respects.

Dated: November 2, 2006

J.S.C.

Warshawsky Delta

11-2.wpd