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IN THE SUPREME COURT OF THE STATE OF DELAWARE

THE JOSEPH PENAR FAMILY TRUST, by its Trustee Joseph Penar; THE WALDER FAMILY TRUST, by its Trustee, Cecile Donnamarie Newkirk; ALLEN COOPER, individually; SUE COOPER, individually; and THE ALLEN AND SUE COOPER TRUST, by its Trustees, Allen and Sue Cooper, Plaintiffs Below-Appellants, v. JASEN ADAMS, DAVID HARTCORN, and BRIAN TOLLEFSON, Defendants, Below-Appellees, And PREMIUM OF AMERICA, LLC, and PREMIUM HOLDING, LLC, Nominal Defendants Below-Appellees.	No. 250, 2016 Court Below: Court of Chancery of the State of Delaware C.A. No. 10441-VCG

AMENDED ANSWERING BRIEF OF DEFENDANTS BELOW – APPELLEES

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Table of Contents

Page(s)

Table of Authorities

Page(s)

Cases

Rules

NATURE OF PROCEEDINGS

Appellants, who were plaintiffs below, have commenced this appeal in response to an April 28, 2016 Memorandum Opinion (the "Opinion")[1] dismissing Appellant's Second Amended Complaint (the "SAC) – which attempted to challenge an alleged transaction (the "Presumed Transaction") – pursuant to Delaware Court of Chancery Rule 12(b)(6). Prior to the filing of the SAC, Appellants had twice amended their complaint; first to substitute a new plaintiff when it was learned that the original plaintiff lacked standing as he was not a member of Premium of America LLC ("POA") during the time of the Presumed Transaction, and then a second time in response to a motion to dismiss filed by Appellees which challenged the first amended complaint under Rule 12(b)(6) for failing to sufficiently state a cause for relief.

At no time have Appellants, or any other member of POA, ever sought access to POA's books and records pursuant to Section 18-305 of Chapter 6 of the Delaware Code ("Section 18-305"). Nor did Appellants ever seek a stay of the litigation below in order to bring a concurrent action under Section 18-305 once Appellees sought to dismiss the complaint for failing to sufficiently plead a factual basis for relief.

[1] The Opinion is attached as Exhibit 1 to the Opening Brief of Appellants.

In its Opinion, the Court of Chancery found that, because Appellant's SAC failed to plead "the nature of the actual transaction by which the assets were liquidated, the nature of the board action, if any, in way of that transaction, who the parties to the transaction were, and the current ownership of the assets sold," the SAC must be dismissed pursuant to Rule 12(b)(6). (Opinion at 11). This Appeal followed.

SUMMARY OF ARGUMENT

1. Appellant's Statement contained in their single paragraph Summary of Argument is denied. The Court of Chancery properly dismissed Appellant's SAC because it failed to plead even the most basic details of the Presumed Transaction, which was being challenged under a bad faith standard.
2. Appellants could have easily pled the necessary details of the Presumed Transaction by first seeking materials related to the transaction in an action brought under Section 18-305. Despite having ample opportunities to seek the relevant materials related to the transaction, Plaintiffs repeatedly choose to forego that step.
3. As a result, the SAC fails to plead any actual facts from which the Court of Chancery could conceivably have drawn an inference that the managers of POA acted in bad faith. Thus, the SAC was properly dismissed pursuant to Rule 12(b)(6).

STATEMENT OF FACTS

While a comprehensive recitation of the relevant facts is provided in the opinion below (see Opinion at 3-11) and will not be fully duplicated in this brief, certain facts require additional elaboration. As the Opinion sets forth, POA was formed by the United States Bankruptcy Court for the District of Columbia to be a liquidating entity for the assets of Beneficial Assurance Ltd. and Premium Escrow Services, Inc. (collectively "Beneficial"). (*Id*. at 4-5). Unlike a typical limited liability company, which may operate indefinitely, the operating agreement of POA set an expiration date on the company. Specifically, the Operating Agreement provided that:

> **Section 2.4 Term**. The term of the Company commenced as of the date that the Certificate of Formation was filed with the Delaware Secretary of State and shall continue, unless sooner terminated in accordance with other provisions of this Agreement, for a period of five (5) years. Notwithstanding the foregoing, the Board of Managers may, in its discretion and without approval of the Members, extend the term of the Company beyond such 5-year period if it determines that such extension is appropriate or necessary to more fully carry out the corporate purposes for which the Company was formed.

(Appellee's Appendix at B90-B91).

As the Opinion details, rather than liquidating POA's assets, the prior managers of POA devoted substantial company resources and years pursuing claims against former brokers in litigation. (Opinion at 6). Ultimately, "none of the lawsuits resolved in favor of POA." (*Id*.)

While the former managers of POA were pursuing fruitless litigations, the value of POA's assets was plummeting. When POA was formed, it held a sum of cash and life insurance policies with a face value of $189 million. (*Id*. at 5). POA's former managers estimated that they could return between $100 million and $120 million to POA'a members during the five year term that POA was supposed to exist. (*Id*.) This did not happen.

By 2013, POA held just $11.6 million in cash and the remaining life insurance policies had a mere face value in the tens of millions of dollars. (SAC ¶24 (A40)). This decline in assets occurred despite only minor distributions having been made to the members of POA in the decade since POA had been created. The decline in POA's fortunes was due to the same circumstances that caused the initial bankruptcy which resulted in the creation of POA – that is, the life insurance policies held by POA are a self-cannibalizing asset. Rather than generating a windfall of profits, these policies depleted POA's assets though premium payments faster than the policies matured and yielded dividends to POA.

The self-cannibalizing nature of POA's insurance assets was ultimately the factor that drove the managers of POA to enter into the Presumed Transaction. In

October of 2013, the board managers of POA[2] issued a letter to POA's members outlining the justifications for its decision to liquidate the assets of POA:

- The Beneficial bankruptcy case occurred almost eleven (11) years ago. The reorganized company, POA, was formed in August 2003 and projected to operate until around 2008 or 2009. It has operated into the year 2013. At this time, projected operating expenses and risks exceed the net present value of the Company's assets.

- In the context of the bankruptcy of the Beneficial Companies, the Members (the original Beneficial purchasers) will have recovered approximately 18% of their original invested amount, which the board considers a reasonable and significant recovery of the general unsecured claims. (In the last five (5) years, the Company has expected that the Member recovery would be no more than 20%, and likely less than 20% of the principal invested amount.)

- The Company is entering a period where operating costs are projected to increase, due to rising premium expenses and increased regulatory risk by federal and state securities and taxing authorities. In particular, as disclosed around January 2011, the Company has been advised it should register its Membership Interests as securities regulated by the Securities and Exchange Commission. In the last two years, the Company has undergone a rigorous investigation of the possibilities for satisfying this federal requirement. The board has determined that it is not in the interests of the Members to bear the increased costs and risks associated with the SEC registration and compliance process. Furthermore, based on the board's review of the Company's expected performance, there is an unreasonable risk that the company will expend all of its cash by the fall of 2014. A final distribution at this time is in the best interests of the Members, before the Company exhausts its cash resources.

[2] It should be noted that the SAC does not actually plead who composed the board of managers of POA at the time this letter was written. The SAC suggests that at least David Hartcorn, Jasen Adams and Brian Tollefson were members of the board of POA at the time of the Presumed Tansaction, but is vague as to whether Lida Bray was or was not a member of the board at the time of the Presumed Transaction, or whether there were any other board members. Appellants suggest that Ms. Bray's participation in the vote is immaterial, but – as will be discussed below – Appellees disagree.

- The average age of the Members exceeds the average age of the insureds under the remaining life insurance portfolio, resulting in the unfortunate situation where, at least in the last year, members are passing at a higher rate than the insureds.

- The operating cost per average Member far exceeds the distributions payable to the average Member, resulting in a situation where the operating costs far exceed the returns it is possible to make to the Members.

- The total Member distribution of $7,015,000 is roughly equal to 3.3 times the net present value of the Company's assets.

- The total Member distribution of $7,015,000 is more than 2.5 times the aggregate value of the Company's shares, according to the most recent business valuation performed by the Company's independent professional advisors. (In December 2012, the Company obtained an independent valuation in the range of $3.4 million to $3.8 million; according to the Company's advisors, the portfolio as a whole has a net value of negative $300,000.)

(Appendix A65-A66).

The letter concluded that "the board believes that the original goals of POA have been achieved, and that a final distribution at this time will protect the Members from known future operating risks and the possibility for diminishing returns. (*Id*. at A66).

After POA sent the above letter and made its final distribution to its members, more that fifteen months passed before the filing of the initial complaint in this matter. Despite that passage of time, Appellants did not uncover and have not pled any details regarding the actual transaction that took place in October of 2013. They have not pled (1) who the board members were at the time of the Presumed Transaction; (2) which of those board members voted in favor of the transaction; (3)

what entities, other than POA, were involved in the Presumed Transaction; (4) who owned the other entity or entities; (5) what was the consideration for the Presumed Transaction; (6) what reserves were set aside; and (7) what is the current ownership status of any assets previously held by POA.

ARGUMENT

A. Question Presented

Whether the Court of Chancery was correct in dismissing, pursuant to Rule 12(b)(6), a complaint that challenged an alleged transaction under a bad faith standard but failed to plead any facts regarding the actual transaction that took place.

B. Standard and Scope of Review

The Court's evaluation of whether the SAC adequately states a claim for relief is a question of law that is reviewed *de novo*. *See Malpiede v. Townson*, 780 A.2d 1075 1082 (Del. 2001).

C. Merits of the Argument

1. Applicable Legal Standards

a. The 12(b)(6) Standard

Pursuant to Court of Chancery Rule 12(b)(6), a court may grant a motion to dismiss for failure to state a claim if a complaint does not assert sufficient facts that, if proven, would entitle the plaintiff to relief. *See Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 537 (Del.2011). "[T]he governing pleading standard in Delaware to survive a motion to dismiss is reasonable conceivability." *Id*.

> When considering a defendant's motion to dismiss, a trial court should accept all well-pleaded factual allegations in the Complaint as true, accept even vague allegations in the Complaint as 'well-pleaded' if they provide the defendant notice of the claim, draw all reasonable inferences in favor of the

> plaintiff, and deny the motion unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof.

Id. at 536 (citation omitted). A court will not credit conclusory allegations or draw unreasonable inferences in favor of a plaintiff. *See Price v. E.I. DuPont de Nemours & Co., Inc.*, 26 A.3d 162, 166 (Del.2011)

b. The Bad Faith Standard

In reaching its decision, the Court of Chancery first determined: "Both [Premium of America's and Premium Holding's] LLC Agreements exculpate certain fiduciary duties; the parties agree and I accept for purposes of this Memorandum Opinion, that the fiduciary duty applicable to the Presumed Transaction was that the managers would act in good faith." (Opinion at 13).

In order to sufficiently state a claim for relief under a "bad faith" standard, plaintiff must plead enough facts to show that a majority of the board of managers breached their fiduciary duty of loyalty to POA's members. *See In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 728 (Del.Ch.1999). Accordingly, to survive a motion to dismiss under Rule 12(b)(6), the SAC needs to contain sufficient facts to support an allegation that either (a) the majority of the board of managers was not both disinterested and independent, or (b) "that the [board] did not act in good faith." *In re Alloy, Inc. S'holder Litig.*, 2011 WL 4863716, at *6 (Del. Ch. Oct. 13, 2011).

A claim of bad faith hinges on a party's tortious state of mind. *See Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199,

1208 (Del. 1993). This Court has explained that an "extreme set of facts" is "required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009)

2. The Complaint Fails to Adequately Plead a Bad Faith Transaction

a. The SAC Does Not Plead Transaction Details

In this matter, the challenged transaction has been referred to as the "Presumed Transaction" for a reason. The reason is that the SAC does not plead *any* details about what actual transaction took place. As the Court of Chancery observed, the SAC did not plead: "the nature of the actual transaction by which the assets were liquidated, the nature of the board action, if any, in way of that transaction, who the parties to the transaction were, and the current ownership of the assets sold." (Opinion at 11).

Appellants claim that the Court should draw the inference that because a prior transaction purported to transfer the insurance assets of POA to TYRSS (a company that we now know did not actually exist (SAC ¶23, A40)), which was purportedly associated with two of the board members, that the Presumed Transaction did indeed transfer assets to those two board members. But that is not what the SAC pled. The one and only statement in the entire SAC regarding the Presumed Transaction is as

follows: "Thus, Defendants apparently implemented some form of the TYRSS proposal, distributing a part of POA's cash and taking the remaining assets of POA/PH for themselves." (SAC ¶33, A43). This is not a pled fact based on a document or even made on information and belief. It is no more than a conclusory statement, and the Court of Chancery was correct in concluding that the SAC failed to meet the pleading standards of Rule 12(b)(6). *See Price v. E.I. DuPont de Nemours & Co., Inc.*, 26 A.3d 162, 166 (Del.2011).

Because Appellants did not plead, on information and belief, any of the actual details of the transaction (such as the parties to the transaction, the consideration for the transaction, which board members approved the transaction, the ownership of the assets after the transaction, etc.), the Court of Chancery properly found that the SAC "was a vessel incapable of bearing the freight of the issues for which they seek adjudication." (Opinion at 2-3).

Appellant's arguments regarding the sufficiency of the SAC's fair value allegations are equally problematic. Appellants suggest that because they pled that the amount distributed to the members by the Presumed Transaction was less than the amount proposed by the rejected TYRSS proposal, that "is a well-pleaded fact demonstrating unfairness." (Opening Brief at 20). The Court of Chancery found that inference was simply not supportable. The Court of Chancery determined that the SAC "fails to describe, among other facts, the Presumed Transaction itself, to

whom Premium's assets were transferred, the details of that transfer, the liabilities of Premium that were discharged before distribution of the remaining assets, and the liability reserves maintained by Premium." (Opinion at 18). Without those facts, it was entirely proper for the Court of Chancery to conclude that is was "unsustainable" to draw an inference that the Presumed Transaction was fundamentally unfair. (Opinion at 18-19).

In sum, the SAC lacks even the most basic information needed to meet the notice pleading standard. While those standards are low, the SAC is a perfect example of a complaint that fails to meet those low standards and must be dismissed pursuant to Rule 12(b)(6).

b. The Composition of the Board Is Critical

Because the standard in this matter is bad faith, Appellants must show that the SAC pled enough facts to support a claim that either (a) a majority or the board of managers who approved the Presumed Transaction were not disinterested, or (b) that the disinterested directors acted in bad faith. *In re Alloy, Inc. S'holder Litig.*, 2011 WL 4863716, at *6. The Court of Chancery correctly concluded that the allegations contained in the SAC provided "a wholly insufficient ground on which to rest an inference on bad faith on the part of [the board]." (Opinion at 16-17).

The facts pled in the SAC cannot not rise to the "extreme" standard required by this Court (*see Lyondell Chem. Co. v. Ryan*, 970 A.2d at 243) because, quite

simply, the SAC does not plead *any* actual fact regarding the Presumed Transaction. Only the after effects of the Presumed Transaction are described in the SAC, and those come from the letter sent by POA to its members. (A65-A66).

Appellants take issue with many of the statements contained within the letter. But it is clear that the points outlined in the letter, taken together with the admitted cannibalizing nature of the POA insurance portfolio, disprove rather than establish the extreme set of facts that would be necessary to adequately plead bad faith on the part of a majority of disinterested directors. The SAC simply cannot support an inference that a majority of disinterested directors breached their duty of loyalty to POA.

The claims of Appellants must, therefore, turn on whether the majority of the board of managers who approved the transaction were interested in the transaction. Here again, the SAC's complete lack of information prevents drawing any inference as to the answer of that question. The SAC does not plead how many directors were on the board when the Presumed Transaction was approved. Nor does it plead who actually voted in favor of the transaction. There is simply no way for the Court to draw any inference whatsoever that the Presumed Transaction was or was not approved by a majority of disinterested directors.

Appellants argue that whether or not Lida Bray voted in favor of the transaction is immaterial (Opening Brief of Appellants at 1, n.1). Ms. Bray was not

named as a defendant in this action and Appellants seem to suggest that she was a disinterested director, even though she was the recipient of $100,000 in parting compensation from POA. Appellants argue that Ms. Bray received this payment in order to resign (SAC ¶31, A42) but do not plead whether or not she voted in favor of the Presumed Transaction. The SAC also alleges that Brian Tollefson[3] received the exact same $100,000 as Ms. Bray. (SAC ¶31, A42). Thus, if Ms. Bray voted for the Presumed Transaction and is still considered by Appellants as being a disinterested manager, despite receiving $100,000 in parting compensation from POA, then a reasonable inference would be that Mr. Tollefson is also a disinterested manager, since he received the identical parting[4] compensation as Ms. Bray.[5] That is why it is critical to understand who was on the board at the time of the Presumed Transaction and who actually voted for the Presumed Transaction. Unfortunately, that is something which the SAC fails to plead, and it therefore must be dismissed pursuant to Rule 12(b)(6).

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[3] While the Appellants' allegations often group the defendants together, this Court has "emphasized that each director has a right to be considered individually" when claims are brought challenging board actions. *In re Cornerstone Therapeutics, Inc. S'holder Litig.*, 115 A.3d 1173, 1182 (Del. 2015). No such individualized pleading is present in the SAC.

[4] Just like Ms. Bray, Mr. Tollefson resigned from the Board of Managers sometime before October 2013. (A73-A74). Appellants also consider this fact to be immaterial. (*Id.*)

[5] Appellants suggest that Mr. Tollefson is a close personal friend of Mr. Adams (SAC ¶¶ 5, 19 – A35, A39) but Appellants do not seem to suggest that the mere existence of a friendship would prohibit Mr. Tollefson from being disinterested in the Presumed Transaction.

3. Appellants Repeatedly Failed to Seek Books and Records

The Court of Chancery lamented the "unexplained" failure of the Appellants to seek the books and records of POA. (Opinion at 17). The Court of Chancery also noted that, had Appellants pursued a books and records action, they could have easily pled all of the facts that are missing from the SAC. (*Id*. at 17 n.3, *citing Thermopylae Capital Partners, L.P. v. Simbol, Inc.*, 2016 WL 368170, * 17 (Del. Ch. Jan. 29, 2016) (granting dismissal under Rule 12(b)(6) where stockholder plaintiffs drafted a complaint without full recourse to Section 220 and omitted pertinent facts to which they would have been entitled under Section 220)).

Here, Appellants had at least three clear chances to seek relevant books and records. They could have filed an action under Section 18-305 before filing their initial complaint. They also could have voluntarily dismissed their action *without prejudice*, or even sought to stay their action prior to filing their first or second amended complaints, in order to pursue an action under Section 18-305. The weakness of the pleadings should have been apparent to Appellants before the filing of the SAC, as Appellees' motion to dismiss the first amended complaint addressed those shortcomings in exacting detail. Yet Appellants again and again choose to forego seeking POA's books and records, insisting to this day that such a step was unnecessary. (Opening Brief at 12, n.5). The Court of Chancery was right in finding

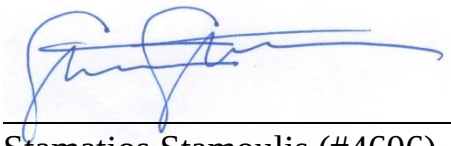
that Appellants should have first sought the books and records of POA before filing the SAC, and the complaint was properly dismissed pursuant to Rule 12(b)(6).

D. Conclusion

For all of the foregoing reasons, the Order of the Court of Chancery dismissing the SAC pursuant to Rule 12(b)(6) was correct and should, therefore, be affirmed.

Dated: August 11, 2016

STAMOULIS & WEINBLATT LLC



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CERTIFICATE OF SERVICE

I, Stamatios Stamoulis, hereby certify that on August 11, 2016, a copy of the foregoing ANSWERING BRIEF OF DEFENDANTS BELOW – APPELLEES was served via File & ServeXpress upon the following counsel of record:

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