BUSINESS ASSOCIATIONS

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INTRODUCTION

The period covered by this *Survey* was marked by significant decisions, of which *Kirschner v. KPMG LLP*, discussed under the topic of Agency below, seems to the authors to be especially worth discussing at length and in detail.

I. LEGISLATIVE DEVELOPMENTS

The *Survey* period contained no legislative developments in the law of business associations.

II. AGENCY

An exceptional decision in this survey period was *Kirschner v. KPMG LLP*.[1] In *Kirschner*, the Court of Appeals reaffirmed the New York doctrine of *in pari delicto* as an affirmative defense and declined to alter precedent relating to the doctrine and its adverse interest exception to agency imputation principles.[2]

A. Kirschner v. KPMG LLP

In *Kirschner v. KPMG LLP* and *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*, the Court of Appeals interpreted and reaffirmed the New York doctrine of *in pari delicto*, whereby courts in New York refrain from interceding in the resolution of disputes between two wrongdoers.[3] In a tightly reasoned opinion, countered by a cogent dissent, a majority of the Court declined to alter precedent relating to the doctrine and its adverse interest exception to agency imputation principles, and by so doing, declined to expand third party liability.[4]

The decision was handed down in response to certified questions presented in *Kirschner* by the United States Court of Appeals for the Second Circuit[5] and for *Teachers' Retirement*[6] by the Supreme Court of Delaware (the "Delaware Court").[7] In each instance, the questions

1. *See generally* 15 N.Y.3d 446, 938 N.E.2d 941, 912 N.Y.S.2d 512 (2010).
2. *Id.* at 457, 938 N.E.2d at 945, 912 N.Y.S.2d at 512.
3. *Id.*, 464, 938 N.E.2d at 945, 950, 912 N.Y.S.2d at 512, 517.
4. *Id.*, 938 N.E.2d at 945, 912 N.Y.S.2d at 512.
5. *See* Kirschner v. KPMG LLP, 590 F.3d 186, 194-95 (2d Cir. 2009).
6. *See* Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers LLP, 998 A.2d 280, 282-83 (Del. 2010).
7. *See* N.Y. CONST. art. 6, § 3(b)(9); N.Y. COMP. CODES R. & REGS. tit. 22, § 500.27

necessitated a close analysis of the *in pari delicto* doctrine and the policy reasons behind its application and exception. Among the eight certified questions presented in *Kirschner*, the Second Circuit particularly requested that the Court address "(2) whether the adverse interest exception [to the *Wagoner*[8] rule of imputing insiders' misconduct to their corporation] is satisfied by showing that the insiders intended to benefit themselves by their misconduct; [and] (3) whether the exception is available only where the insiders' misconduct has harmed the corporation . . . ."[9]

In *Teachers' Retirement*, the Delaware Court inquired:

> Would the doctrine of *in pari delicto* bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence based on the auditor's failure to detect fraud committed by the corporation; and, the outside auditor did not knowingly participate in the corporation's fraud, but instead, failed to satisfy professional standards in . . .audits of the corporation's financial statements[.][10]

1. Kirschner

A. Facts

Kirschner was "triggered by the collapse of Refco," a corporation which had been a "leading provider of brokerage and clearing services in the derivatives, currency and futures markets. After a leveraged buyout [(LBO)] in . . . 2004, Refco became a public company in . . . 2005 [pursuant to] an initial public offering [of shares]."[11] In October 2005, Refco disclosed that, as far back as 1998, its president and CEO had caused the company to enter into a series of loans "which hid hundreds of millions of dollars of the company's uncollectible debt from the public and regulators," presenting a false picture of the company's financial condition and causing a "run" on customer accounts, resulting in Refco's filing for bankruptcy protection.[12]

In 2006, the bankruptcy court confirmed Refco's bankruptcy plan which provided for payment of creditors and established a litigation

(2010).

8. *See generally* Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2d Cir. 1991).

9. *Kirschner*, 590 F.3d at 194-95.

10. *Teachers' Ret. Sys.*, 998 A.2d at 282-83.

11. Kirschner v. KPMG, LLP, 15 N.Y.3d 446, 457, 938 N.E.2d 941, 945, 912 N.Y.S.2d 512, 512 (2010).

12. *Id*. at 457-58, 938 N.E.2d at 945-46, 912 N.Y.S.2d at 512-13.

trust for the benefit of Refco's general unsecured creditors (the "Trust").[13] Marc Kirschner, the named plaintiff in *Kirschner*, was appointed Litigation Trustee (the "Trustee"), empowered "to pursue claims and causes of action possessed by Refco prior to its bankruptcy filing."[14] In 2007, the Trustee filed a complaint in Illinois state court that asserted, inter alia, "fraud, breach of fiduciary duty and malpractice" by Refco's officers, owners, and senior managers, as well as retained professionals, such as its law firm, the "investment banks [which had] served as underwriters [of] the LBO," its accounting firm, and certain customers who participated in the allegedly deceptive loans.[15] The Trustee alleged that "these defendants all aided and abetted the Refco insiders in carrying out the fraud, or were negligent in neglecting to discover it."[16] A year later a similar suit was filed in Massachusetts state court asserting claims against the accounting firm KPMG LLP.[17] "Both lawsuits were [subsequently] removed to federal court and transferred to the [U.S. District Court for the] Southern District of New York . . . ."[18]

Defendants moved to dismiss the Trustee's claims and the district court granted the motion.[19] "Because the Trustee acknowledged that the Refco insiders masterminded Refco's fraud, the judge identified as the threshold issue whether the claims were subject to dismissal [under] the Second Circuit's *Wagoner* rule."[20] The *Wagoner* rule meant, in effect, that the Trustee lacked "standing to seek recovery from [the] third parties [which had] joined with the debtor corporation in defrauding creditors."[21] "Further, since '[a]ll parties agree[d] that if the *Wagoner* rule applie[d], the Litigation Trustee lack[ed] standing to assert any of Refco's claims against the defendants,' the judge observed that 'the parties' dispute focus[ed] solely on whether the narrow exception to the *Wagoner* rule—the adverse-interest exception—applie[d]."[22]

13. *Id.* at 458, 938 N.E.2d at 946, 912 N.Y.S.2d at 513.

14. *Id.*

15. *Id.* at 458-59, 938 N.E.2d at 946, 912 N.Y.S.2d at 513.

16. *Kirschner*, 15 N.Y.3d at 459, 938 N.E.2d at 946, 912 N.Y.S.2d at 513.

17. *Id.*

18. *Id.*

19. *Id.* (citing FED. R. CIV. P. 12(b)(1), (6)).

20. *Id.*

21. *Kirschner*, 15 N.Y.3d at 459, 938 N.E.2d at 946, 912 N.Y.S.2d at 513 (citing Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991)).

22. *Id.*, 938 N.E.2d at 946-47, 912 N.Y.S.2d at 513-14 (quoting Kirschner v. Grant Thornton LLP, No. 07 Civ. 11604, 2009 WL 1286326, at *5 (S.D.N.Y. 2009)).

B. Standing v. Affirmative Defense

In a footnote, the Court observed that, despite the district court's broad characterization of the *Wagoner* rule as "an application of the substantive law of New York,"[23] the rule was in fact derived from federal bankruptcy law and:

> is not part of New York law except as it reflects the *in pari delicto* principle, and in New York, *in pari delicto* is an affirmative defense, not a matter of standing. Even so—and although the Litigation Trustee may be understood to imply otherwise—*in pari delicto* may be resolved on the pleadings in a state court action in an appropriate case.[24]

The Court first reviewed the reasoning of the district court in light of Second Circuit precedents. The district court had concluded that the Trustee had failed to "establish injury to Refco, because the Refco insiders did not embezzle or steal assets from Refco, but instead sold their holdings in Refco to third parties at fraudulently inflated prices," with the result that the insiders benefitted, not from the corporation, but from the new purchasers of the inflated value securities.[25] In other words, for the district court, "the Trustee must allege, not that the [Refco] insiders intended to, or to some extent did, benefit from their scheme, but that the corporation was *harmed* by the scheme, rather than being one of its beneficiaries."[26] Said another way, "the [corporate officer] must have totally abandoned [the corporation's] interests and be acting entirely for his own or another's purposes . . . because where an officer acts entirely in his own interests and adversely to the interests of the corporation, that misconduct cannot be imputed to the corporation."[27]

The Trustee's appeal from that decision prompted the Second Circuit to reconsider how "the adverse interest exception is [to be] satisfied" under New York law, and notably, "whether the exception is available only where . . . insiders [have] harmed the corporation."[28] Both questions, with six others, were then certified and presented to the

23. *Id.* at 459 n.3, 938 N.E.2d at 946 n.3, 912 N.Y.S.2d at 513 n.3 (quoting *Kirschner*, 2009 WL 1286326, at *1 n.4).

24. *Id*. at 459, 938 N.E.2d at 947, 912 N.Y.S.2d at 514.

25. *Id*. at 461, 938 N.E.2d at 948, 912 N.Y.S.2d at 515.

26. *Kirschner*, 15 N.Y.3d at 461, 938 N.E.2d at 948, 912 N.Y.S.2d at 515 (quoting *Kirschner*, 2009 WL 1286326, at *7).

27. *Id*. at 460, 938 N.E.2d at 947, 912 N.Y.S.2d at 514 (quoting *Kirschner*, 2009 WL 1286326, at *5).

28. *Id.* at 462, 938 N.E.2d at 948, 912 N.Y.S.2d at 515 (quoting Kirschner v. KPMG LLP, 590 F.3d 186, 194-95 (2d Cir. 2009)).

Court of Appeals.[29]

2. Teachers' Retirement

This lawsuit began as a derivative action brought on behalf of American International Group (AIG) by the derivative plaintiffs, the Teachers' Retirement System of Louisiana and the City of New Orleans Employees' Retirement System.[30] The complaint claimed that "senior officers of AIG set up a fraudulent scheme to misstate AIG's financial performance in order to deceive investors into believing that the company was more prosperous and secure than it really was."[31] In addition, the officers were accused of:

> causing the corporation to avoid taxes by falsely claiming that workers' compensation policies were other types of insurance, and of engaging in "covered calls" to recognize investment gains without paying capital gains taxes. It also claimed that AIG conspired with other companies to rig markets to subvert supposedly competitive auctions, and that the senior officers exploited their familiarity with improper financial machinations by selling the company's "expertise" in balance sheet manipulation.[32]

When this wrongdoing eventually came to light, AIG experienced undeniable harm.[33] "Stockholder equity was reduced by $3.5 billion, and AIG was saddled with litigation and regulatory proceedings requiring it to pay over $1.6 billion in fines and other costs."[34]

The "[d]erivative plaintiffs [did] not allege that . . . PricewaterhouseCoopers LLP (PwC) conspired with AIG," but rather, that it "did not perform its auditing responsibilities in accordance with professional standards of conduct, and so failed to detect or report the fraud perpetrated . . . ."[35] When PwC moved to dismiss, "the Delaware Court of Chancery granted the motion, concluding that New York law applied to the claims and that, under New York law, the claims were barred."[36] As with the district court in *Kirschner*:

> the vice-chancellor decided that . . . the wrongdoing of AIG's senior officers was imputed to AIG and that, based on the allegations in the

29. *Id.*

30. *Id.*, 938 N.E.2d at 948-49, 912 N.Y.S.2d at 515-16.

31. *Kirschner*, 15 N.Y.3d at 462, 938 N.E.2d at 949, 912 N.Y.S.2d at 516.

32. *Id.*

33. *Id.* at 463, 938 N.E.2d at 949, 912 N.Y.S.2d at 516.

34. *Id.*

35. *Id.*

36. *Kirschner*, 15 N.Y.3d at 463, 938 N.E.2d at 949, 912 N.Y.S.2d at 516 (citing *In re* Am. Intl. Grp., Inc., 965 A.2d 763, 823 (Del. Ch. 2009)).

> complaint, AIG's senior officers did not totally abandon AIG's interests such that the adverse interest exception to imputation would apply. Once the wrongdoing was imputed to AIG, the Court of Chancery decided that AIG's claims against PwC were barred by New York's in pari delicto doctrine and the *Wagoner* rule . . . .[37]

The appeal to the Delaware Court, resulted in the certified question being presented to the Court of Appeals and set the stage for the decision under review.[38]

3. The Majority's Analysis

A. In pari delicto

The majority stated that "*in pari delicto* mandates that the courts . . . not intercede to resolve a dispute between two wrongdoers."[39] Applied in case law in New York since 1800,[40] the doctrine is shorthand for "*in pari delicto potior est conditio defendentis*," that is, "[i]n a case of equal or mutual fault, the position of the [defending party] is the better one."[41] Anchoring its decision on this principle, the majority held that public policy to deter illegality is better served by "denying judicial relief to an admitted wrongdoer" and by avoiding entanglement in disputes between wrongdoers.[42] "[N]o court should be required to serve as paymaster of the wages of crime, or referee between thieves."[43] Further, the principle applies not only where "both parties acted willfully," but is "so strong in New York that we have said the defense applies even in difficult cases and should not be 'weakened by exceptions.'" [44]

37. *Id.*

38. *Id.*

39. *Id.* at 464, 938 N.E.2d at 950, 912 N.Y.S.2d at 517.

40. *Id.*; *see also* Woodworth v. Janes, 2 Johns. Cas. 417, 423 (1801); Sebring v. Rathbun, 1 Johns. Cas. 331, 332 (1800) (two cases arising out of the same transaction between the buyer and seller of land, both of whom were aware that title to the land was faulty).

41. *Kirschner*, 15 N.Y.3d at 464 n.4, 938 N.E.2d at 950 n.4, 912 N.Y.S.2d at 517 n.4 (quoting Baena v. KPMG LLP, 453 F.3d 1, 6 n.5 (1st Cir. 2006) (emphasis added)).

42. *Id.* at 464, 938 N.E.2d at 950, 912 N.Y.S.2d at 517.

43. *Id.* at 464 n.4, 938 N.E.2d at 950 n.4, 912 N.Y.S.2d at 517 n.4 (quoting Stone v. Freeman, 298 N.Y. 268, 271, 82 N.E.2d 571, 572 (1948) (where principal gave agent money for payment of a commercial bribe and agent did not use all of the money, the principal cannot sue the agent to recoup the unspent amount)).

44. *Id*. at 464, 938 N.E.2d at 950, 912 N.Y.S.2d at 517 (quoting McConnell v. Commonwealth Pictures Corp., 7 N.Y.2d 465, 470, 166 N.E.2d 494, 497, 199 N.Y.S.2d 483, 486 (1960)).

B. Imputation

In construing the doctrine, the Court noted that "[t]raditional agency principles play an important role in an *in pari delicto* analysis," and is substantively informed by the "law of agency and corporations . . . namely [that] the acts of agents, and the knowledge they acquire while acting within the scope of their authority are presumptively imputed to their principals . . . [c]orporations are not natural persons."[45]

Reciting chapter and verse of corporate and agency law, the Court took note of the fact that corporations "must act solely through the instrumentality of their officers or other duly authorized agents,"[46] which then must "be responsible for the acts of its . . . agents, even if particular acts were unauthorized";[47] and that the "[t]he risk of loss from unauthorized acts of a dishonest agent falls on the principal that selected the agent"[48] because the law recognizes that the "principal is generally better suited than a third party to control the agent's conduct . . . ."[49] "Agency law presumes imputation even where the agent acts less than admirably, exhibits poor business judgment, or commits fraud."[50]

Rounding out its argument, the Court observed that the "presumption that agents communicate information to their principals does not depend on a case-by-case assessment of whether this is likely to happen. Instead, it is a legal presumption that governs in every case, except where the corporation is actually the agent's intended victim" and, that in such circumstances, the corrupt agent "cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose."[51] Summing up, the Court concluded that, "as with in pari delicto, there are strong considerations of public policy underlying th[e] precedent: imputation fosters an incentive for a principal to select

45. *Id*. at 465, 938 N.E.2d at 950, 912 N.Y.S.2d at 517 (emphasis added).

46. *Kirschner*, 15 N.Y.3d at 465, 938 N.E.2d at 950, 912 N.Y.S.2d at 517 (quoting Lee v. Pittsburgh Coal & Min. Co., 56 How. Pr. (n.s.) 373, 375 (N.Y. Sup. Ct. 1877)).

47. *Id.*

48. *Id.*, 938 N.E.2d at 951, 912 N.Y.S.2d at 518 (quoting Andre Romanelli, Inc. v. Citibank, N.A., 60 A.D.3d 428, 429, 875 N.Y.S.2d 14, 16 (1st Dep't 2009)).

49. *Id.*

50. *Id.*; *see also* Price v. Keyes, 62 N.Y. 378, 384-85 (1875) (observing that the "critical issue is whether agent was acting in furtherance of his duties, regardless of his 'selfish motive'").

51. *Kirschner*, 15 N.Y.3d at 466, 938 N.E.2d at 951, 912 N.Y.S.2d at 518 (quoting Ctr. v. Hampton Affiliates, Inc., 66 N.Y.2d 782, 784, 488 N.E.2d 828, 829, 497 N.Y.S.2d 898, 899-900 (1985)).

honest agents and delegate duties with care."[52]

C. Adverse interest exception to imputation

As to the doctrine's corollary, the Court stated:

> "To come within the exception, the agent must have *totally abandoned* his principal's interests and be acting *entirely* for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." This rule avoids ambiguity where there is a benefit to both the insider and the corporation, and reserves this most narrow of exceptions for those cases—outright theft or looting or embezzlement—where the insider's misconduct benefits only himself or a third party; i.e., where the fraud is committed *against* a corporation rather than on its behalf.[53]

In a fairly broad generalization, the Court posited that an agent can be relied upon to communicate material information to his principal in all situations "except in the narrow circumstance where the corporation is actually the victim of a scheme undertaken by the agent to benefit himself or a third party personally . . . ."[54] Having thus stated its premise and its narrowly defined exception, the majority concluded that "[a] fraud that by its nature will benefit the corporation is not 'adverse' to the corporation's interests, even if it was actually motivated by the agent's desire for personal gain."[55]

In a reprise on this theme, the majority stated: "[a]gain, because the exception requires adversity, it cannot apply unless the scheme that benefitted the insider operated at the corporation's expense. The crucial distinction is between conduct that defrauds the corporation and conduct that defrauds others for the corporation's benefit."[56] Rejecting the Trustee's pleading, the Court declared that a filing of bankruptcy is insufficient to evidence the degree of harm necessary to trigger the exception: "[e]ven where the insiders' fraud can be said to have caused the company's ultimate bankruptcy, it does not follow that the insiders 'totally abandoned' the company."[57]

The majority continued with a veritable exegesis of the nature of the harm required to trigger an exception to the rule, holding that only harm from the fraud itself, not the discovery of the fraud, meets the

52. *Id*., 938 N.E.2d at 951-52, 912 N.Y.S.2d at 518-19.

53. *Id.* at 466-67, 938 N.E.2d at 952, 912 N.Y.S.2d at 519 (quoting *Ctr*., 66 N.Y.2d at 784-85, 488 N.E.2d at 830, 497 N.Y.S.2d at 900) (emphasis in original).

54. *Id*. at 467, 938 N.E.2d at 952, 912 N.Y.S.2d at 519.

55. *Id*. (citing *Price*, 62 N.Y. at 384).

56. *Kirschner*, 15 N.Y.3d at 467-68, 938 N.E.2d at 952, 912 N.Y.S.2d at 519.

57. *Id*. at 468, 938 N.E.2d at 953, 912 N.Y.S.2d at 520.

test;[58] and that consideration of the insiders' intent "does not defeat the adverse interest exception," nor does demonstrated corruption and plundering of the company by insiders.[59] Indeed, "fraudsters are presumably not, as a general rule, motivated by charitable impulses, and a company victimized by fraud is always likely to suffer long-term harm once the fraud becomes known."[60] In the majority's view, to entertain arguments such as these would require reformulation of the adverse interest exception and would, in the words of the district court, "'explode' the exception."[61]

D. Comparative negligence and the rule

The majority then turned to a careful analysis of the decisions made by the highest courts of two other states which reconsidered, and then revised, the doctrine. "Our sister states fashioned carve-outs from traditional agency law in cases of corporate fraud so as to deny the in pari delicto defense to negligent or otherwise culpable outside auditors (New Jersey)[62] and [to] collusive outside professionals (Pennsylvania)."[63]

In the New Jersey case, two corporate officers of a publicly traded company intentionally misrepresented the company's financial status to investors and to its accounting firm, KPMG.[64] After KPMG discovered the fraud "by spotting and reporting certain accounting irregularities," the corporation's "fortunes quickly sank, leading to bankruptcy and significant investor losses."[65] Shareholder groups filed lawsuits against the company and the corporate wrongdoers.[66] A litigation trust was established as part of the bankruptcy plan, and the trust filed suit against the accounting firm alleging that it had "negligently failed to exercise due professional care in the performance of its audits and in the

58. *Id.* at 469, 938 N.E.2d at 953, 912 N.Y.S.2d at 520.

59. *Id*. at 470, 938 N.E.2d at 954, 912 N.Y.S.2d at 521.

60. *Id*. at 470-71, 938 N.E.2d at 955, 912 N.Y.S.2d at 522.

61. *Kirschner*, 15 N.Y.3d at 470, 938 N.E.2d at 954-55, 912 N.Y.S.2d at 521-22 (quoting Kirschner v. Grant Thornton LLP, No. 07 Civ. 11604, 2009 WL 1286326, at *7 n.14 (S.D.N.Y. 2009)).

62. *Id*. at 471, 938 N.E.2d at 955, 912 N.Y.S.2d at 522; *see generally* NCP Litig. Trust v. KPMG LLP, 901 A.2d 871 (N.J. 2006).

63. *Kirschner*, 15 N.Y.3d at 471, 938 N.E.2d at 955, 912 N.Y.S.2d at 522; *see generally* Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers LLP, 989 A.2d 313 (Pa. 2010).

64. *Kirschner*, 15 N.Y.3d at 471, 938 N.E.2d at 955, 912 N.Y.S.2d at 522.

65. *Id.*

66. *Id.*

preparation of the financial statements and audit reports."[67]

When KPMG raised the doctrine as an affirmative defense, "the New Jersey Supreme Court held that 'when an auditor is negligent within the scope of its engagement, the imputation doctrine does not prevent corporate shareholders from seeking to recover.'"[68] As the majority observed, "the New Jersey rule calls for the relative faults of the company/shareholders and auditors to be sorted out by the factfinder as matters of comparative negligence and apportionment."[69]

In the Pennsylvania case, "a nonprofit operator of health care facilities . . . embarked []on an aggressive campaign" to expand its operations into various health care fields.[70] The plan not only failed to produce any cost savings or revenue increases, as anticipated, but actually resulted in substantial losses.[71] The company's "chief executive and financial officers allegedly knowingly misstated [the company's] finances in figures they provided to the organization's outside auditor[s] . . . in 1996 and 1997 to hide the corporation's substantial operating losses."[72] The company's bankruptcy filing resulted in the creation of a committee of unsecured creditors which, acting on behalf of the debtor corporation, brought claims in federal court against the corporation's insiders and its accounting firm, PwC.[73]

> The claims against PwC alleged professional negligence, breach of contract, and aiding and abetting the breach of fiduciary duty by the [company's] officers. The committee's theory was that PwC's audits in 1996 and 1997 should have brought management's misstatements to light, but rather than issuing an adverse opinion as generally accepted accounting principles (GAAP) . . . required, PwC knowingly assisted in the corporate insiders' misconduct by issuing "clean" opinions.[74]

On appeal from the district court's decision denying its claims, "[t]he committee . . . argue[d] that imputation was inapplicable because the auditors were alleged to have wrongfully colluded with [the company's] insiders . . . ."[75] The Third Circuit, deciding that the issue

67. *Id.* (quoting *NCP Litig. Trust*, 901 A.2d at 876-77).

68. *Id.* at 472, 938 N.E.2d at 955, 912 N.Y.S.2d at 522 (quoting *NCP Litig. Trust*, 901 A.2d at 890).

69. *Kirschner*, 15 N.Y.3d at 472, 938 N.E.2d at 955, 912 N.Y.S.2d at 522.

70. *Id.*, 938 N.E.2d at 956, 912 N.Y.S.2d at 523.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Kirschner*, 15 N.Y.3d at 472, 938 N.E.2d at 956, 912 N.Y.S.2d at 523.

75. *Id*. at 472-73, 938 N.E.2d at 956, 912 N.Y.S.2d at 523.

was one of first impression under Pennsylvania law, certified the following question to the Pennsylvania Supreme Court: "whether imputation [was] appropriate when the party invoking that doctrine [was] not conceded to be an innocent third party, but an alleged co-conspirator in the agent's fraud."[76]

Upon reconsideration of the issue, as presented by the Third Circuit, the Pennsylvania Supreme Court shifted away from its strict doctrinal approach. The result was the Third Circuit's holding that, "when a third party, such as an auditor, colludes with agents to defraud their principal, 'Pennsylvania law requires an inquiry into whether the third party dealt with the principal in good faith . . . .'"[77]

E. Public policy and the majority

The majority in *Kirschner* expressly acknowledged that the decision whether or not to apply the *in pari delicto* doctrine was a question of public policy.[78]

The Court noted that someone has to bear the loss from the wrongdoing and asked, "why should the interests of [the] innocent stakeholders of corporate fraudsters trump those of innocent stakeholders of the outside professionals . . .?"[79] In the Court's view, "owners and creditors of KPMG and PwC may be said to be at least as 'innocent' as Refco's unsecured creditors and AIG's stockholders."[80] The Court also thought that any shifting of liability would ultimately mean added costs to the public; supporting this view with a quotation from the U.S. Court of Appeals for the First Circuit: "[n]o one sophisticated about markets believes that multiplying liability is free of cost. And the cost, initially borne by those who raise capital or provide audit or other services to companies, gets passed along to the public."[81]

In furtherance of its hypothesis, the majority observed that the corporation has received some benefit from the fraud by its officers, even if that benefit is evanescent or theoretical; but if the corporation

76. *Id.* at 473, 938 N.E.2d at 956, 912 N.Y.S.2d at 523 (quoting Official Comm. of Unsecured Creditors of Alleghany Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP, No. 07-1397, 2008 WL 3895559, at *4 (3d Cir. 2008)).

77. *Id.* at 474, 938 N.E.2d at 957, 912 N.Y.S.2d at 524 (quoting Official Comm. of Unsecured Creditors of Alleghany Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP, 607 F.3d 346, 348 (3d Cir. 2010)).

78. *See id.* at 474-75, 938 N.E.2d at 957, 912 N.Y.S.2d at 524.

79. *Kirschner*, 15 N.Y.3d at 475, 938 N.E.2d at 958, 912 N.Y.S.2d at 525.

80. *Id.* at 476, 938 N.E.2d at 958, 912 N.Y.S.2d at 525.

81. *Id.* (quoting Sec. & Exch. Comm'n v. Tambone, 597 F.3d 436, 452-53 (1st Cir. 2010) (Boudin, J., concurring)).

did not, then the adverse interest exception would apply, with the consequence that the auditor could not impute the agent's fraud to its principal, and the auditor could not plead the *in pari delicto* defense.[82] If the corporation could hold the auditor liable in such a case, then "the creditors and shareholders of the company that employs miscreant agents [would] enjoy the benefit of their misconduct without suffering the harm."[83]

In addition to reasoning that equity favored the auditors, if it favored either side, the majority was not convinced that auditors needed to be held liable in order to deter malpractice or misconduct, nor did it think that the auditors were given a "'get-out-of-jail-free' card":

> [A]s any former partner at Arthur Andersen LLP—once one of the "Big Five" accounting firms—could attest, an outside professional (and especially an auditor) whose corporate client experiences a rapid or disastrous decline in fortune precipitated by insider fraud does not skate away unscathed. In short, outside professionals—underwriters, law firms and especially accounting firms—already are at risk for large settlements and judgments in the litigation that inevitably follows the collapse of an Enron, or a Worldcom or a Refco or an AIG-type scandal. Indeed, in the Refco securities fraud litigation, the IPO's underwriters, including the three underwriter defendants in this action, have agreed to settlements totaling $53 million. In the AIG securities fraud litigation, PwC settled with shareholder plaintiffs last year for $97.5 million.[84]

The majority further noted that so-called "gatekeeper failure" had been addressed by Congress and the United States Securities and Exchange Commission in the Sarbanes-Oxley Act of 2002 and the Commission's implementing rules.[85]

Finally, the majority invoked stare decisis:

> The speculative public policy benefits advanced by the . . . plaintiffs to vindicate the changes they seek do not, in our view, outweigh the important public policies that undergird our precedents in this area or the importance of maintaining the stability and fair measure of certainty which are prime requisites in any body of law. We are simply not presented here with the rare case where, in the words of former Chief Judge Loughran, the justification and need for departure

82. *See id*. at 466-69, 938 N.E.2d at 952-53, 912 N.Y.S.2d at 519-20 (the Court's discussion of "Adverse Interest Exception to Imputation").

83. *Id.* at 476-77, 938 N.E.2d at 959, 912 N.Y.S.2d at 526.

84. *Kirschner*, 15 N.Y.3d at 476, 938 N.E.2d at 958, 912 N.Y.S.2d at 525 (internal citations omitted).

85. *Id*. at 476 n.6, 938 N.E.2d at 958 n.6, 912 N.Y.S.2d at 525 n.6.

from carefully developed legal principles are clear and cogent.[86]

4. The Dissent's Analysis

Judge Ciparick, in her dissenting opinion, joined by Chief Judge Lippman and Judge Pigott, argued that there should be an exception "for cases involving corporate insider fraud enabled by complicit or negligent outside gatekeeper professionals."[87]

The dissent agreed with the majority that the *in pari delicto* doctrine is an affirmative defense and not a matter of standing, but differed as to its practical application.[88] In *Kirschner*, corporate insiders had engaged in conduct at least as bad—if not worse—than the defendants were alleged to have committed.[89] For the majority, by strictly applying the doctrine, no further presentation of facts by the defendants was necessary.[90] The dissent strongly disagreed, pointing out that the majority's:

> [D]ismissal of the complaints at this early stage of litigation based on agency principles and public policy, effectively creat[es] a per se rule that fraudulent insider conduct bars any actions against outside professionals by derivative plaintiffs or litigation trustees for complicitous assistance to the corrupt insider or negligent failure to detect the wrongdoing. The principles underlying this doctrine do not support such a hard-line stance.[91]

The dissent also questioned the majority's assertion that public policy benefits will better flow from strict application of the doctrine:

> [A] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it. Indeed, prolonging a corporation's existence in the face of ever increasing insolvency may be doing no more than keeping the enterprise perched at the brink of disaster. As was borne out here, in the case of Refco, insider fraud that merely gives the corporation life longer than it would naturally have is not a true benefit to the corporation but can be considered a harm. The majority's assertion that any corporate insider fraud that enables the business to survive defeats the adverse interest exception would, as alleged here, condone the actions of the

86. *Id.* at 477, 938 N.E.2d at 959, 912 N.Y.S.2d at 526 (internal citation omitted) (internal quotation marks omitted).

87. *Id.* at 484, 938 N.E.2d at 964, 912 N.Y.S.2d at 531 (Ciparick, J., dissenting).

88. *Id.* at 477, 478, 938 N.E.2d at 959, 960, 912 N.Y.S.2d at 526, 527 (Ciparick, J., dissenting).

89. *Kirschner*, 15 N.Y.3d at 457-58, 459, 938 N.E.2d at 945, 946, 912 N.Y.S.2d at 512, 513.

90. *Id.* at 477, 938 N.E.2d at 959, 912 N.Y.S.2d at 526.

91. *Id.* at 479, 938 N.E.2d at 960, 912 N.Y.S.2d at 527 (Ciparick, J., dissenting).

defendants.[92]

Beyond any potential harm or benefit to the corporation, the dissent's paramount concern was that "gatekeepers"— when they fail in that vital role—are more likely to escape: "[i]ndeed, these simplistic agency principles as applied by the majority serve to effectively immunize auditors and other outside professionals from liability wherever any corporate insider engages in fraud."[93] Stressing the importance of independently audited financial statements, the dissent expressed concern that the majority's strict construction of the doctrine—essentially immunizing the gatekeepers—will more likely encourage lax oversight.[94] In support of its contention, the dissent cited five law review articles criticizing immunization of auditors or attorneys.[95]

The dissent then turned to the New Jersey and Pennsylvania decisions, and how the doctrine was addressed.[96] The New Jersey Supreme Court focused on compensating innocent shareholders when an auditor is negligent, concluding that limiting the imputation rule "will properly compensate the victims of corporate fraud without indemnifying wrongdoers for their fraudulent activities. To the extent that shareholders are innocent of corporate wrongdoing, our holding provides just compensation to those plaintiffs."[97] The Pennsylvania Supreme Court focused instead on the fact that the principal and agent relationship between two human beings necessarily operates differently when the principal is a corporation:

> As to auditor collusion . . . the Pennsylvania Supreme Court explained that "the ordinary rationale supporting imputation breaks down completely in scenarios involving secretive, collusive conduct between corporate agents and third parties . . . because imputation rules justly operate to protect third parties on account of their reliance on an agent's actual or apparent authority." Accordingly, the court held that imputation—and therefore in pari delicto—"do[es] not (and should not) apply in circumstances in which the agent's authority is neither actual nor apparent, as where both the agent and the third party know very well that the agent's conduct goes unsanctioned by one or

92. *Id.* at 480-81, 938 N.E.2d at 962, 912 N.Y.S.2d at 529 (Ciparick, J., dissenting) (internal citations omitted) (internal quotation marks omitted).

93. *Id.* at 481, 938 N.E.2d at 962, 912 N.Y.S.2d at 529.

94. *Kirschner*, 15 N.Y.3d at 481-82, 938 N.E.2d at 962, 963, 912 N.Y.S.2d at 529, 530.

95. *Id.*, 938 N.E.2d at 962-63, 912 N.Y.S.2d at 529-30 (citations omitted).

96. *Id.* at 482, 938 N.E.2d at 963, 912 N.Y.S.2d at 530.

97. *Id.* (quoting NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 890 (N.J. 2006)).

more of the tiers of corporate governance."[98]

In a footnote, the dissent helpfully recapitulated the definition of apparent authority under New York law:

> Bearing on the underlying premises supporting imputation, agency law generally holds a principal responsible for the actions of an agent that are taken with actual or apparent authority. Whether apparent authority exists is a fact-based determination requiring inquiry into the conduct of the principal. In other words, apparent authority may exist if the principal's conduct has given rise to the appearance and belief that the agent possesses authority to act with respect to the third party. Notably, a third party with whom the agent deals may only rely on an appearance of authority to the extent that such reliance is reasonable.[99]

Declining to choose between either New Jersey's comparative negligence approach or Pennsylvania's good faith approach, the dissent simply credited both courts for having created reasonable exceptions to the *in pari delicto* doctrine.[100]

5. Conclusion

Kirschner is a significant decision in several ways. Both the majority and the dissenting opinions provide black-letter summaries of important agency law doctrines that apply to business entities and their agents. New York's *in pari delicto* doctrine, with its narrow imputation exception, was held to apply, virtually unchanged in theory since 1800, and was affirmed as an affirmative defense for a defendant to plead and prove.

While the opinions of both the majority and the dissent are tightly reasoned and compelling, it remains to be seen whether the law will continue to evolve to hold gatekeeper professionals to a higher standard than other corporate agents. If so, then the majority's strict application of the *in pari delicto* doctrine in cases of fraud by corporate insiders could well become an impediment to that purpose.

B. Other

DDJ Management, LLC v. Rhone Group LLC discusses how scienter can be imputed to persons holding the positions of directors,

98. *Id.* at 483, 938 N.E.2d at 963-64, 912 N.Y.S.2d at 530-31 (footnote omitted) (quoting Official Comm. of Unsecured Creditors of Alleghany Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP, 989 A.2d 313, 336 (Pa. 2010)).

99. *Kirschner*, 15 N.Y.3d at 483 n.3, 938 N.E.2d at 963 n.3, 912 N.Y.S.2d at 530 n.3 (internal citations omitted) (internal quotation marks omitted).

100. *Id.* at 484, 938 N.E.2d at 964, 912 N.Y.S.2d at 531.

officers, or agents of a business entity which is a defendant in an action for fraudulent concealment.[101] The plaintiffs in *DDJ Management* alleged that they made loans to the defendant, American Remanufacturers Holdings, Inc. (ARI), based upon fraudulent concealment of information by the borrower and other individual and corporate defendants, in the borrower's financial statements.[102] The complaint included the individuals who held positions with the corporate defendants.[103] The plaintiffs' difficulty was how, in the absence of discovery, plaintiffs could plead that the individuals acted with scienter.[104]

The court held that, "a plaintiff alleging an aiding-and-abetting fraud claim may plead actual knowledge generally, particularly at the pre-discovery stage, so long as such intent may be inferred from the surrounding circumstances."[105] The court found the surrounding circumstances "in part [from] the corporate positions and titles of the individual defendants," because it could be assumed that persons holding those positions would have knowledge of the fraud.[106] Not only could their knowledge be assumed, but the positions and titles implied "that these individuals actually operate the day-to-day business of corporate defendant, and consequently were involved in or knew about the alleged fraudulent concealment," and that they were acting on behalf of the corporate defendant and its shareholders and managers, who were also defendants.[107] The court took notice of the "numerous e-mails tending to establish the individual defendants' knowledge of the alleged misrepresentations," which, combined with their corporate positions and titles, allowed the individuals to be sued, as well as the entities they served.[108]

III. PARTNERSHIPS

In *Frame v. Maynard*, the Appellate Division, First Department, addressed calculation of the measure of damages in the context of a

101. *See generally* 78 A.D.3d 442, 911 N.Y.S.2d 7 (1st Dep't 2010).

102. *Id.* at 442-43, 911 N.Y.S.2d at 9.

103. *Id.* at 444, 911 N.Y.S.2d at 10.

104. *Id.* at 442, 911 N.Y.S.2d at 9.

105. *Id.* at 443, 911 N.Y.S.2d at 9; *see also* Oster v. Kirschner, 77 A.D.3d 51, 55-56, 905 N.Y.S.2d 69, 72 (1st Dep't 2010).

106. *DDJ Mgmt., LLC*, 78 A.D.3d at 444, 911 N.Y.S.2d at 10 (citing JP Morgan Chase Bank v. Winnick, 350 F. Supp. 2d 393, 400 (S.D.N.Y. 2004)).

107. *Id.* (quoting Pludeman v. N. Leasing Sys., Inc., 40 A.D.3d 366, 367, 837 N.Y.S.2d 10, 12 (1st Dep't 2007), *aff'd*, 10 N.Y.3d 486, 890 N.E.2d 184, 860 N.Y.S.2d 422 (2008)).

108. *Id.* at 444-45, 911 N.Y.S.2d at 10.

partner's breach of fiduciary duty.[109]

Frame and Maynard were the general partners of a limited partnership ("the Partnership") "formed in 1980, to acquire and operate a building at 5008 Broadway," which they called the "Project," situated on land which they had acquired as tenants in common.[110] Shares in the Partnership were purchased by limited partners, including Maynard.[111] Under the terms of the limited partnership agreement ("the Agreement"), net proceeds from the sale or refinancing of the Project "were to be split [sixty-forty] between the limited partners and the general partners."[112] In 1986, pursuant to the terms of a settlement agreement, "Frame conveyed his half-interest in the underlying land to the Partnership and resigned as general partner."[113] Maynard remained a fifty percent owner of the land.[114] The Agreement was later amended to provide that Frame was to "receive [twenty percent] of the net proceeds of a sale or refinancing of the 'real property in the Project,' with the remainder to be split [twenty-five percent] to the general partner and [seventy-five percent] to the limited partners."[115]

"In May 2001, Maynard offered to [purchase all] limited partners' interest[s] in the Partnership property for $842,427."[116] The offer included schedules purportedly showing the value of the building based on cash flow as shown in historical profit and loss statements.[117] "A majority of the limited partners consented to [the] acquisition[—by Maynard or a wholly owned entity—of] the building and the [fifty percent] ownership interest in the land owned by the [P]artnership."[118] Maynard, however, failed to disclose that since March, he had been negotiating with the Community Preservation Corporation (CPC) and a lender for a mortgage loan on the property in the proposed amount of $1,550,000; and, that in the course of the negotiations, Maynard had "provided CPC with 'adjusted' historical profit and loss [figures in] support[] [of] the proposed loan amount."[119] The independent appraisal prepared in June 2001 for the loan application valued the land and

109. *See generally* 83 A.D.3d 599, 922 N.Y.S.2d 48 (1st Dep't 2011).
110. *Id.* at 600, 922 N.Y.S.2d at 49.
111. *Id.*
112. *Id.*
113. *Id.*, 922 N.Y.S.2d at 49-50.
114. *Frame*, 83 A.D.3d at 601, 922 N.Y.S.2d at 50.
115. *Id.* at 600, 922 N.Y.S.2d at 50.
116. *Id.*
117. *Id.* at 600-01, 922 N.Y.S.2d at 50.
118. *Id.* at 601, 922 N.Y.S.2d at 50.
119. *Frame*, 83 A.D.3d at 601, 922 N.Y.S.2d at 50.

building at roughly $2.2 million.[120] In November 2001, Maynard distributed checks to each limited partner in the amount of $40,000, purportedly representing individual payouts for shares in the sale of the Partnership property.[121]

In February 2002, "Maynard assigned his right to acquire the Partnership property to . . . 5008 Broadway Associates, LLC (5008 LLC) for nominal consideration . . . ."[122] A deed to the property was filed.[123] "On the same date, 5008 LLC received a mortgage loan [through] CPC in the amount of $1,485,000," leaving approximately $1 million in net proceeds.[124] Later that month, Maynard made an additional distribution of $5,000 per share to each limited partner as a final distribution.[125]

At trial, Maynard testified that he never disclosed facts regarding the loan to his limited partners because he "simply didn't see any connection."[126] He denied knowledge of the appraisal prepared for the mortgage application to CPC, and claimed that his representations to the limited partners as to the value of the Partnership property were true and that it was the mortgage lenders which had overvalued the property.[127] As for his former general partner, Frame, Maynard testified that Frame had not received any distribution "because, after deducting the value of the half-interest in the land, there were no sales proceeds to distribute to him."[128]

In its analysis, the court deferred to the finder of fact and confirmed the legal principle that the lower court's decision is "not [to] be disturbed unless . . . the court's conclusions could not be reached under any fair interpretation,"[129] holding that "Maynard was not a credible witness, and that the limited partners, the loan mortgage officer from CPC and the appraiser who appraised the property . . . were credible." [130] As an aside, the court noted that Maynard's testimony was also at odds with documentary evidence and common sense: the

120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Frame*, 83 A.D.3d at 601, 922 N.Y.S.2d at 50.
125. *Id.*
126. *Id.*
127. *Id.*
128. *Id.*
129. *Frame*, 83 A.D.3d at 601-02, 922 N.Y.S.2d at 50 (citing Thoreson v. Penthouse Int'l, Ltd., 80 N.Y.2d 490, 495, 606 N.E.2d 1369, 1370, 591 N.Y.S.2d 978, 979 (1992)).
130. *Id.* at 602, 922 N.Y.S.2d at 50.

defendant had to have known about the appraisal.[131]

Furthermore, the record fully supported the trial court's conclusion that Maynard, as general partner, had breached his fiduciary duty to the limited partners—a duty which continued "until the moment the buy-out transaction closed."[132] Such a duty, the court went on to say, "imposes a stringent standard of conduct that requires a fiduciary to act with 'undivided and undiluted loyalty.'"[133]

> "Consistent with [that] standard of conduct, . . . when a fiduciary . . . deals with the beneficiary of the duty in a matter relating to the fiduciary relationship, the fiduciary is strictly obligated to make full disclosure of all material facts," meaning those "that could reasonably bear on [the beneficiary's] consideration of [the fiduciary's] offer."[134]

The appellate court also held that it was "beyond dispute that the facts relating to Maynard's negotiation of [the] mortgage loan"—a loan that required that the property be valued at over $2 million—necessarily had a bearing on the offer valued at $842,427 that Maynard presented to the limited partners.[135] "Since the consents were revocable and the partnership was not dissolved, Maynard had a continuing duty to inform the limited partners of material facts."[136] Likewise, the limited partners "were entitled to rely on Maynard's 'representations and undivided loyalty' and were not required to perform 'independent inquiries' in order to reasonably rely on their fiduciary's representations."[137]

It did not matter that certain of the limited partners, who had joined in the lawsuit against Maynard, had misgivings as to the "amazingly low" price of their distributions, since "[n]either was aware of any information that rendered their reliance unreasonable . . . ."[138] Nor did another investor's:

> impressive educational and professional credentials . . . warrant a finding that that he did not justifiably rely on Maynard's material misrepresentations and omissions. Even if he had inquired further,

131. *Id.*, 922 N.Y.S.2d at 50-51.

132. *Id.*, 922 N.Y.S.2d at 51 (quoting Blue Chip Emerald LLC v. Allied Partners, Inc., 299 A.D.2d 278, 279, 750 N.Y.S.2d 291, 294 (1st Dep't 2002), *abrogated in part by* Centro Empresarial Cempresa S.A. v. Am. Movil, 17 N.Y.3d 269, 952 N.E.2d 995, 929 N.Y.S.2d 3 (2011)).

133. *Id.* (quoting *Blue Chip Emerald LLC*, 229 A.D.2d at 279, 750 N.Y.S.2d at 294).

134. *Frame*, 83 A.D.3d at 602, 922 N.Y.S.2d at 51 (quoting *Blue Chip Emerald LLC*, 229 A.D.2d at 279, 750 N.Y.S.2d at 294).

135. *Id.*

136. *Id.*

137. *Id.* (quoting TPL Assocs. v. Helmsley-Spear, Inc., 146 A.D.2d 468, 471, 536 N.Y.S.2d 754, 756 (1st Dep't 1989)).

138. *Id.* at 602-03, 922 N.Y.S.2d at 51.

> there is no basis for finding that he could have discovered the concealed information, since Maynard testified that he saw no reason to disclose it and did not know of the appraisal himself.[139]

The court also agreed that Maynard breached the settlement with Frame:

> To accept Maynard's argument would render meaningless the provision requiring distribution of the first [twenty percent] of proceeds of a sale or refinancing of the "Project" to Frame, and also would require interpreting the . . . term differently within the same section of the contract. The court properly accorded the words of the contract their "fair and reasonable meaning" consistent with the parties' "reasonable expectations."[140]

As to the measure of damages, the court stated that:

> The general rule is that the measure of damages when a fiduciary has sold property for an inadequate price is the difference between what was received and what should have been received, so that the beneficiary of the fiduciary duty is placed in the same position he or she would have been in absent the breach. *In re Rothko*, however, established an exception to this general rule. In that case, the trustees of the artist Mark Rothko's estate engaged in self-dealing. Specifically, they sold paintings to galleries with which they were affiliated and the galleries promptly resold the paintings for up to [ten] times the amounts paid to the estate. The Surrogate awarded damages in the amount of the difference between the sale price and the value of the paintings at the time of . . . trial. The Court of Appeals upheld the award, holding that this increased measure of damages is appropriate "where the breach of trust consists of a serious conflict of interest—which is more than merely selling for too little." The *Rothko* Court specified that the "serious conflict of interest" was the self-dealing of the trustees who sought to profit from the low sales prices to the detriment of the estate.[141]

The First Department concluded its opinion by observing that the instant case was indistinguishable from *Rothko*.[142] In each case "the trial court found a breach of fiduciary duty as well as both constructive and actual fraud resulting from self-dealing by the fiduciaries."[143] In a biblical flourish, the court reversed the trial court's determination to

139. *Frame*, 83 A.D.3d at 603, 922 N.Y.S.2d at 52.

140. *Id.* (quoting Sutton v. E. River Sav. Bank, 55 N.Y.2d 550, 555, 435 N.E.2d 1075, 1078, 450 N.Y.S.2d 460, 463 (1982)).

141. *Id.* at 603-04, 922 N.Y.S.2d at 52 (quoting Rothko v. Reis, 43 N.Y.2d 305, 321, 372 N.E.2d 291, 297, 401 N.Y.S.2d 449, 456 (1977)).

142. *Id.* at 604, 922 N.Y.S.2d at 52.

143. *Id.*

exclude Maynard's limited partnership share from the distribution calculation, stating that:

> While a faithless servant forfeits his right to compensation, Maynard did not acquire his interest as a result of fraud or breach of duty, and is not receiving any compensation on account of his share. Disregarding his share in calculating damages leads to an unwarranted windfall for the litigating limited partners, who are entitled only to their fair share of net proceeds received from the sale of partnership property at fair market value.[144]

IV. LIMITED LIABILITY COMPANIES

In re Fassa Corp. (*Emmy Kodiak Developers of Woodbury, LLC*) involved an LLC whose operating agreement contained the peculiar provision that the agreement would terminate upon sixty days notice from any member.[145] The provision was silent as to whether the termination notice would result in the dissolution of the LLC.

Fassa Corp. ("Fassa"), Prasad Realty Corp., and Eric Silverstein each had equal membership interests in Emmy Kodiak Developers of Woodbury, LLC ("the LLC").[146] Although the stated purpose of the LLC in its operating agreement was "to engage in any lawful act or activity for which limited liability companies may be formed," the members intended for the LLC to acquire, and develop for sale, residential property in Woodbury, New York.[147] Fassa and Prasad each contributed $600,000, and Silverstein was to contribute that amount of construction costs.[148]

Fassa sought to dissolve the LLC on the grounds that title to the lot had been taken in the name of a different entity and that Silverstein had not begun construction of the house because he first wished to sell another property in the vicinity in which he had an interest, before offering the LLC's property for sale.[149] Fassa served the sixty-days dissolution notice on July 19, 2010 and filed articles of dissolution of the LLC with the Department of State on September 23, 2010.[150] On October 6, 2010, Fassa petitioned for the judicial winding up of the dissolved LLC under section 703 of the Limited Liability Company

144. *Frame*, 83 A.D.3d at 604, 922 N.Y.S.2d at 53.
145. 31 Misc. 3d 782, 783, 924 N.Y.S.2d 736, 737 (Sup. Ct. Nassau Cnty. 2011).
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *Fassa Corp.*, 31 Misc. 3d at 784, 924 N.Y.S.2d at 737, 738.

Law[151] and the appointment of a receiver or liquidating trustee,[152] presumably because Fassa needed judicial intervention to retrieve its $600,000 and have the title of the lot transferred to the LLC.

Section 703 provides in relevant part:

> (a) In the event of a dissolution of a limited liability company, except for a dissolution pursuant to section seven hundred two of this article, unless otherwise provided in the operating agreement, the members may wind up the limited liability company's affairs. Upon cause shown, the supreme court in the judicial district in which the office of the limited liability company is located may wind up the limited liability company's affairs upon application of any member, or his or her legal representative or assignee, and in connection therewith may appoint a receiver or liquidating trustee.[153]

The respondent in the case countered that the sixty-day termination provision applied solely to the operating agreement and not to the LLC, and that the LLC had not been dissolved; thus section 703 was not applicable.[154] Fassa, the respondent claimed, would have to petition for judicial dissolution under section 702 of the Limited Liability Company Law instead.[155]

The termination provision was silent as to its effect on the LLC. The court noted in dicta that the rule of construing ambiguities in a contract against the drafter applies to LLC operating agreements as well as to other agreements.[156] The drafter in this case was Fassa's president, who was an attorney.[157] Unfortunately, Fassa's president was apparently inexperienced in forming limited liability companies and had used the form of an operating agreement which Silverstein had given him and which Silverstein and Prasad had used in other real estate transactions.[158] The court declined to decide which of the two sides was the drafter.[159]

Section 702 of the Limited Liability Company Law provides for judicial dissolution of an LLC "whenever it is not reasonably

151. *Id.*, 924 N.Y.S.2d at 738; *see generally* N.Y. LTD. LIAB. CO. LAW § 703 (McKinney 2007).

152. *Fassa Corp.*, 31 Misc. 3d at 784, 924 N.Y.S.2d at 738.

153. N.Y. LTD. LIAB. CO. LAW § 703(a).

154. *Fassa Corp.*, 31 Misc. 3d at 784, 924 N.Y.S.2d at 738.

155. *Id.*

156. *Id.* (citing KSI Rockville, LLC v. Eichengrun, 305 A.D.2d 681, 682, 760 N.Y.S.2d 520, 521 (2d Dep't 2003)).

157. *Id.* at 783, 924 N.Y.S.2d at 737.

158. *Id.*

159. *Fassa Corp.*, 31 Misc. 3d at 784, 924 N.Y.S.2d at 737.

practicable to carry on the business in conformity with the articles of organization or operating agreement."[160] "However," said the court:

> if the operating agreement is terminated, there is no basis for the court to determine whether "in the context of the . . . operating agreement," the stated purpose of the company may be realized or is financially unfeasible. Since the parties could not have intended for Emmy Kodiak to continue without an operating agreement, the court interprets the [sixty]-day notice provision as providing for dissolution of the company.[161]

As an alternative grounds for granting dissolution, the court stated: "disagreement or conflict among the members regarding the means, methods, or finances of the company's operations is so fundamental and intractable as to make it unfeasible for the company to carry on its business as originally intended."[162]

Thus, even if the sixty-day notice of termination had not resulted in dissolution of the LLC, the court held that the LLC should be dissolved judicially.[163]

The use of the alternative grounds for dissolution is significant, considering that the court might well have reasoned differently regarding the termination of the operating agreement. Other decisions regarding judicial dissolution of New York LLCs have determined that the LLC Law provides the "default" terms by which an LLC is governed when the members have not adopted a written operating agreement or where the operating agreement does not cover a particular subject.[164] The court in *Fassa* could have held that, even when the termination notice caused the written operating agreement to expire by its terms, the LLC Law offers default terms which govern the LLC in the absence of a written operating agreement among the members and

160. N.Y. LTD. LIAB. CO. LAW § 702 (McKinney 2007).

161. *Fassa Corp.*, 31 Misc. 3d at 785, 924 N.Y.S.2d at 738 (quoting *In re* 1545 Ocean Ave., LLC, 72 A.D.3d 121, 131, 893 N.Y.S.2d 590, 598 (2d Dep't 2010)).

162. *Id.* (quoting *1545 Ocean Ave., LLC*, 72 A.D.3d at 133, 893 N.Y.S.2d at 599 (Fisher, J., concurring in part and dissenting in part)).

163. *Id.*, 924 N.Y.S.2d at 740.

164. *See, e.g.*, Manitaras v. Beusman, 56 A.D.3d 735, 736, 868 N.Y.S.2d 121, 123 (2d Dep't 2008) (operating agreement was silent regarding a vote needed to sell LLC's sole asset and default provisions of LLC law applied); Horning v. Horning Constr., LLC, 12 Misc. 3d 402, 402, 816 N.Y.S.2d 877, 877 (Sup. Ct. Monroe Cnty. 2006) (there was no operating agreement and grounds for dissolution under Limited Liability Company Law section 702 was not met); Spires v. Lighthouse Solutions, LLC, 4 Misc. 3d 428, 428, 778 N.Y.S.2d 259, 259 (Sup. Ct. Monroe Cnty. 2004) (there was no operating agreement and section 702 standard for judicial dissolution was met).

so dissolution could have been avoided.[165] On the other hand, perhaps the court in *Fassa* was reluctant to force members to remain in an LLC where the original working partnership had failed.

The court also held that the irregular transfer of title to the lot provided a sufficient basis for its supervision of the winding up of the LLC under section 703, but denied the appointment of a liquidating trustee until *Fassa* showed that the LLC had obtained title to the real property.[166]

A procedural decision held that where spouses are the sole members of an LLC and one commences a divorce action against the other, the divorce action can include an action for judicial dissolution of the LLC.[167]

New York Domestic Relations Law section 234 provides, in relevant part:

> In any action for divorce, for a separation, for an annulment or to declare the nullity of a void marriage, the court may (1) determine any question as to the title to property arising between the parties, and (2) make such direction, between the parties, concerning the possession of property, as in the court's discretion justice requires having regard to the circumstances of the case and of the respective parties.[168]

In *Rossignol*, the divorcing spouses were opponents in two separate lawsuits, one being the divorce action and the other an action for judicial dissolution of the LLC.[169] One moved to dismiss the LLC dissolution proceeding "on the ground that, among other things, there was another action pending between the same parties and involving the same issues."[170] The lower court dismissed the dissolution proceeding in accordance with New York Civil Practice Law and Rules (CPLR) 3211(a)(4),[171] and the Appellate Division upheld the dismissal:

> Pursuant to Domestic Relations Law [section] 234, [s]upreme [c]ourt

165. N.Y. LTD. LIAB. CO. LAW § 701(5)(b) (McKinney 2007).

166. *Fassa Corp.*, 31 Misc. 3d at 785, 924 N.Y.S.2d at 740.

167. *See generally* Rossignol v. Rossignol, 82 A.D.3d 1335, 918 N.Y.S.2d 631 (3d Dep't 2011).

168. N.Y. DOM. REL. LAW § 234 (McKinney 2010).

169. *Rossignol*, 82 A.D.3d at 1336, 918 N.Y.S.2d at 632.

170. *Id.*

171. *Id.* N.Y. CPLR 3211(a)(4) provides, in relevant part:

> A party may move for judgment dismissing one or more causes of action asserted against him on the ground that: there is another action pending between the same parties for the same cause of action in a court of any state or the United States; the court need not dismiss upon this ground but may make such order as justice requires . . . .

N.Y. C.P.L.R. 3211(a)(4) (McKinney Supp. 2012).

> is empowered to determine all issues with respect to the property owned by the parties. Indeed, the courts and the parties should ordinarily be able to plan for the resolution of all issues relating to the marriage relationship in the single matrimonial action. Inasmuch as the husband and wife are the only owners of the LLC, and both are parties to the divorce action, we see no reason why any issues should be left for resolution after equitable distribution of the parties' property. Given the availability of complete relief pursuant to Domestic Relations Law [section] 234 and our public policy of resolving equitable distribution within the context of a divorce action, we conclude that dismissal of the second action was within [s]upreme [c]ourt's broad discretion pursuant to CPLR 3211(a)(4).[172]

This result promotes judicial economy at no perceptible cost to procedural fairness.

V. CORPORATIONS

A. Dissolution

Section 1005(a)(1) of the New York Business Corporation Law (BCL) provides, "[a]fter dissolution: [t]he corporation shall carry on no business except for the purpose of winding up its affairs."[173] In *Brooklyn Electrical Supply Co., Inc. v. Jasne & Florio, LLP*, the plaintiff was a dissolved corporation bringing an action for legal malpractice.[174] The court held, however, that the lawsuit did "not relate to the plaintiff's winding up of its corporate affairs."[175] Therefore the plaintiff "lacked the capacity to sue."[176]

B. Section 630

The *Survey* period included important cases interpreting BCL section 630.[177] Under BCL section 630, the holders of the ten largest amounts of shares by value of a New York corporation, other than a publicly traded corporation or registered investment company, "shall jointly and severally be personally liable for all debts, wages or salaries due and owing to any of its laborers, servants or employees other than

172. *Rossignol*, 82 A.D.3d at 1336-37, 918 N.Y.S.2d at 632-33 (internal citations omitted) (internal quotation marks omitted).

173. N.Y. BUS. CORP. LAW § 1005(a)(1) (McKinney 2003).

174. 84 A.D.3d 997, 997, 922 N.Y.S.2d 804, 804 (2d Dep't 2011).

175. *Id.*

176. *Id.*

177. *See generally* N.Y. BUS. CORP. LAW § 630(a).

contractors, for services performed by them for such corporation."[178]

To enforce shareholder liability under BCL section 630, section 630(a) provides:

> Before such laborer, servant or employee shall charge such shareholder for such services, he shall give notice in writing to such shareholder that he intends to hold him liable under this section. Such notice shall be given within one hundred and eighty days after termination of such services, except that if, within such period, the laborer, servant or employee demands an examination of the record of shareholders under paragraph (b) of section 624 (Books and records; right of inspection, prima facie evidence), such notice may be given within sixty days after he has been given the opportunity to examine the record of shareholders. An action to enforce such liability shall be commenced within ninety days after the return of an execution unsatisfied against the corporation upon a judgment recovered against it for such services.[179]

The U.S. District Court for the Western District of New York's decision in *Brousseau v. Briggs* considered when a shareholder's liability under section 630 arises relative to the shareholder's filing of a federal bankruptcy petition.[180]

Briggs was the sole shareholder of Summit Wholesale, Inc. ("Summit"), a New York corporation located in LeRoy, New York.[181] Brousseau was a sales representative for Summit, and between November 2007 and May 2008, earned sales commissions, bonuses, and vacation pay, and incurred reimbursable expenses, none of which were paid.[182] Summit ceased operating in June 2008, although it did not go through bankruptcy proceedings; Briggs personally filed for bankruptcy under Chapter 7 in August 2008.[183] Briggs acknowledged his liability under section 630 for unpaid wages by listing Brousseau in his bankruptcy schedules as an unsecured creditor.[184] Brousseau received notice of Briggs's bankruptcy petition and notices of meetings of Briggs's creditors, but Brousseau asserted that he did not bring his claim in the bankruptcy court at that time because he thought his claim under section 630 had not yet ripened.[185] Perhaps Brousseau hoped

178. *Id.*
179. *Id.*
180. No. 11-CV-73A, 2011 U.S. Dist. LEXIS 64428, at *11-13 (W.D.N.Y. 2011).
181. *Id.* at *2.
182. *Id.* at *2, 3.
183. *Id.* at *3.
184. *Id.*
185. *Brousseau*, 2011 U.S. Dist. LEXIS 64428, at *3-4.

that, as a post-petition claim, it would not be discharged by Briggs' Chapter 7 proceeding.

While Briggs's bankruptcy proceeding was pending, in October 2008 Brousseau sued Summit in state court for unpaid wages and Summit did not file an appearance to contest Brousseau's lawsuit.[186] In January 2009, Briggs received a discharge in bankruptcy and Brousseau received notice of the discharge.[187]

In March 2009, Brousseau obtained a default judgment against Summit in state court.[188] In February 2010, Brousseau sent the judgment to the sheriff's office for execution.[189] In April 2010, the sheriff's office returned the execution unsatisfied and in June, Brousseau sued Briggs personally under section 630 in state court.[190] Briggs then filed a motion in bankruptcy court against Brousseau;[191] the bankruptcy court acknowledged that Brousseau's claim against Briggs for section 630 liability was a pre-petition claim and was thus barred by the final discharge in bankruptcy.[192]

On appeal from the bankruptcy court decision, Brousseau argued that the section 630 liability against Briggs did not exist until Brousseau had first tried, then failed, to collect from the corporation.[193]

The district court dismissed Brousseau's appeal on two grounds. Procedurally, the court held that Brousseau could not ignore Briggs's inclusion of his section 630 liability during the bankruptcy proceeding as a pre-petition and dischargeable liability: "[a]s a result of Briggs' inclusion of Brousseau's claim in his bankruptcy petition and Brousseau's failure to do anything about it, Brousseau's claim does not escape the general discharge that Briggs received."[194]

Alternatively, the court held that, under New York law, Brousseau's claim arose pre-petition:

> The plain language of *BCL* [*section*] *630(a)* does not set any

186. *Id.* at *4.

187. *Id.*

188. *Id*.

189. *Id.* at *5.

190. *Brousseau*, 2011 U.S. Dist. LEXIS 64428, at *5. The *Brousseau* decision states that Brousseau properly sent the notice required under section 630(a) informing Briggs that Brousseau intended to hold him liable, but the decision does not say whether Brousseau sent the notice within the required 180-day period following Brousseau's final services in May 2008. *Id.*

191. *Id.* at *6.

192. *Id.*

193. *Id.* at *2.

194. *Brousseau*, 2011 U.S. Dist. LEXIS 64428, at *8.

> conditions for when a shareholder's personal liability arises. Personal liability arises instantaneously as soon as a corporation incurs a financial obligation described in the statute. Thus, Briggs's personal liability under *BCL* [*section*] *630(a)* came into being in November 2007 and increased between then and May 2008 as Brousseau continued to work. Brousseau is correct that he could not enforce Briggs's personal liability right away, because he first had to exhaust his judicial remedy against Summit. . . . When Briggs's personal liability could be enforced, however, is not the same as when it arose. Under the plain language of *BCL* [*section*] *630(a)*, Briggs's personal liability arose months before he filed his bankruptcy petition on August 29, 2008. At most, Brousseau's inability to enforce Briggs's liability before April 14, 2010, when the execution against Summit returned unsatisfied, might have made it a contingent liability under the Bankruptcy Code. Under *11 U.S.C.* [*section*] *101(5)(A)*, though, a contingent liability is as much a claim as any other.[195]

A shareholder becomes contingently liable as soon as an employee commences work. Thus, Briggs was right to include his potential section 630 liability on his bankruptcy schedule of creditors, and Brousseau was barred from collecting it as a post-petition obligation.[196]

The plaintiff in *Stuto v. Kerber* attempted to apply section 630 to the stockholders of a defunct Delaware corporation.[197] The Appellate Division, Third Department analyzed the BCL closely and found no basis to apply the statute to foreign corporations.[198]

On the one hand, section 103(a) of the BCL states that the BCL "'applies to every domestic corporation and to every foreign corporation' doing business in New York . . . ."[199] On the other hand, "the applicability of the [BCL] to foreign corporations is refined in article 13, which comprehensively regulates the conduct of foreign corporations in the state . . . ."[200] BCL article 13 includes provisions for: (i) authorizing a foreign corporation to do business in New York;[201] (ii) termination of a foreign corporation;[202] (iii) lawsuits by and against

195. *Id.* at *11-13 (internal citations omitted).

196. *Id.* at *3.

197. 77 A.D.3d 1233, 1233, 910 N.Y.S.2d 215, 216 (3d Dep't 2010).

198. *Id.* at 1234-36, 910 N.Y.S.2d at 216-17.

199. *Id.* at 1234, 910 N.Y.S.2d at 216 (quoting N.Y. BUS. CORP. LAW § 103(a) (McKinney 2003)).

200. *Id.*

201. *Id.* (citing N.Y. BUS. CORP. LAW § 1301).

202. *Stuto*, 77 A.D.3d at 1234, 910 N.Y.S.2d at 216 (citing N.Y. BUS. CORP. LAW § 1311).

foreign corporations;[203] and (iv) "the scope of application of other provisions of the [BCL] to foreign corporations."[204]

The court noted that section 1319 expressly provides that certain BCL sections "shall apply to a foreign corporation doing business in this state, its directors, officers and shareholders."[205] The sections expressly applicable include BCL articles 1, 3, and 13 and specific sections in articles 6, 7, 8, and 9.[206] Notably, section 1319(a) includes three sections from article 6: sections 623, 626, and 627.[207] Section 630 is not included.

The plaintiff argued that even though the BCL does not expressly apply section 630 to foreign corporations, neither does it exempt foreign corporations, while BCL section 1320 exempts foreign corporations from provisions that are specified in that section.[208] The implication of

203. *Id.*, 910 N.Y.S.2d at 217 (citing N.Y. BUS. CORP. LAW §§ 1312, 1313, 1314).

204. *Id.* at 1234-35, 910 N.Y.S.2d at 217 (citing N.Y. BUS. CORP. LAW §§ 1319, 1320).

205. *Id.* at 1235, 910 N.Y.S.2d at 217 (quoting N.Y. BUS. CORP. LAW § 1319(a)). Section 1319(a) [there is no (b)] provides:

§ 1319. Applicability of other provisions

(a) In addition to articles 1 (Short title; definitions; application; certificates; miscellaneous) and 3 (Corporate name and service of process) and the other sections of article 13, the following provisions, to the extent provided therein, shall apply to a foreign corporation doing business in this state, its directors, officers and shareholders:

(1) Section 623 (Procedure to enforce shareholder's right to receive payment for shares).

(2) Section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor).

(3) Section 627 (Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor).

(4) Sections 721 (Exclusivity of statutory provisions for indemnification of directors and officers) through 727 (Insurance for indemnification of directors and officers), inclusive.

(5) Section 808 (Reorganization under act of congress).

(6) Section 907 (Merger or consolidation of domestic and foreign corporations).

N.Y. BUS. CORP. LAW § 1319(a).

206. *Stuto*, 77 A.D.3d at 1235, 910 N.Y.S.2d at 217.

207. *Id.* (citing N.Y. BUS. CORP. LAW §§ 1319(a)(1)-(3)).

208. *Id.* N.Y. BCL section 1320 provides:

§ 1320. Exemption from certain provisions

(a) Notwithstanding any other provision of this chapter, a foreign corporation doing business in this state which is authorized under this article, its directors, officers and shareholders, shall be exempt from the provisions of paragraph (e) of section 1316 (Voting trust records), subparagraph (a)(1) of section 1317 (Liabilities of directors and officers of foreign corporations), section 1318 (Liability of foreign corporations for failure to disclose required information) and subparagraph (a)(4) of section 1319 (Applicability of other provisions) if when such provision would otherwise apply:

(1) Shares of such corporation were listed on a national securities exchange, or

(2) Less than one-half of the total of its business income for the preceding three fiscal

that parsing is that, if the legislature intended to exempt foreign corporations from section 630, then section 630 would have been listed in section 1320.

The court disagreed, responding that section 1320 was only meant to scale back section 1319:

> [S]ection 1320 only discusses specific circumstances under which particular sections of article 13 shall not apply to foreign corporations, and it does not purport to cover the [BCL] in its entirety or describe each section that does not apply to foreign corporations. Section 1320 is specifically necessary to define the inapplicability of the provisions of article 13, as [BCL section] 1319(a) provides that article 13, generally, applies to foreign corporations. Plaintiff's suggested interpretation would make applicable to foreign corporations all those provisions of the [BCL] not excluded by section 1320, rendering section 1319 mere surplusage.[209]

To paraphrase the court, if all of the BCL applies to foreign corporations, except for what section 1320 exempts, then what do we need section 1319 for?[210]

The plaintiff also argued that "[section] 630 should be read to include foreign corporations because the statute is remedial and should be broadly construed."[211] The court agreed that "section 630 does appear to be remedial in nature," but stated that "even a remedial provision cannot be construed 'beyond the clearly expressed provisions of the act . . . .'"[212] The court referred to decisions before the enactment of the BCL to support its view, stating that "[section] 630 is essentially the reenactment of former Stock Corporation Law [section] 71,"[213] citing *Armstrong v. Dyer*[214] (affirming dismissal of a suit under section 71 against stockholders of a Maryland corporation for unpaid wages of a New York employee) and *Bogardus v. Fitzpatrick*[215] (section 71 did not apply to stockholders of a Delaware corporation). The court

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> years, or such portion thereof as the foreign corporation was in existence, was allocable to this state for franchise tax purposes under the tax law.

N.Y. BUS. CORP. LAW § 1320.

209. *Stuto*, 77 A.D.3d at 1235, 910 N.Y.S.2d at 217 (internal citation omitted).

210. *Id.*

211. *Id.*

212. *Id.* (quoting Miller v. Town of Irondequoit, 243 A.D. 240, 242, 276 N.Y.S. 497, 499-500 (4th Dep't 1935)).

213. *Id.* at 1234, 910 N.Y.S.2d at 216.

214. *Stuto*, 77 A.D.3d at 1234, 910 N.Y.S.2d at 216 (citing Armstrong v. Dyer, 268 N.Y. 671, 672, 198 N.E. 551, 552 (1935)).

215. *Id.* (citing Bogardus v. Fitzpatrick, 139 Misc. 533, 534, 247 N.Y.S. 692, 693 (Sup. Ct. N.Y. Cnty. 1931)).

concluded that the Legislature intended to accept the existing decisional law when it replaced section 71 with section 630: "[i]t is well settled that the legislative history of a particular enactment must be reviewed in light of the existing decisional law which the Legislature is presumed to be familiar with and to the extent it left it unchanged, that it accepted."[216]

Following *Stuto*, the trial court in *White v. Landau* dismissed a section 630 case against defendants who were alleged to be shareholders of a "Gibraltar-based corporation," because "[t]he [a]ppellate [d]ivision has recently and unequivocally concluded that '[BCL section] 630 does not apply to foreign corporations.'"[217]

The decision in *Stuto* appears to be the right result because enforcing section 630 against foreign corporations seems problematic; however, leave to appeal to the Court of Appeals has been granted.[218] It will be interesting to see what the Court of Appeals does with this case.

C. Professional Corporations

In re Bernfeld[219] describes the mechanics of how article 15 of the BCL,[220] governing professional corporations, works upon the death of a shareholder in a professional corporation.[221]

Michael Bernfeld and Yakov Kurilenko owned seventy-five percent and twenty-five percent, respectively, of the shares of a professional corporation that practiced dentistry.[222] When Michael Bernfeld died, his widow, as executor of his estate, voted to dissolve the corporation and sell it to another dentist, one Dr. Cohen, for $530,000.[223]

Mrs. Bernfeld (the petitioner) then commenced a proceeding to dissolve the corporation judicially pursuant to section 1103 of the BCL,[224] on the grounds that Kurilenko was not cooperating.[225]

216. *Id.* (quoting Knight-Ridder Broad., Inc. v. Greenberg, 70 N.Y.2d 151, 157, 511 N.E.2d 1116, 1119, 518 N.Y.S.2d 595, 598 (1987)).

217. No. 115190/10, 2011 N.Y. Slip Op. 51098(U), at 7 (Sup. Ct. N.Y. Cnty. 2011) (quoting *Stuto*, 77 A.D.3d at 1235-36, 910 N.Y.S.2d at 217).

218. Stuto v. Kerber, 16 N.Y.3d 704, 944 N.E.2d 657, 919 N.Y.S.2d 199 (2011).

219. 86 A.D.3d 244, 925 N.Y.S.2d 122 (2d Dep't 2011); *see also* Bernfeld v. Kurilenko, 91 A.D.3d 893, 893, 937 N.Y.S.2d 314, 315 (2d Dep't 2012).

220. N.Y. BUS. CORP. LAW art. 15 (McKinney 2003).

221. *Bernfeld*, 86 A.D.3d at 248-49, 925 N.Y.S.2d at 125-26.

222. *Id.* at 246, 925 N.Y.S.2d at 123-24.

223. *Id.*, 925 N.Y.S.2d at 124.

224. *Id.*; N.Y. BUS. CORP. LAW § 1103.

225. *Bernfeld*, 86 A.D.3d at 246, 925 N.Y.S.2d at 124.

Kurilenko answered that "petitioner could not take control of the [professional corporation because] she was not a licensed dentist."[226] After the proceeding had commenced, Kurilenko stated to petitioner that the book value of the corporation was a negative $159,000,[227] and he offered to purchase her shares for zero dollars.[228]

To determine the petitioner's rights, the court began with BCL sections 1510 and 1511.[229] Section 1510 provides, in relevant part:

> A professional service corporation shall purchase or redeem the shares of a shareholder in case of his death . . . at the book value of such shares as of the end of the month immediately preceding the death or disqualification of the shareholder as determined from the books and records of the corporation in accordance with its regular method of accounting. The certificate of incorporation, the by-laws of the corporation or an agreement among the corporation and all shareholders may modify this section by providing for . . . an alternate method of determining the price to be paid for the shares . . . .[230]

BCL section 1511 provides, in relevant part:

> No shareholder of a professional service corporation may sell or transfer his shares in such corporation except to another individual who is eligible to have shares issued to him by such corporation or except in trust to another individual who would be eligible to receive shares if he were employed by the corporation. Nothing herein contained shall be construed to prohibit the transfer of shares by operation of law or by court decree. No transferee of shares by operation of law or court decree may vote the shares for any purpose whatsoever except with respect to corporate action under [BCL section 909] and [BCL section 1001] . . . .[231]

Based upon these two sections, the court held that the petitioner "has two sets of rights:" the corporation could buy her shares under section 1510, and the right to vote as a shareholder on actions under BCL sections 909 and 1001.[232] This did not, said the court, include the right to seek judicial dissolution under BCL section 1103:[233] "the petitioner seeks to amplify her right to vote for nonjudicial dissolution

226. *Id.*
227. *Id.*
228. *Id.* at 248, 925 N.Y.S.2d at 125.
229. *Id.* at 248-49, 925 N.Y.S.2d at 125-26.
230. N.Y. BUS. CORP. LAW § 1510(a) (McKinney 2003).
231. *Id.* § 1511.
232. *Bernfeld*, 86 A.D.3d at 250, 925 N.Y.S.2d at 126.
233. *Id.* (citing N.Y. BUS. CORP. LAW § 1103).

to also allow her to vote for judicial dissolution."[234]

The court found the reason for treating a judicial dissolution differently from a nonjudicial dissolution in BCL section 1511 (after the portion of section 1511 quoted above), providing:

> Any sale or transfer, except by operation of law or court decree or except for a corporation having only one shareholder, may be made only after the same shall have been approved by the board of directors, or at a shareholders' meeting specially called for such purpose by such proportion, not less than a majority, of the outstanding shares as may be provided in the certificate of incorporation or in the by-laws of such professional service corporation. At such shareholders' meeting the shares held by the shareholder proposing to sell or transfer his shares may not be voted or counted for any purpose, unless all shareholders consent that such shares be voted or counted.[235]

According to the court, the purpose of this provision is to protect surviving shareholders (in this case, Kurilenko) against being forced to share their practice with one or more new professionals,[236] unless a majority of the surviving shareholders consent. The court was concerned that:

> in her attempt to dissolve the P.C. and sell its assets to Dr. Cohen, the petitioner seeks to avoid compliance with the limitations articulated in [BCL section] 1511 with respect to stock sales by a nonprofessional shareholder that might otherwise be effectuated by selling the P.C. in an asset sale.[237]

It is not clear, however, why the petitioner could not have accomplished the result of selling the corporation in an asset sale by approving a sale of substantially all assets under BCL section 909,[238] on which a non-professional transferee shareholder is expressly authorized to vote by section 1511.[239] Therefore, it is not clear how "the limitations articulated in [BCL section] 1511" would have protected Kurilenko if petitioner had used BCL section 909 instead of seeking judicial dissolution under BCL section 1103. The court noted, however, that "it remains unresolved whether the P.C.'s right to [re]purchase the petitioner's shares pursuant to [BCL section] 1510 can be nullified by dissolution."[240] If the court's concern was that the dissolution

234. *Id.*
235. N.Y. BUS. CORP. LAW § 1511.
236. *Bernfeld*, 86 A.D.3d at 251-52, 925 N.Y.S.2d at 127.
237. *Id.* at 255, 925 N.Y.S.2d at 130.
238. N.Y. BUS. CORP. LAW § 909.
239. *Id.* § 1151.
240. *Bernfeld*, 86 A.D.3d at 255, 925 N.Y.S.2d at 130.

proceeding before it might result in the corporation being deprived of its right to repurchase the petitioner's shares, then it might seem an unfair result if the corporation could pay zero dollars for seventy-five percent of the shares of a corporation that was valued at $530,000 by a third-party bidder.[241] The court left it open to the petitioner to raise this issue if there were "an action to compel purchase or redemption" of the petitioner's shares.[242]

D. Foreign Corporations

1. Section 1310

GS Plasticos Limitada v. Bureau Veritas[243] applied BCL sections 1310(a)(5) and 1314(b)[244] in the case of a Brazilian company authorized to do business in New York against Bureau Veritas (BV) and its indirect subsidiary, Bureau Veritas Consumer Products Services, (BVCPS) for tortious interference with contractual relations.[245] BV, a French company, had been authorized to do business in New York, but surrendered its authority before the commencement of the suit.[246] BVCPS had facilities located in Buffalo, New York.[247]

The court held that BV's surrender of authority did "not insulate it from the court's assertion of personal jurisdiction over it . . . ."[248] BCL section 1310(a)(5) provides, in relevant part, that a certificate of surrender of authority must include the corporation's consent:

> that process against it in any action or special proceeding based upon any liability or obligation incurred by it within this state before the filing of the certificate of surrender may be served on the secretary of state after the filing thereof in the manner set forth in paragraph (b) of section 306 (service of process).[249]

241. *Id.* at 246, 248, 925 N.Y.S.2d at 124, 125.

242. *Id.* at 256, 925 N.Y.S.2d at 130.

243. *See generally* 80 A.D.3d 511, 915 N.Y.S.2d 68 (1st Dep't 2011), *other proceedings sub nom.* GS Plasticos Limitada v. Bureau Veritas Consumer Prod. Serv., Inc., 84 A.D.3d 518, 518-19, 922 N.Y.S.2d 365, 366-67 (1st Dep't 2011), *sub nom.* 5447 & GS Plasticos Limitada v. Bureau Veritas Consumer Prod. Serv., Inc., 88 A.D.3d 510, 510, 931 N.Y.S.2d 567, 568 (1st Dep't 2011), *motion for leave to appeal denied*, 17 N.Y.3d 714, 714, 957 N.E.2d 1159, 1159, 933 N.Y.S.2d 655, 655 (2011), *motion for reargument denied* 2012 N.Y. Slip Op. 61173(U), at 1 (2012).

244. *See generally* N.Y. BUS. CORP. LAW §§ 1310(a)(5), 1314(b).

245. *GS Plasticos Limitada*, 80 A.D.3d at 511, 915 N.Y.S.2d at 69.

246. *Id.*

247. *Id.*

248. *Id.*

249. N.Y. BUS. CORP. LAW § 1310(a)(5) (citing N.Y. BUS. CORP. LAW § 306).

Furthermore, jurisdiction pursuant to BCL section 1310(a)(5) was not limited to suits by New York residents.[250] Because this suit was brought by a non-resident company, the court considered how BCL section 1314(b)(3) applied.[251] Section 1314(b) provides, in relevant part:

> (b) Except as otherwise provided in this article, an action or special proceeding against a foreign corporation may be maintained by another foreign corporation of any type or kind or by a non-resident in the following cases only:
>
> . . .
>
> (3) Where the cause of action arose within this state . . . .
>
> (4) Where, in any case not included in the preceding subparagraphs, a non-domiciliary would be subject to the personal jurisdiction of the courts of this state under section 302 of the civil practice law and rules.[252]

The court held that the cause of action arose in Brazil and not in New York, hence, there was no jurisdiction under clause (3).[253] Apparently the plaintiff was unable to show direct jurisdiction over BV under clause (4) and CPLR 302.[254] The plaintiff argued that BV was subject to New York jurisdiction on the grounds that BV's indirect subsidiary, BVCPS, which had facilities in New York,[255] acted "as an agent or mere department of BV."[256] This argument failed because:

> The record does not support a finding that BVCPS's activities are "so complete that [it] is, in fact, merely a department of [BV]," i.e., it was "performing the same activities (i.e., doing all the business) that [BV] would have performed had it been doing or transacting business in New York."[257]

The *GS Plasticos* decision shows that an action under BCL section 1310(a)(5) is available for foreign entities as well as for New York residents.[258]

250. *GS Plasticos Limitada*, 80 A.D.3d at 511, 915 N.Y.S.2d at 69.

251. *Id.* at 512, 915 N.Y.S.2d at 69-70.

252. N.Y. BUS. CORP. LAW § 1314(b)(3)-(4) (citing N.Y. C.P.L.R. 302 (McKinney 2010)).

253. *GS Plasticos Limitada*, 80 A.D.3d at 512, 915 N.Y.S.2d at 69-70.

254. *Id.*, 915 N.Y.S.2d at 70.

255. *Id.* at 511, 915 N.Y.S.2d at 69.

256. *Id.* at 512, 915 N.Y.S.2d at 70.

257. *Id.*; *see also* Porter v. LSB Indus., Inc., 192 A.D.2d 205, 213-14, 600 N.Y.S.2d 867, 873 (4th Dep't 1993).

258. *GS Plasticos Limitada*, 80 A.D.3d at 511, 915 N.Y.S.2d at 69.

2. BCL section 1312

BCL section 1312(a) provides, in relevant part:

> A foreign corporation doing business in this state without authority shall not maintain any action or special proceeding in this state unless and until such corporation has been authorized to do business in this state and it has paid to the state all fees and taxes imposed under the tax law . . . as well as penalties and interest charges related thereto, accrued against the corporation.[259]

Before section 1312(a) will successfully preclude an unauthorized foreign corporation from maintaining its suit in New York courts, the defendant must show not only that the plaintiff is unauthorized to do business in New York, but is actually "doing business" in New York, within the meaning of section 1312(a).[260] Under those circumstances, the unauthorized foreign corporation will be given the opportunity to come into compliance before its suit is dismissed.

McKenzie Banking Co. v. Billinson described the procedure that a defendant must follow to effectively bar suit:

> the application of this statutory bar may only be effected when it has been raised as an affirmative defense . . . , and the burden of proof is placed upon the party asserting [the bar]. Whether a foreign corporation is doing business within the purview of section 1312 of the [BCL] so as to foreclose access to our courts depends upon the particular facts of each case with inquiry into the type of business activities being conducted. Here, while defendant established that plaintiff is a foreign corporation that has not been authorized to do business in this state, defendant presented no evidence that plaintiff is in fact doing business in this state . . . .[261]

Therefore, plaintiff was allowed to proceed.[262]

Similarly, *Lew Beach Co. v. Carlson*[263] held in dictum that, if an unauthorized foreign corporation doing business in New York is otherwise prohibited by BCL section 1312[264] from maintaining a suit in New York, the courts will nevertheless allow the corporation the opportunity to pay back taxes, obtain authority, and maintain the

259. N.Y. BUS. CORP. LAW § 1312(a) (McKinney 2003).

260. *Id.*; *see also* McKenzie Banking Co. v. Billinson, 79 A.D.3d 1728, 1728, 914 N.Y.S.2d 843, 843 (4th Dep't 2010).

261. 79 A.D.3d at 1728-29, 914 N.Y.S.2d at 843-44 (internal citations omitted) (internal quotation marks omitted).

262. *Id.* at 1728, 1729, 914 N.Y.S.2d at 843, 844.

263. *See generally* 77 A.D.3d 1127, 910 N.Y.S.2d 565 (3d Dep't 2010).

264. N.Y. BUS. CORP. LAW § 1312.

action.[265] Further, in *Horizon Bancorp v. Pompee*, the defendant's attempted use of section 1312(a) was defeated when "plaintiff resolved any issue with respect to its capacity to maintain this action by filing for and obtaining authority to do business in New York pursuant to [BCL section] 1304(a)."[266]

The defendant in *Greystone Bank v. 15 Hoover Street, LLC* could not raise the section 1312(a) defense against a plaintiff, which was a bank.[267]

E. Other

In *Baez v. Ende Realty Corp.*,[268] a corporate defendant attempted to vacate a default judgment on the ground, among others, that the corporation's address on file with the Secretary of State, under BCL section 306,[269] was not current.[270] The court held that "failure to keep a current address on file with the Secretary of State . . . does not constitute a 'reasonable excuse' for its default" and denied this ground for vacatur of the default judgment.[271]

VI. PIERCING THE ENTITY VEIL

A. Owner liability

In *East Hampton Union Free School District v. Sandpebble Builders, Inc.*, the Court of Appeals reviewed a complaint seeking to hold Victor Canseco, president and sole shareholder of defendant corporation, personally liable for breach of corporate obligations.[272] The Court restated its traditional two-part test for piercing the corporate veil: "plaintiff must allege facts that, if proved, indicate that the shareholder exercised complete domination and control over the corporation and 'abused the privilege of doing business in the corporate form to perpetrate a wrong or injustice.'"[273]

Next, the Court held that the second part of the test, the abuse of the corporate form, requires more than simple impropriety or bad faith:

265. *Lew Beach Co.*, 77 A.D.3d at 1128, 910 N.Y.S.2d at 567.

266. 82 A.D.3d 935, 936, 918 N.Y.S.2d 574, 575 (2d Dep't 2011).

267. No. 007223-10, 2010 N.Y. Slip Op. 51762(U), at 1 (Sup. Ct. Nassau Cnty. 2010).

268. *See generally* 78 A.D.3d 576, 911 N.Y.S.2d 68 (1st Dep't 2010).

269. N.Y. BUS. CORP. LAW § 306.

270. *Baez*, 78 A.D.3d at 576, 911 N.Y.S.2d at 68-69.

271. *Id.*

272. 16 N.Y.3d 775, 776, 944 N.E.2d 1135, 1136, 919 N.Y.S.2d 496, 497 (2011).

273. *Id.* (quoting Morris v. N.Y. State Dep't of Taxation & Fin., 82 N.Y.2d 135, 142, 623 N.E.2d 1157, 1161, 603 N.Y.S.2d 807, 811 (1993)).

> Since, by definition, a corporation acts through its officers and directors, to hold a shareholder/officer such as Canseco personally liable, a plaintiff must do more than merely allege that the individual engaged in improper acts or acted in "bad faith" while representing the corporation. In this case, plaintiff failed to allege any facts indicating that Canseco engaged in acts amounting to an abuse or perversion of the corporate form . . . .[274]

In *Sugar Foods de Mexico v. Scientific Scents, LLC*, the defendant corporation was held liable at the trial court level for failure to pay for goods ordered and delivered to defendant.[275] After the defendant's sole officer and shareholder testified at a deposition that the corporation "had no assets and that she deposited money into defendant's bank account to pay its operating expenses," the plaintiff was allowed to amend its complaint to add a claim to pierce the corporate veil.[276]

In *Emposimato v. CIFC Acquisition Corp.*,[277] the court upheld a complaint seeking to pierce the corporate veil where plaintiffs sued a private equity firm for failure to perform under an agreement to purchase the plaintiffs' stock.[278] The party that executed the agreement, as purchaser, was a second-tier subsidiary (that is, a wholly-owned subsidiary of a wholly-owned subsidiary) of a private equity firm,[279] while the private equity firm parent was not a party to the agreement.[280] The court sustained a complaint for alter ego liability against the private equity firm, over a motion for summary judgment, holding:

> A corporate veil may be pierced, and an entity affiliated with a corporation may be liable for the corporation's breach of contract, either "where the officers and employees of the [affiliated entity] exercise control over the daily operations of the [corporation] and act as the true prime movers behind the [corporation's] action, or on the theory that the [affiliated entity] conducts business through the [corporation], which exists solely to serve the [affiliated entity] . . . ."
>
> . . .
>
> . . . [A]n entity that is affiliated with a corporation may be liable for the corporation's breach of a contract where the affiliated entity has caused the corporation to breach the contract, or rendered the

274. *Id.*

275. 79 A.D.3d 1551, 1551-52, 914 N.Y.S.3d 352, 353 (3d Dep't 2010).

276. *Id.* at 1552, 914 N.Y.S.3d at 353.

277. No. 601728/2008, 2011 N.Y. Slip Op. 50343(U) (Sup. Ct. N.Y. Cnty. 2011), *aff'd*, 89 A.D.3d 418, 932 N.Y.S.2d 33 (1st Dep't 2011).

278. *Id.* at 1.

279. *Id.* at 2.

280. *Id.* at 3.

> corporation unable to meet its obligations under the contract, and/or the corporation is a mere shell or "dummy" corporation which has no assets of its own.[281]

B. Successor Liability

A summary of the requirements to find successor liability by de facto merger appears in *Perceptron, Inc. v. Silicon Video, Inc.*:[282]

> For a "*de facto* merger" to occur, there must be continuity of the successor and predecessor corporation as evidenced by the following: "(1) continuity of ownership; (2) a cessation of ordinary business and dissolution of the predecessor as soon as practically and legally possible; (3) assumption by the successor of the liabilities ordinarily necessary for the uninterrupted continuation of the business of the predecessor; and (4) a continuity of management, personnel, physical location, assets, and general business operation." "Not all of these factors are needed to demonstrate a merger; rather, these factors are only indicators that tend to show a *de facto* merger."[283]

CONCLUSION

The period covered by this *Survey* brought a number of decisions which are instructive on points of New York business law. The authors believe that practitioners will find the reading of these decisions to be time well spent.

281. *Id.* at 3-4 (alteration in original) (citations omitted).

282. No. 5:06-CV-0412(GTS/DEP), 2010 U.S. Dist. LEXIS 88740 (N.D.N.Y. 2010); *see also* No. 5:06-CV-0412(GTS/DEP), 2011 U.S. Dist. LEXIS 112523 (N.D.N.Y. 2011).

283. *Perceptron, Inc.*, 2010 U.S. Dist. LEXIS 88740, at *11-12 (quoting Lumbard v. Maglia, Inc., 621 F. Supp. 1529, 1535 (S.D.N.Y. 1985)).