BUSINESS ASSOCIATIONS

Sandra S. O'Loughlin[†] & Christopher J. Bonner[‡]

CONTENTS

INTRODUCTION 590
I. LEGISLATIVE DEVELOPMENTS 590
II. PARTNERSHIPS 591
III. LIMITED LIABILITY COMPANIES 595
A. In re Estate of Hausman 595
1. The LLC Fails as a De Facto Entity 596
2. Conclusion 599
B. Fiduciary obligations 599
C. Dissolution 601
IV. CORPORATIONS 606
A. Shareholders 606
B. Directors 609
1. The Facts 609
2. Fraud in the Inducement and Direct vs. Derivative Claims 611
3. The Court of Appeals Decision 613
4. Conclusion 615
C. Insider Trading and Breach of Fiduciary Duty 616
1. Futility of Demand 616
2. Sufficiency of Allegations 617
3. Conclusion 618
D. Votta v. Garcy 618
1. The Facts 619
2. Procedural Background 620
3. Jurisdiction 620
4. Defendants' Motion to Dismiss 621
5. BCL Section 626(c) 621
6. General Business Law Section 130 621
7. Breach of Contract 622
8. Fraud 622
9. Fraud Predicated on Contractual Obligations 624

† Partner, Hiscock & Barclay, LLP, Buffalo, New York; Adjunct Professor and Lecturer, University at Buffalo Law School, State University of New York; J.D., State University of New York at Buffalo Law School; B.A., Daemen College; Rosary Hill College.

‡ Of Counsel, Hiscock & Barclay, LLP, Syracuse, New York; J.D., Harvard Law School; B.A., Williams College.

10. Violation of the Securities Act of 1933 625
11. Conclusion 625
E. Dissolution 626
V. FOREIGN BUSINESS ENTITIES 628
VI. PIERCING THE ENTITY VEIL 628
CONCLUSION 629

INTRODUCTION

The period covered by this *Survey* saw a continuation of the trend by New York courts to treat limited liability companies (LLC) similarly to corporations, except in matters of dissolution when the owners are deadlocked. Overall, there was an abundance of helpful court decisions. Many of the decisions are discussed in a short form that focuses on their holdings. Other cases seemed to be of greater legal interest and were selected by the authors for more extended discussion.

I. LEGISLATIVE DEVELOPMENTS

The only legislative development during this *Survey* period was the addition of a new subsection (b) to section 1004 of the New York Business Corporation Law (BCL).[1] The legislative change requires that any New York business corporation, which has done business in the City of New York and incurred liability for city taxes referred to in subsection (b), attach the consent of the Commissioner of Finance of the City of New York to a certificate of dissolution before filing of the certificate of dissolution with the Department of State.[2] Effective October 1, 2009, the subsection is in addition to the already-existing requirement to obtain the consent of the New York State Department of Taxation and Finance.[3] A parallel addition was made to section 1004 of the New York Not-for-Profit Corporation Law (N-PCL).[4]

These amendments will "[r]equir[e] companies that go out of business in New York City to pay all of their obligations before they are allowed to dissolve," according to the Legislative Memorandum in Support to the New York State Assembly.[5] To accomplish this, a

1. N.Y. BUS. CORP. LAW § 1004 (McKinney Supp. 2010).

2. Act of July 11, 2009, ch. 201, 2009 McKinney's Sess. Laws of N.Y. 822 (codified at N.Y. BUS. CORP. LAW 1004(b)).

3. *Id.* (codified at N.Y. BUS. CORP. LAW § 1004(a)).

4. *Id.* (codified at N.Y. NOT-FOR-PROFIT CORP. LAW § 1004(b) (McKinney Supp. 2011)).

5. 2009 McKinney's Sess. Laws of N.Y. 1633 (legislative memorandum).

change was made to subdivision (c) of BCL section 1007,[6] adding the italicized text below:

> (c) Notwithstanding this section and section 1008 . . . , tax claims and other claims of this state, of the United States *and of the department of finance of the city of New York* shall not be required to be filed under those sections, and such claims shall not be barred because not so filed, and distribution of the assets of the corporation, or any part thereof, may be deferred until determination of any such claims.[7]

A parallel amendment was made to section 1007 of the N-PCL.[8]

Prior to these amendments, a New York corporation owing City of New York taxes could file a certificate of dissolution and, under BCL section 1007, demand that all creditors, including the Department of Finance of New York City, present to the corporation whatever claims they might have by a certain date.[9] A creditor, including the Department of Finance, that failed to respond timely faced a statutory presumption in favor of barring the claim.[10] In effect, these amendments are to prevent the section 1007 claim-barring procedure from affecting New York City tax claims.

It will be crucial for the City of New York Department of Finance to respond within a reasonable time to requests for consent to dissolution. Otherwise, frustrated business owners trying to comply with law may consider avoiding the procedure altogether by incorporating in another jurisdiction, or, in the case of an existing corporation, by changing its jurisdiction of incorporation.

II. PARTNERSHIPS

In *Parr v. Ronkonkoma Realty Venture I, LLC*, the Second Department confirmed the proposition that partners in a joint venture stand as fiduciaries to each other.[11] The Second Department reaffirmed

6. N.Y. BUS. CORP. LAW § 1007(c) (McKinney Supp. 2010).

7. *Id.* (amended by Act of July 11, 2009, ch. 201, 2009 McKinney's Sess. Laws of N.Y. 822) (emphasis added).

8. Act of July 11, 2009, ch. 201, 2009 McKinney's Sess. Laws of N.Y. 822 (codified at N.Y. NOT-FOR-PROFIT CORP. LAW § 1007(c) (McKinney Supp. 2011)).

9. *See* N.Y. BUS. CORP. LAW § 1007(a). "At any time after dissolution, the corporation may give a notice requiring all creditors and claimants . . . to present their claims in writing and in detail at a specified place and by a specified day . . . ," and BCL section 1007(b), "all other claims which are not timely filed as provided in such notice . . . shall be forever barred as against the corporation, its assets, directors, officer and shareholders, except to such extent, if any, as the court may allow . . . ." *See also* N.Y. BUS. CORP. LAW §§ 1004(a) and (b) (McKinney Supp. 2010).

10. N.Y. BUS. CORP. LAW § 1007(b).

11. 65 A.D.3d 1199, 1201, 885 N.Y.S.2d 522, 524 (2d Dep't 2009).

that position in *Plumitallo v. Hudson Atlantic Land Co., LLC*,[12] with the important additional holding that the statute of frauds[13] will not defeat a plaintiff who pleads the existence of an oral joint venture in real estate:

> The statute of frauds does not render void oral joint venture agreements to deal in real property because the interest of each partner in a partnership is deemed personalty . . . . The plaintiff is not seeking to acquire an interest in real property, but rather, is asserting an alleged interest in joint venture assets.[14]

In the *Parr* and *Plumitallo* cases, it was important to establish a fiduciary relationship between the plaintiff and the defendant so that the plaintiff could ask the court to place a constructive trust on property which the plaintiff had transferred to the defendant.[15]

Partnership Law section 121-1002(a) provides that a limited partner may bring a derivative action in the right of the limited partnership.[16] The plaintiffs in *Wallace v. Perret* brought direct and derivative claims against the management of a family limited partnership.[17] A meeting of the limited partners was called by the defendants and at least seventy percent of the limited partnership interests voted in person or by proxy to "withdraw" the plaintiffs' claims, to the extent that the claims were derivative claims belonging to the partnership as a whole.[18] In light of the vote, the court stated "that continuation of the derivative action is not in their [i.e., the limited partners'] best interests [and] it is clear that the plaintiffs will not be able to fairly represent the interests of the Partnership in a continued derivative action."[19] The court did not address the question as to whether the derivative claims alleged that defendants' acts were of a kind that can only be approved unanimously.[20]

The causes of action in the plaintiffs' complaint mixed individual and derivative claims and for this reason was dismissed by the court.[21]

12. 74 A.D.3d 1038, 903 N.Y.S.2d 127 (2d Dep't 2010).

13. N.Y. GEN. OBLIG. LAW § 5-701 (McKinney Supp. 2010).

14. *Plumitallo*, 74 A.D.3d at 1039, 903 N.Y.S.2d at 128 (citation omitted).

15. *Parr*, 65 A.D.3d at 1201-02, 885 N.Y.S.2d at 524; *Plumitallo*, 74 A.D.3d at 1039, 903 N.Y.S.2d at 129.

16. N.Y. P'SHIP LAW § 121-1002 (McKinney 2006).

17. 28 Misc. 3d 1023, 1025 & n.2, 903 N.Y.S.2d 888, 892 & n.2 (Sup. Ct. Kings Cnty. 2010).

18. *Id.* at 1034, 903 N.Y.S.2d at 898.

19. *Id.* (citing Gilbert v. Kalikow, 272 A.D.2d 63, 707 N.Y.S.2d 100 (1st Dep't 2000)).

20. *See, e.g.*, Gantler v. Stephens, 965 A.2d 695, 713 n.54 (Del. 2009) ("[V]oid acts such as fraud, gift, waste and *ultra vires* acts cannot be ratified by a less than unanimous shareholder vote.").

21. *Wallace*, 28 Misc. 3d at 1032, 903 N.Y.S.2d at 897.

The court, however, granted leave to replead the individual causes of action.[22]

The court provided guidance to differentiate individual claims from those that are derivative. The court held that "[i]n determining whether a cause of action is derivative in nature regarding limited partnership law, the case law relevant to corporation law may be looked to for guidance."[23] The court then determined that certain claims were individual, rather than derivative, such as a claim by a general partner for compensation from the partnership;[24] a claim by the general partner that she was denied access to the books and records;[25] a claim by one general partner that she was excluded by another from acting as a general partner and that such other general partner owed her an accounting for the partnership;[26] and a claim that a general partner had converted real property to which a plaintiff had title and the right to possession.[27]

On the other hand, claims that a general partner violated the partnership agreement by failing to make distributions to the partners;[28] that a partner diverted partnership assets;[29] that a manager took excessive fees;[30] and that one general partner paid legal and accounting fees without obtaining the consent of the other general partner[31] were derivative.

Wallace is also useful because the partnership agreement provided that, upon the death of one of the general partners, his daughter (a plaintiff in the case) would succeed to his position as a general partner.[32] The defendants argued that this appointment constituted an attempt to make a testamentary disposition without the proper formalities.[33] The court rejected this approach, quoting a 1968 decision by the Court of Appeals, "'[a] partnership agreement which provides

22. *Id.* at 1035, 903 N.Y.S.2d at 899.

23. *Id.* at 1030, 903 N.Y.S.2d at 895 (quoting Strain v. Seven Hills Assocs., 75 A.D.2d 360, 370, 429 N.Y.S.2d 424, 431 (1st Dep't 1980)).

24. *Id.* at 1033, 903 N.Y.S.2d at 897.

25. *Id.*

26. *Wallace*, 28 Misc. 3d at 1033, 903 N.Y.S.2d at 898.

27. *Id.*

28. *Id.*, 903 N.Y.S.2d at 897.

29. *Id.*, 903 N.Y.S.2d at 898.

30. *Id.*

31. *Wallace*, 28 Misc. 3d at 1033, 903 N.Y.S.2d at 898.

32. *Id.* at 1025, 903 N.Y.S.2d at 892.

33. *Id.* at 1027-28, 903 N.Y.S.2d at 893 (citing N.Y. EST. POWERS & TRUSTS LAW § 3-2.1 (McKinney 1998)).

that, upon the death of one partner, his interest shall pass to the surviving partner or partners, resting as it does in contract, is unquestionably valid and may not be defeated by labeling it a testamentary disposition.'"[34]

Section 487 of the Judiciary Law provides, inter alia, that an attorney who makes a material misrepresentation to a court, with intent to deceive, is liable for treble damages to a party harmed by the misrepresentation.[35] In *Dupree v. Voorhees*, a divorced spouse sued her ex-husband's attorney for violation of section 487 and sought treble damages.[36] She also claimed that the attorney's law partner was vicariously liable for the treble damages.[37]

The trial court held that section 487 should not be grounds "to hold a second attorney responsible for the deceit of another unless that second attorney also could be charged as having participated in or having consented to the acts complained of."[38]

The appellate division, however, agreed with the plaintiff, citing sections 24 and 26 of the Partnership Law:

> Partnership Law 24 provides that "[w]here, by *any wrongful act* or omission of any partner acting in the ordinary course of the business of the partnership, or with the authority of his copartners, loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefor to the same extent as the partner so acting or omitting to act" (Partnership Law 24). Partnership Law 26(a)(1) provides that "all partners are liable . . . [j]ointly and severally for everything chargeable to the partnership under section[ ] twenty-four." The pivotal test for liability in this regard is whether the wrong was committed on behalf of and within the reasonable scope of the partnership business, not whether the wrongful act was criminal in nature, or whether the other partners condoned the offending partner's actions.[39]

Accordingly, the court held that the law partner could be vicariously liable if the primary defendant violated section 487 of the Judiciary Law.[40] The opinion does not say whether the two attorneys

34. *Id.* at 1028, 903 N.Y.S.2d at 894 (quoting *In re* Estate of Hillowitz, 22 N.Y.2d 107, 109, 238 N.E.2d 723, 725, 291 N.Y.S.2d 325, 326 (1968)).

35. N.Y. JUD. LAW § 487 (McKinney 2005).

36. 68 A.D.3d 807, 809, 891 N.Y.S.2d 124, 125-26 (2d Dep't 2009).

37. *Id.*, 891 N.Y.S.2d at 126.

38. Dupree v. Voorhees, 24 Misc. 3d 396, 404, 876 N.Y.S.2d 840, 847 (Sup. Ct. Suffolk Cnty. 2009).

39. *Dupree*, 68 A.D.3d at 809, 891 N.Y.S.2d at 126 (citation omitted).

40. *Id.* at 810, 891 N.Y.S.2d at 126.

practiced as a limited liability partnership (LLP), which should have limited damages recoverable against the partner to the assets of the partnership.[41]

III. LIMITED LIABILITY COMPANIES

A. In re Estate of Hausman

In *In re Estate of Hausman*, the Court of Appeals considered whether the conveyance of decedent's property to an LLC prior to the filing of its articles of organization by the Department of State was nevertheless valid.[42]

On October 16, 2000, Lena Hausman executed her last will and testament, providing for division of her residuary estate into four equal portions, as follows: twenty-five percent each, to her daughter, Susan, and her son, George; and twenty–five percent each, to the children of her two predeceased sons.[43] The will "empowered" George, who was the executor, to create an LLC, and to transfer ownership of income generating real property to the LLC for the benefit of all of his mother's heirs.[44]

> In the event that the LLC was formed and her real property conveyed to it, the will required that the executor "distribute the membership interests in accordance with the directions set forth above" and "[a]ny beneficiary . . . who refuse[d] to cooperate in the establishment of the LLC" would be entitled to the share of the distribution in a special payment.[45]

On October 4, 2001, George and Susan executed articles of organization for the LLC for the purpose of owning, operating, and managing the LLC.[46] They also prepared an operating agreement naming themselves as sole members which, the Court points out, had "the effect of depriving the other heirs, decedent's grandchildren, from receiving any benefit from the rental property."[47] The operating agreement was also signed at some point.[48] On November 2, 2001, Lena Hausman executed a deed, later recorded on December 3, 2001, transferring her ownership of the real estate to the LLC; and the LLC's

41. N.Y. P'SHIP LAW § 26(b) (McKinney 2006).
42. 13 N.Y.3d 408, 410, 921 N.E.2d 191, 192, 893 N.Y.S.2d 499, 500 (2009).
43. *Id.*
44. *Id.* at 410-11, 921 N.E.2d at 192, 893 N.Y.S.2d at 500.
45. *Id.* at 411, 921 N.E.2d at 192, 893 N.Y.S.2d at 500.
46. *Id.*
47. *In re Hausman*, 13 N.Y.3d at 411, 921 N.E.2d at 192, 893 N.Y.S.2d at 500.
48. *See id.* at 413, 921 N.E.2d at 194, 893 N.Y.S.2d at 502.

articles of organization were filed with the New York Department of State on November 16, 2001.[49] Lena Hausman died in a nursing home the following June.[50] When the will was admitted to probate, the grandchildren disputed the validity of the property's conveyance to the LLC, and argued that it should remain "part of the estate subject to their distributive interests, as stated in the will."[51] The executor maintained that the conveyance was valid and filed a petition in surrogate's court to settle the issue.[52]

The surrogate determined "that the LLC operated as a valid de facto company prior to the filing of the articles of organization."[53] The Court additionally applied the doctrine of estoppel, concluding that "'decedent adopted the corporation [sic] by express ratification and acceptance of benefits referable to it.'"[54] The appellate division reversed, finding that the executor failed to make a "colorable attempt to comply with the statute governing the organization of limited liability companies" because he made no effort to file the articles of organization with the state prior to the execution of the deed, and as no entity existed capable of taking title to the property, this conveyance was void.[55] The Court of Appeals affirmed.[56]

1. The LLC Fails as a De Facto Entity

Judge Ciparik, writing for the majority, first addressed statutory requirements and stated that:

> [Section] 203 [of the Limited Liability Company Law] provides three specific requirements to form an LLC: (1) preparation of the articles of organization; (2) execution of the articles of organization; and (3) the filing of the articles of organization with the State. [LLC Law] [section] 209 requires that the articles of organization be delivered to the Department of State and a filing fee be paid. Here, no attempt to file articles of organization was made before the conveyance of the property.[57]

Finding that the de facto doctrine is applicable to LLCs because

49. *Id.* at 414, 921 N.E.2d at 194, 893 N.Y.S.2d at 502.

50. *Id.* at 411, 921 N.E.2d at 192, 893 N.Y.S.2d at 500.

51. *Id.*

52. *In re Hausman*, 13 N.Y.3d at 411, 921 N.E.2d at 192, 893 N.Y.S.2d at 500.

53. *Id.*

54. *Id.*

55. *In re* Estate of Hausman, 51 A.D.3d 922, 924, 858 N.Y.S.2d 330, 332 (2d Dep't 2008).

56. *In re Hausman*, 13 N.Y.3d at 412, 921 N.E.2d at 193, 893 N.Y.S.2d at 501.

57. *Id.*

"[t]he statutory schemes of the Business Corporation Law and the Limited Liability Company Law are very similar," the Court then analyzed the "very limited circumstances [when] courts may invoke the de facto corporation doctrine," namely, "'where there exists (1) a law under which the corporation might be organized, (2) an attempt to organize the corporation and (3) an exercise of corporate powers thereafter.'"[58] Applying that test to the instant case, Judge Ciparik found that the first prong of the test had been satisfied, but under *Kiamesha Development Corp. v. Guild Properties*,[59] the formation of a de facto company requires a "colorable attempt to comply with the statutes governing incorporation" prior to the exercise of corporate powers, including the filing requirement,[60] and held that the second prong had not been met.[61]

The executor had argued that under *In re Planz*, "a de facto entity may exist even where it has failed to make an attempt to file statutorily required organizational papers with the State."[62] The Court, however, pointed out that *Planz*, which had allowed application of the de facto doctrine despite a month's wait to file a certificate of incorporation with the state, was superseded by *Kiamesha*, which mandated "a good faith effort to comply with mandatory state filing requirements . . . ."[63]

And the Court continued:

> Here, it is undisputed that there was no bona fide attempt to comply with the ministerial, yet essential, requirement of filing the articles of organization prior to the attempted conveyance. Although challenged by defendant and the dissenting opinion, merely executing articles of organization along with an operating agreement and nothing more is insufficient to meet the longstanding requirements of a de facto entity. Because an entity that is neither de facto nor de jure cannot take title to real property, there was no entity in existence capable of receiving title to the real property and the purported conveyance is therefore void.[64]

For good measure, the Court found that "there is no ground for an estoppel claim because there is no evidence that decedent acted

58. *Id.*

59. 4 N.Y.2d 378, 151 N.E.2d 214, 175 N.Y.S.2d 63 (1958).

60. *Id.* at 388, 151 N.E.2d at 219, 175 N.Y.S.2d at 70; *In re Hausman*, 13 N.Y.3d at 412, 921 N.E.2d at 193, 893 N.Y.S.2d at 501.

61. *In re Hausman*, 13 N.Y.3d at 413, 921 N.E.2d at 193-94, 893 N.Y.S.2d at 501-02.

62. *Id.* at 413, 921 N.E.2d at 193, 893 N.Y.S.2d at 501 (citing *In re* Planz, 282 A.D. 552, 553, 125 N.Y.S.2d 750, 752 (3d Dep't 1953)).

63. *Id.*, 921 N.E.2d at 193-94, 893 N.Y.S.2d at 501-02.

64. *Id.*, 921 N.E.2d at 194, 893 N.Y.S.2d at 502.

inequitably or took unfair advantage of George or Susan."[65]

Judge Pigott vigorously dissented, observing that the majority "takes the holding in [*Kiamesha*] too far—to the point of virtually eliminating the legal concept of a de facto corporation . . . ."[66]

The dissenting opinion points out that:

> [A]t the time the property was conveyed from the decedent to the LLC, the articles of organization for the LLC had not yet been filed. But the sequence of events preceding the filing is important. The articles of organization and operating agreement for the LLC were executed on October 4, 2001. The decedent conveyed the property to the LLC on November 2. The articles of organization were filed on November 16 and the deed was filed on December 3, 2001. The delay in filing is about the only misstep, if a misstep at all, in an otherwise fairly normal series of events in the creation of the LLC. Five years later, only after counsel for the disinherited legatees in litigation in Surrogate Court discovered that the filing of the articles of organization followed the execution of the deed, rather than vice versa, did the timing of the filing come into question.[67]

The dissent then sets forth the rule for invoking the de facto corporation doctrine, which is, "where there exists: (1) a law under which the corporation might be organized, (2) an attempt to organize the corporation and (3) an exercise of corporate powers thereafter. All of these requirements were met here."[68] Judge Pigott goes on to assert that the *Kiamesha* case, while "interesting in its facts, should be limited to them."[69] The doctrine does not apply where there is no attempt at formal organization, but "[h]ere, however, the organization of the LLC was complete."[70]

Furthermore, he observes that in *Hausman*, the operating agreement was executed and adopted, and that:

> Those documents reveal that the LLC was organized to "solely own, operate or manage the real property and to do any and all things necessary, convenient, or incidental to that purpose." Pursuant to that purpose, the LLC took title as grantee to the real property in the name of the LLC. And it was the decedent as grantor who executed the deed naming the LLC the grantee. Two weeks after the deed was

65. *Id.* at 413, 921 N.E.2d at 194, 893 N.Y.S.2d at 502.

66. *In re Hausman*, 13 N.Y.3d at 314, 921 N.E.2d at 194, 893 N.Y.S.2d at 502 (Pigott, J., dissenting).

67. *Id.* at 413-14, 921 N.E.2d at 194, 893 N.Y.S.2d at 502.

68. *Id.* at 414, 921 N.E.2d at 194, 893 N.Y.S.2d at 502 (citation omitted).

69. *Id.*

70. *Id.* at 414, 921 N.E.2d at 194, 893 N.Y.S.2d at 502.

> executed—a reasonable period—the articles of organization were filed with the Secretary of State. The related ancillary papers, including a New York City Real Property Transfer Tax Return as well as city and state transfer tax returns, which named the LLC as grantee, were executed and filed as required.[71]

2. Conclusion

The majority decision is unsettling. It would appear that, had the majority wanted to, it could have held that the facts of the case fell within the de facto doctrine, as generally applied. Surely the facts of *Hausman* could have been reconciled with the *Kiamesha* test, which simply requires a "good faith effort to comply with mandatory state filing requirements."[72] The interpretation of "good faith" in *Hausman* appears to be unusually demanding. After *Hausman*, little appears to be left of the de facto doctrine. Was that the intent of the majority?

Or was it rather that the Court preferred not to be in the unseemly position of supporting the disinheritance of decedent's other heirs, the grandchildren of her deceased sons? No matter what the basis for the decision, a useful rule has been significantly undercut with little guidance going forward.

B. Fiduciary Obligations

Roni LLC v. Arfa extended the fiduciary obligations of a corporate promoter to an organizer of an LLC.[73] In this case, plaintiffs purchased LLC membership interests in LLCs that were organized to purchase and manage apartment buildings.[74] Plaintiffs alleged that the defendants, promoters of the LLCs, induced the plaintiffs to invest by allegedly disclosing certain of the profits that the defendants would be making, while intentionally concealing kickbacks of up to fifteen percent of the purchase price that they were to receive from the property sellers and from mortgage brokers.[75] The court's holding extended the common-law fiduciary duty of full disclosure under corporation law to the law of LLCs:

> However, plaintiffs' allegations that the promoter defendants planned the business venture, organized the LLCs, and solicited plaintiffs to

71. *In re Hausman*, 13 N.Y.3d at 414-15, 921 N.E.2d at 195, 893 N.Y.S.2d at 503.

72. *See* Kiamesha Dev. Corp. v. Guild Props., 4 N.Y.2d 378, 151 N.E.2d 214, 175 N.Y.S.2d 63 (1958).

73. 74 A.D.3d 442, 444, 903 N.Y.S.2d 352, 355 (1st Dep't 2010).

74. *Id.* at 443, 903 N.Y.S.2d at 354.

75. *Id.*

> invest in them are sufficient to establish a fiduciary relationship.[76] It is well settled that both before and after a corporation comes into existence, its promoter acts as the fiduciary of that corporation and its present and anticipated shareholders.[77] By extension, the organizer of a limited liability company is a fiduciary of the investors it solicits to become members.[78] The fiduciary duty includes the obligation to disclose fully any interests of the promoter that might affect the company and its members, including profits that the promoter makes from organizing the company.[79] Accordingly, plaintiffs stated a cause of action for breach of fiduciary duty by alleging that the promoter defendants failed to reveal that they would receive commissions from sellers and mortgage brokers in addition to their other, disclosed, profit from the venture.[80]

The citations are noteworthy because the *Roni* decision has been criticized on the grounds that it creates a fiduciary duty for an LLC organizer where there was none before.[81] The common-law authorities cited by the court should be sufficient to demonstrate the existence of such a fiduciary duty; it is well settled in corporation common law that a promoter of stock cannot conceal material facts relevant to the investment. In addition to the authorities cited, New York courts have also long recognized a similar duty by promoters of investments in partnerships. In *Huang v. Sy*, for example, the court recognized a cause of action where, during preliminary negotiations to form a partnership, the promoter allegedly concealed material facts from his partners-to-be.[82] Both strands of legal precedent support the court's extension of the principle to LLCs in *Roni*, which had more to do with the promoters' function as promoters, and less with the form of entity they used to sell their investments.

---

76. *See* Dickerman v. N. Trust Co., 176 U.S. 181, 203-04 (1900).

77. *See* Brewster v. Hatch, 122 N.Y. 349, 25 N.E. 505 (1890); Gates v. Megargel, 266 F. 811 (2d Cir. 1920), *cert. denied*, 254 U.S. 639 (1920); *see also* 1 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 192.10 (perm. ed).

78. *See generally* N.Y. LTD. LIAB. CO. LAW § 203(a)(iii) (McKinney 2007).

79. *See Brewster*, 122 N.Y. 349, 25 N.E. 505; *see also* FLETCHER ET AL., *supra* note 78, § 193.10, at 353-57.

80. *Roni LLC*, 74 A.D.3d at 444-45, 903 N.Y.S.2d at 355-56.

81. *See* Peter A. Mahler, *Are LLC Organizers Fiduciaries?*, N.Y. BUS. DIVORCE (June 28, 2010, 6:00 AM), http://www.nybusinessdivorce.com/2010/06/articles/llcs/are-llc-organizers-fiduciaries/index.html; Larry Ribstein, *Pre-formation Fiduciary Duties in LLCs: Another NY Problem*, TRUTH ON THE MARKET (June 21, 2010), http://truthonthemarket.com/2010/06/21/pre-formation-fiduciary-duties-in-llcs-another-ny-problem.

82. No. 15115/90, 2008 N.Y. Slip Op. 50391(U), at 6-7 (Sup. Ct. Queens Cnty. 2008), *aff'd*, 62 A.D.3d 660, 878 N.Y.S.2d 398 (2d Dep't 2009).

C. Dissolution

The decision in *In re 1545 Ocean Avenue, LLC* confirms that LLCs are difficult to dissolve.[83]

1545 Ocean Avenue, LLC ("1545 LLC") was formed under New York law in November 2006,[84] to purchase property at 1545 Ocean Avenue, Bohemia, New York, repair the building on that site, and construct a second building.[85] 1545 LLC had two equal members, Crown Royal Ventures, LLC ("Crown Royal") and Ocean Suffolk Properties, LLC ("Ocean Suffolk"), each contributing fifty percent of the capital.[86] Under its operating agreement, 1545 LLC had two managers: John J. King ("King"), who was the representative member on behalf of Crown Royal, and Walter T. Van Houten ("Van Houten"), who was the representative member on behalf of Ocean Suffolk.[87]

The operating agreement of 1545 LLC provided that:

> "At any time when there is more than one Manager, any one manager may take any action permitted under the Agreement, unless the approval of more than one of the Managers is expressly required pursuant to the Agreement [i.e., the operating agreement] or the Act" [i.e., the LLC Law].[88]

The operating agreement did not require that the managers meet regularly.[89]

A consequence of this flexibility was that Van Houten was able to hire the company he owned, Van Houten Construction ("VHC"),[90] to perform the demolition, rehabilitation, and construction work on the buildings for 1545 LLC[91] without obtaining the prior approval of King.[92] King thought that VHC's construction work, although "awesome," cost too much, was not being progressed timely, and that Van Houten was intentionally avoiding meeting with him on a regular basis.[93]

By April 2007, six months after 1545 LLC was formed, King

83. 72 A.D.3d 121, 893 N.Y.S.2d 590 (2d Dep't 2010).

84. *Id.* at 123, 893 N.Y.S.2d at 592.

85. *Id.*

86. *Id.*

87. *Id.*

88. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 130, 893 N.Y.S.2d at 597 (emphasis omitted).

89. *Id.* at 125, 893 N.Y.S.2d at 593.

90. *Id.* at 123, 893 N.Y.S.2d at 592.

91. *Id.* at 123-24, 893 N.Y.S.2d at 592-93.

92. *Id.* at 123, 893 N.Y.S.2d at 592.

93. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 124, 893 N.Y.S.2d at 593.

informed Van Houten that he wanted to withdraw his investment from the LLC and notify all vendors that Van Houten "was taking over the management of 1545 LLC."[94] Then a period of negotiations began between King and Van Houten, with each member offering to buy out the other, but reaching no conclusion.[95] During this period, VHC continued to perform work on the project bringing it to within three or four weeks of completion.[96] At that point, Crown Royal brought an action against Ocean Suffolk and Van Houten seeking dissolution of 1545 LLC under LLC Law section 702.[97] Van Houten's response was that King had effectively resigned as a manager of 1545 LLC, and that the construction work and business of 1545 LLC had been proceeding as if Van Houten were the sole manager, that is, until the trial court enjoined Van Houten's work in connection with the dissolution proceeding.[98]

The operating agreement of 1545 LLC did not address dissolution, except to state that dissolution was to be governed by applicable provisions of the LLC Law.[99] King, on behalf of Crown Royal, argued for dissolution on the grounds that the members did not hold regular meetings, or achieve quorums, and were essentially deadlocked.[100]

Section 702 of the LLC Law provides, in relevant part:

> On application by or for a member, the supreme court in the judicial district in which the office of the limited liability company is located may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles or organization or operating agreement.[101]

The opinion by Judge Austin for the Second Department parsed the phrase "whenever it is not reasonably practicable to carry on the business in conformity with the articles or organization or operating agreement,"[102] which the court believed had not been discussed in previous New York decisions.[103] The court then distinguished between

94. *Id.*

95. *Id.*

96. *Id.* at 124, 125, 893 N.Y.S.2d at 593, 594.

97. *Id.* at 125, 893 N.Y.S.2d at 593.

98. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 125-26, 893 N.Y.S.2d at 594.

99. *Id.* at 125, 893 N.Y.S.2d at 593.

100. *Id.* at 129, 893 N.Y.S.2d at 596.

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

102. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 126, 893 N.Y.S.2d at 594 (emphasis omitted) (citation omitted).

103. *Id.* at 127, 893 N.Y.S.2d at 594.

the judicial dissolution provisions of the New York BCL[104] and the New York Partnership Law[105] on the one hand, and the LLC Law on the other,[106] holding that the dissolution standards for the first two kinds of entities should not apply to LLCs.[107] The court also distinguished between the effect of "deadlock" under section 1104 of the New York BCL,[108] where "'[d]eadlock' is a basis, in and of itself, for judicial dissolution,"[109] and section 702 of the LLC Law,[110] where deadlock does not form an "independent ground for dissolution."[111] That being the case, the court believed that it "must consider the managers' disagreement in light of the operating agreement and the continued ability of 1545 LLC to function in that context," and then looked to decisions from other states, particularly Delaware, for applying the "not reasonably practicable" standard.[112]

Following its analysis of various statutes and cases, the Second Department held that:

> [F]or dissolution of a limited liability company pursuant to LLCL 702, the petitioning member must establish, in the context of the terms of the operating agreement or articles of incorporation [sic], that (1) the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or (2) continuing the entity is financially unfeasible.[113]

The Second Department concluded that Crown Royal, the petitioner for dissolution, had not met this standard.[114] The dispute between King and Van Houten had not interfered with the purpose of the LLC,[115] which was the repair and construction of the buildings at 1545 Ocean Avenue.[116] "King never objected to the quality of Van Houten's construction work, but only to its expense."[117] Nor could

104. *Id.*, 893 N.Y.S.2d at 595 (citing N.Y. BUS. CORP. LAW §§ 103(a), 1104, 1104-a (McKinney 2003).

105. *Id.* (citing N.Y. P'SHIP LAW §§ 10(2), 62 (McKinney 2006)).

106. *Id.* at 127-28, 893 N.Y.S.2d at 595 (citing N.Y. LTD. LIAB. CO. LAW 702).

107. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 128, 893 N.Y.S.2d at 595.

108. N. Y. BUS. CORP. LAW § 1104.

109. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 129, 893 N.Y.S.2d at 596.

110. N.Y. LTD. LIAB. CO. LAW § 702.

111. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 129, 893 N.Y.S.2d at 596.

112. *Id.* at 129-31, 893 N.Y.S.2d at 596-97.

113. *Id.* at 131, 893 N.Y.S.2d at 598 (the phrase "articles of incorporation" in the quotation should probably read "articles of organization").

114. *Id.*

115. *Id.* at 132, 893 N.Y.S.2d at 598.

116. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 132, 893 N.Y.S.2d at 598.

117. *Id.* at 132, 893 N.Y.S.2d at 598.

King invoke violations of the operating agreement of 1545 LLC, because the operating agreement expressly permitted one manager of the LLC to act unilaterally, unless another provision expressly required the approval of more than one manager.[118] The court observed, "the managers, King and Van Houten, communicated with each other on a regular basis without the formality of a noticed meeting which appears to conform with the spirit and letter of the operating agreement and the continued ability of 1545 LLC to function . . . ."[119]

Furthermore, two other remedies were available to "regulate" Van Houten,[120] including LLC Law section 411:

> LLCL 411 permits a limited liability company to avoid contracts entered into between it and an interested manager, or another limited liability company in which a manager has a substantial financial interest, unless the manager can prove the contract was fair and reasonable.
>
> The notion that 1545 LLC could void the contract with VHC in its entirety may serve as a check on Van Houten's unilaterally hiring his own company for future construction work on the property, and may result in Van Houten being made to disgorge excess moneys paid in derogation of 1545 LLC's best interest at the time of the accounting of the members.[121]

The court also pointed out that Crown Royal could have availed itself of a derivative action under the recent Court of Appeals decision in *Tzolis v. Wolff*.[122] Thus, Crown Royal was not completely without recourse.[123]

Finally, quoting *In re Extreme Wireless* for the rule that dissolution of an LLC is to be determined "'in the sound discretion of the court hearing the petition,'"[124] in this instance, the Second Department found that the trial court "did not providently exercise its discretion" and ordered that the petition for dissolution be dismissed.[125]

The decision in *1545 Ocean Avenue* once again serves to prompt careful drafting of dissolution provisions in an LLC operating agreement, particularly if the members want dissolution rights beyond the very limited rights provided by the LLC Law. If an operating

118. *Id.* at 130, 893 N.Y.S.2d at 597.

119. *Id.* at 129, 893 N.Y.S.2d at 596.

120. *Id.*

121. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 132, 893 N.Y.S.2d at 598.

122. *Id.* (citing 10 N.Y.3d 100, 884 N.E.2d 1005, 855 N.Y.S.2d 6 (2008)).

123. *See id.*

124. *Id.* at 133, 893 N.Y.S.2d at 598-99 (quoting *In re Extreme Wireless*, 299 A.D.2d 549, 550, 750 N.Y.S.2d 520, 521 (2d Dep't 2002)).

125. *Id.* at 133, 893 N.Y.S.2d at 599.

agreement does not provide for dissolution, then members of an LLC might better continue their business arrangement, notwithstanding disagreements.

In *Naples v. Olin*, an LLC member obtained a less favorable result by going to court too early.[126] In *Naples*, the operating agreement "prohibited the parties from 'tak[ing] any action which would make it impossible to carry on the ordinary business or accomplish the purposes of the [company]'"[127] and,

> provided that the company "shall be dissolved and shall commence winding up its business and affairs" upon the happening of any event that made it impossible or impractical to carry on the business of the company. That provision further indicated that the company could not dissolve prior to a dissolution event and that if it were determined that an attempt was made to dissolve the company prior to such an event, the members were required to "continue the business of the Company without winding up its affairs."[128]

The LLC in *Naples* had two equal members.[129] The operating agreement provided that one of the members, Naples, was to be paid $5,000 per month for six months in consideration for services to be provided to the LLC.[130] Notwithstanding the anti-dissolution language in the operating agreement, after one month and the payment of $10,000 to Naples, the members had a falling out.[131] Olin, the other member, unilaterally filed articles of dissolution of the LLC with the department of state.[132] Naples then brought a special proceeding to be appointed as the liquidating trustee in accordance with section 703 of the LLC Law,[133] and sought the remaining $20,000 compensation to be paid to him for the remaining four months.[134] Olin objected on the grounds that the dispute over the compensation should have been taken to arbitration.[135]

The special proceeding resulted in the supreme court appointing a third party to be the liquidating trustee who found that Naples was not

126. 66 A.D.3d 1310, 887 N.Y.S.2d 378 (3d Dep't 2009).

127. *Id.* at 1311, 887 N.Y.S.2d at 380.

128. *Id.*

129. *Id.* at 1310, 887 N.Y.S.2d at 379.

130. *Id.* at 1311, 887 N.Y.S.2d at 380.

131. *In re Naples*, 66 A.D.3d at 1310, 887 N.Y.S.2d at 379.

132. *Id.*

133. N.Y. LTD. LIAB. CO. LAW § 703 (McKinney 2007).

134. *In re Naples*, 66 A.D.3d at 1310-11, 887 N.Y.S.2d at 379-80.

135. *Id.* at 1311-12, 887 N.Y.S.2d at 380. The opinion does not state whether the operating agreement contained an arbitration clause. *See id.*

entitled to the claimed $20,000.[136] Although Naples contested the trustee's finding, the supreme court upheld it.[137] Naples then appealed the supreme court's decision, not only claiming his $20,000, but also claiming that Olin had no authority to dissolve the LLC unilaterally, and that the question of dissolution should have gone to arbitration.[138]

The appellate division affirmed the lower court:

> We note that while petitioner now argues that respondent lacked the authority to unilaterally determine that petitioner's conduct caused a dissolution event and that respondent should have pursued arbitration with respect to that issue, it was petitioner himself who commenced this special proceeding seeking to wind up the company's business affairs—over respondent's objection that the matter should be referred to arbitration. Under these circumstances—with petitioner having implicitly conceded that a dissolution event occurred, consented to the winding up of the company's affairs by commencing this proceeding, and expressly urged Supreme Court to deny respondent's request to refer the matter to arbitration—the court correctly determined that respondent's filing of the articles of dissolution did not prevent petitioner's continued performance.[139]

Based on this decision, Naples might have had better success claiming the remaining $20,000 had he simply continued to perform services for the LLC, notwithstanding his dispute with Olin, and forgone his attempt to wind up the LLC.

According to *In re Superior Vending, LLC*, if an LLC is to be judicially dissolved, then the powers of the supreme court under the LLC Law extend to providing one member the right to purchase the interest of another member.[140] According to *Chiu v. Chiu*, however, the courts cannot expel an LLC member, however, unless the operating agreement provides for this remedy.[141]

IV. CORPORATIONS

A. Shareholders

In *Waldman v. 853 St. Nicholas Realty Corp.*, the plaintiffs owned twenty percent of the stock of the defendant corporation, whose sole

136. *Id.* at 1311, 887 N.Y.S.2d at 380.
137. *Id.*
138. *In re Naples*, 66 A.D.3d at 1311, 887 N.Y.S.2d at 380.
139. *Id.* at 1311-12, 887 N.Y.S.2d at 380.
140. 71 A.D.3d 1153, 1154, 898 N.Y.S.2d 191, 192 (2d Dep't 2010).
141. 71 A.D.3d 646, 647, 896 N.Y.S.2d 131, 132 (2d Dep't 2010).

asset was an apartment building.[142] The plaintiffs alleged that in 1992, the corporation was controlled by a majority shareholder who told the plaintiffs that the corporation was planning to abandon the building and cease operations.[143] The majority shareholder, however, sold the apartment building and what supposedly was all of the outstanding shares of stock to a third party.[144] The purchase price was paid by checks made payable to the corporation.[145] The plaintiffs discovered the sale in 2006, and brought an action for a "judgment declaring the rights of the plaintiffs as owners of . . . shares in the defendant corporation."[146]

The court denied the defendant corporation's motion for summary judgment, stating:

> The majority shareholder owed a fiduciary duty to the plaintiffs, who were minority shareholders. The power to manage the affairs of a corporation is vested with its directors and majority shareholders. As such, the directors and majority shareholders of corporations are cast in the fiduciary role of guardians of corporate welfare. In undertaking any corporate action, they must act in good faith.[147]

Interestingly, the court held that the facts presented a "justiciable controversy" precluding summary judgment in favor of the defendant corporation, although it was the majority shareholder and not the defendant corporation who allegedly violated a fiduciary duty.[148] Perhaps it was because the corporation was the recipient of the sale proceeds, not the majority shareholder.[149] Whatever the thinking of the court, *Waldman* reaffirms the general principle that a majority shareholder has a fiduciary obligation to minority shareholders.[150]

Section 630 of the New York BCL[151] imposes personal liability on the ten largest shareholders of a New York corporation for unpaid wages and salaries.[152] *Stuto v. Kerber* held that section 630 applies only

142. 64 A.D.3d 585, 586, 882 N.Y.S.2d 481, 482 (2d Dep't 2009).

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. *Waldman*, 64 A.D.3d at 587, 882 N.Y.S.2d at 482 (citation omitted).

148. *Id.*

149. *See id.* at 586, 882 N.Y.S.2d at 482.

150. *Id.* at 587, 882 N.Y.S.2d at 483.

151. N.Y. BUS. CORP. LAW § 630 (McKinney 2003).

152. *Id.* Section 630 expressly exempts investment companies registered under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (2006), or companies having shares listed on a national securities exchange or regularly traded by a members of a national or affiliated securities association. *Id.*

to corporations organized under New York law and did not apply to a Delaware corporation doing business in New York.[153] In *Flannigan v. Vulcan Power Group, L.L.C.*, the Federal District Court of the Southern District of New York came to the same conclusion and held that the plaintiff in a diversity action with a judgment against foreign business entities for unpaid sales commissions could not use section 630 against the entities' shareholders.[154]

El-Roh Realty Corp. v. Schwimmer discussed a provision in a shareholders' agreement, which required a shareholder, who attempted to transfer shares in violation of the agreement, to offer her shares to the corporation and the remaining shareholders for purchase within 120 days after the corporation received notice of the attempted transfer.[155] In an earlier proceeding, the court determined that a shareholder's petition for dissolution of the corporation, filed in 2006, constituted such an attempted transfer.[156] The shareholders' agreement further provided that the purchase price was to be determined either by annual agreement of the shareholders, or, if they had not made an agreement during the twelve months preceding the attempted transfer, the corporation's independent certified public accounts were to calculate the purchase price.[157]

In the course of the dissolution proceeding, the accountants delivered their calculation of the purchase price, and the corporation and the remaining shareholders stated they would purchase the shares at that price.[158] The petitioner argued that the 120 day period, during which the corporation and the other shareholders had the right to purchase her shares, had long since passed,[159] but the court held that the right was validly exercised, stating:

> [T]he only reasonable interpretation of those provisions in the agreement that gives effect to all provisions and the intent of the shareholders is that the corporation and shareholders are entitled to know the purchase price of the shares before determining whether to purchase them . . . . It would be commercially unreasonable and absurd to require respondents to agree to purchase petitioner's shares without knowing the price.[160]

153. 26 Misc. 3d 535, 539, 888 N.Y.S.2d 872, 875 (Sup. Ct. Albany Cnty. 2009).
154. 712 F. Supp. 2d 63, 70 (S.D.N.Y. 2010).
155. 74 A.D.3d. at 1797-99, 902 N.Y.S.2d at 728-30 (4th Dep't 2010).
156. *Id.* at 1797, 902 N.Y.S.2d at 728.
157. *Id.* at 1799, 902 N.Y.S.2d at 730.
158. *Id.* at 1798, 902 N.Y.S.2d, at 729.
159. *In re El-Roh Realty Corp.*, 74 A.D.3d at 1798, 902 N.Y.S.2d at 729.
160. *Id.* at 1799-1800, 902 N.Y.S.2d at 730 (citing *In re* Lipper Holdings v. Trident

B. Directors

This past year brought a development in the law of directors' duties as to the extent of directors' fiduciary duties to creditors in the "zone of insolvency." The court in *RSL Communications PLC v. Bildirici*, a diversity case applying New York law, held that there is no such duty:

> Plaintiff has failed to provide sufficient authority under New York law to sustain a cause of action based on the existence of a duty of care owed by directors of a corporation to the corporation's creditors while the corporation allegedly operates in the so-called "zone of insolvency . . . ."[161]

In discussing its conclusion, the court expressly noted that Delaware corporate law decisions can provide persuasive (although not binding) authority in cases involving New York corporate law: "It goes without saying that, while the Court is not obligated to follow Delaware law in this matter, many courts—including this one—appropriately look to the views of Delaware's learned jurists when analyzing issues of corporate law."[162]

This case is another instance of New York courts looking to Delaware decisions, where authority in New York is lacking.

C. Continental Casualty Co. v. PricewaterhouseCoopers, LLP

In *Continental Casualty Co. v. PricewaterhouseCoopers, LLP*, the Court of Appeals addressed the issue of direct versus derivative damages and plaintiffs' burden of proof when claiming fraud in the inducement in an investment matter.[163]

1. The Facts

Plaintiffs were former limited partners of Lipper Convertibles, LP ("Fund"), a private investment hedge fund managed for the benefit of the limited partners by its general partner, Lipper Holdings, LLC, a Delaware limited liability company ("Holdings").[164] Under the partnership agreement, the passive limited partners "held interests equal to their initial investment amounts plus (or minus) any gains (or losses)

Holdings, 1 A.D.3d 170, 766 N.Y.S.2d 561 (1st Dep't 2003)).

161. 649 F. Supp. 2d 184, 198 (S.D.N.Y. 2009).

162. *Id.* at 205-06.

163. *See generally* 15 N.Y.3d 264, 933 N.E.2d 738, 907 N.Y.S.2d 139 (2010).

164. *Id.* at 266-67, 933 N.E.2d at 739, 907 N.Y.S.2d at 140.

resulting from the partnership's investment activities."[165] During the period at issue, PricewaterhouseCoopers ("PwC") audited the Fund, reviewed the financial statements, detailed its performance, and valued each partners' interest.[166]

Between 1997 and 2001, the plaintiffs, who had invested more than $120 million in the Fund, claimed that their investments were made in justifiable reliance upon the financial statements prepared by PwC for the years 1995 through 2000, and PwC's representation that the financial statements were accurate and prepared in conformity with generally accepted accounting principles (GAAP).[167] Nonetheless, despite the fact that the statements and reports consistently showed growth in the value of the Fund's portfolio, the Fund's assets were later proven to be fraudulently overstated "by many millions of dollars."[168]

In the case before the Court, the issue of fraud was not in doubt. The fraud had been publicly revealed in 2002, when the Fund's portfolio manager publicly resigned and Holdings conducted a review of the Fund's portfolio.[169] Holdings "discovered that its manager had used an improper method for valuing the Fund's securities, materially overstating the value of the holdings."[170] The manager was later investigated by the United States Securities and Exchange Commission (SEC), was criminally prosecuted, and ultimately entered a guilty plea for securities fraud.[171] As for PwC, the individual accountant in charge of conducting the audits of the Fund's financial statements was suspended by the SEC, which had determined that PwC's representations that it had conducted audits of the Fund's financial statements in compliance with generally accepted accounting principles "were materially false and that its approval of the certification of the Fund's financial statements was 'highly unreasonable.'"[172]

As a result, the Fund was reevaluated and the limited partners, including the plaintiffs, were advised of a reduced assessment of the Fund's "net equity value by approximately $400 million, a 40% 'write down' in its previously reported capital."[173] "A proceeding to dissolve the Fund was commenced," and a new accounting firm engaged to

165. *Id*. at 267, 933 N.E.2d at 739, 907 N.Y.S.2d at 140.
166. *Id.*
167. *Id.*
168. *Cont'l Cas. Co.*, 15 N.Y.3d at 267, 933 N.E.2d at 739, 907 N.Y.S.2d at 140.
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*
173. *Cont'l Cas. Co.*, 15 N.Y.3d at 268, 933 N.E.2d at 740, 907 N.Y.S.2d at 141.

"determine a methodology for distribution of assets," including a recalculation of the existing partners' percentage interests for the purpose of a distribution.[174] Eventually, a plan for distribution was developed and the plaintiffs recovered approximately $111.5 million of their investment.[175]

In spring 2003, a Trustee was appointed and charged with bringing claims against the former Fund manager and others.[176] In 2004, "the Trustee commenced an action against PwC for damages" caused by alleged improper audits, asserting causes of action for "accountant malpractice, fraud, breach of fiduciary duty and breach of contract," alleging that, among other things, PwC had been aware of the misstatements in the financial reports, but had failed to bring them to the attention of management, all the while falsely representing that the financial statements were prepared in accordance with GAAP.[177]

2. Fraud in the Inducement and Direct vs. Derivative Claims

In late 2003, the plaintiffs "commenced these three separate actions against PwC."[178] "Each action asserted claims of fraud, aiding and abetting fraud, aiding and abetting breach fiduciary duty, negligent representation and negligence."[179] For the fraud cause of action, "plaintiffs allege[d] that PwC induced them to invest in the Fund through the year-end statements, as well as monthly reports, without having employed the proper auditing methods necessary to ensure that the financial statements were accurate."[180] PwC moved to dismiss, "arguing that plaintiffs had pleaded no injury distinct from the injury attributed to the Fund as a whole, which was the subject of the Trustee action that had been brought on behalf of, and would inure to the benefit of, all injured limited partners," and that "plaintiffs' action should be dismissed because it alleged only a derivative injury or, alternatively, should be stayed pending resolution of the Trustee's action."[181]

Plaintiffs countered that their claims were distinct from the Trustee's action because they were seeking a recovery "predicated on fraud in the inducement, [namely,] that they had been fraudulently induced to rely on PwC's audits when they made their initial investment

174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.*
178. *Cont'l Cas. Co.*, 15 N.Y.3d at 268, 933 N.E.2d at 740, 907 N.Y.S.2d at 141.
179. *Id.*
180. *Id.* at 268-69, 933 N.E.2d at 740, 907 N.Y.S.2d at 141.
181. *Id.* at 269, 933 N.E.2d at 740, 907 N.Y.S.2d at 141.

in the Fund and thus sustained injury on the very day of their purchase."[182] In contrast, the Trustee's action sought recovery for excessive management and incentive fees paid as a result of the overvaluation, and "net income loss"[183] (a crucial category that raises an important question regarding the difference between accounting treatment and legal treatment). PwC moved to dismiss.[184]

The trial court denied, in part, PwC's motion to dismiss and held that "'to the extent that Plaintiffs assert direct claims, such as fraud in the inducement of their initial investment in the Partnership, they are not derivative . . . .'"[185] At the discovery phase, both parties presented expert testimony to address the extent, if any, of distinct, non-derivative injury.[186] Discovery concluded with PwC moving for summary judgment, claiming that the plaintiffs had failed to show proof of injuries distinctly their own.[187]

> In support of the motion, PwC submitted the affidavit of an expert economist who opined that all of the damages articulated by plaintiffs were derivative as they consisted only of plaintiffs' pro rata share, as limited partners, of the Fund's losses from (1) net income loss, (2) overpayments of general partner fees, and (3) overpayments of capital to withdrawn limited partners.[188]

Plaintiffs' accounting expert argued that "because the Fund had been overvalued at the time of the plaintiffs' investment, the damages plaintiffs suffered should be calculated as 'the difference between their initial investments and the amount they actually recovered through withdrawals or distributions from the Fund, plus an appropriate amount of prejudgment interest.'"[189] The total shortfall for the plaintiffs, the expert concluded, was approximately thirty-five million dollars, and that the plaintiffs would recover "far less" from the Fund, if limited solely to the Trustee's proceeding.[190]

The trial court granted PwC's motion, finding that "plaintiffs failed to carry their burden to respond to PwC's prima facie showing with

182. *Id.*

183. *Cont'l Cas. Co.*, 15 N.Y.3d at 269, 933 N.E.2d at 740-41, 907 N.Y.S.2d at 141-42.

184. *Id.* at 269, 933 N.E.2d at 741, 907 N.Y.S.2d at 142.

185. *Id.* (citing Jones v. PricewaterhouseCoopers, LLP, No. 602962/2003, 2004 N.Y. Slip Op. 51789(U), at 1, 4 (Sup. Ct. N.Y. Cnty. 2004)).

186. *Id.* at 269, 933 N.E.2d at 741, 907 N.Y.S.2d at 142.

187. *Id.*

188. *Cont'l Cas. Co.*, 15 N.Y.3d at 269, 933 N.E.2d at 741, 907 N.Y.S.2d at 142.

189. *Id.* at 269-70, 933 N.E.2d at 741, 907 N.Y.S.2d at 142.

190. *Id.* at 270, 933 N.E.2d at 741, 907 N.Y.S.2d at 142.

competent evidence."[191] The trial court's conclusion was that the pleadings showed all of the losses to be derivative:

> [T]he injuries that the plaintiffs suffered derived from their status as limited partners. Any duty that P[w]C owed to the limited partners was derivative of P[w]C's obligations to the limited partnership. Plaintiffs' resulting injury is attributable to a loss the limited partnerships suffered and then to plaintiffs through the allocation of those losses on a pro rata basis.[192]

The court also concluded that the plaintiffs were not to be given any further opportunities to argue that they suffered any direct special losses, "discovery is now closed and plaintiffs fail to produce any evidence to support their claim that they suffered a direct injury at the time of their investments that is distinct from injury to the Partnerships . . . ."[193]

The appellate division affirmed.[194]

3. The Court of Appeals Decision

The Court of Appeals' analysis begins with the assumption that the plaintiffs had properly alleged a cause of action against PwC, but that the gravamen of the dispute was "whether plaintiffs came forward with proof to refute PwC's showing that all the damages claimed under that cause of action were plaintiffs' share of partnership losses and thus derivative in nature."[195] Citing *Reno v. Bull*,[196] Judge Pigott, writing for the majority, affirmed the rule that "a plaintiff may recover only the actual pecuniary loss sustained as a direct result of the wrong,"[197] and that "the actual loss sustained as a direct result of the fraud that induces an investment is the 'difference between the value of the bargain which a plaintiff was induced by fraud to make and the amount or value of the consideration exacted as the price of the bargain.'"[198] The Court distinguished *Hotaling v. Leach & Co.*,[199] which had been relied on by

191. *Id.*

192. Cont'l Cas. Co. v. PricewaterhouseCoopers LLP, No. 0120016/2003, 2007 N.Y. Slip Op. 33619(U), at 6 (Sup. Ct. N.Y. Cnty. 2007).

193. *Cont'l Cas. Co.*, 15 N.Y.3d at 270, 933 N.E.2d at 741, 907 N.Y.S.2d at 142 (quoting *Cont'l Cas. Co.*, 2007 N.Y. Slip Op. 33619(U), at 6)).

194. *Id.* (citing Cont'l Cas. Co. v. PricewaterhouseCoopers, LLP, 57 A.D.3d 411, 411, 869 N.Y.S.2d 506, 507 (1st Dep't 2008)).

195. *Id.* at 271, 933 N.E.2d at 742, 907 N.Y.S.2d at 143.

196. 226 N.Y. 546, 124 N.E. 144 (1919).

197. *Cont'l Cas. Co.*, 15 N.Y.3d at 271, 933 N.E.3d at 742, 907 N.Y.S.2d at 143.

198. *Id.* (citing Sager v. Friedman, 270 N.Y. 472, 481, 1 N.E.2d 971, 974 (1936)).

199. 247 N.Y. 84, 159 N.E. 870 (1928).

plaintiffs as an exception to the fraud damages rule.[200] Affirming the appellate division's dismissal of the fraud cause of action, the Court observed:

> [T]he Court in *Hotaling* rejected a measure of damages based on the market value of the bond when the plaintiff purchased it, explaining that such value could not be determined and would have left plaintiff without any remedy. Here, in contrast, plaintiffs could have come forward with portfolio valuations showing the amount of the claimed overvaluation of the portfolio on the day of their respective investments. Indeed, plaintiffs' expert acknowledged that such an analysis could be undertaken, but he failed to do one, and BDO Seidman undertook a similar calculation in relation to the liquidation proceeding. Further there was no overlapping derivative claim in *Hotaling* that would inure to the plaintiff's benefit. Here, the Trustee has prosecuted claims seeking the very same categories of damages allegedly suffered by plaintiffs. The presence of the overlapping claims requires plaintiffs to come forward with direct, distinct date-of-investment injuries.
>
> Plaintiffs failed to meet their burden. The only injury they seek to establish is the diminution in value of their limited partnership interests at liquidation. However, that diminution is attributable to their pro rata share of the partnership's losses after the date of their investments, and they experienced those losses in their capacities as limited partners in common with all other limited partners.[201]

In the sole dissent, Judge Read notes that "the record is replete with evidence that the fund's investment assets were spuriously inflated during the years when plaintiffs made individual cash contributions."[202] Furthermore,

> there is no dispute that each plaintiff's initial percentage ownership interest in the fund was calculated by taking the value of that plaintiff's cash contribution and dividing it by the total *stated* value of all existing limited partners' capital accounts. As a matter of mathematics, since the stated value of the capital accounts of the existing limited partners was artificially inflated . . . the relative percentage ownership interest of each plaintiff's investment in the fund was necessarily understated on the day it was made.[203]

Noting that PwC "did not fulfill its initial burden to establish that plaintiffs could not prove unique date-of-investment injuries," Judge

200. *Cont'l Cas. Co.*, 15 N.Y.3d at 271, 933 N.E.2d at 742, 907 N.Y.S.2d at 143.
201. *Id.* at 271-72, 933 N.E.2d at 742-43, 907 N.Y.S.2d at 143-44.
202. *Id.* at 272, 933 N.E.2d at 743, 907 N.Y.S.2d at 144 (Read, J., dissenting).
203. *Id*. at 273, 933 N.E.2d at 743, 907 N.Y.S.2d at 144.

Read disagrees with the majority that in order to avoid summary judgment, plaintiffs "had to produce evidence of the *amount* of their damages for direct injuries whose existence PwC did not refute."[204]

4. Conclusion

Upon reading this case, one comes away with a sense that the majority and the dissent are more closely aligned than a quick reading of both opinions might otherwise suggest. The majority and Judge Read do not disagree as to the burden of proof that the plaintiffs must carry.[205] Rather, they disagree as to when the opportunity to discharge that burden expires in the context of a motion to dismiss or a motion for summary judgment.[206]

The dissent appears to be prepared to allow plaintiffs an extended period of time to prove the amount of their direct damages in a motion for summary judgment, so long as the existing record clearly supports a basis for doing so.[207] The majority, on the other hand, appears loathe to create another exception to a fairly straight-forward rule.[208] Plaintiffs, after all, recognized the issue early on, and had an opportunity at the time of discovery to carry their burden and present a mathematical analysis necessary to establish and preserve their individual claims of fraud in the inducement as to their initial investments.[209] They did not do so. The time came and passed, litigation moved on, and the majority refused to re-open that door.

Finally, it appears that while plaintiffs did not present any calculation of special damages, under the facts they may not have been able to do so. Judge Read points out in his dissent that fraud in the inducement affected each investor differently, depending on the time at which each investment was made.[210] Under this scenario, individual investments appear to have been inflated in differing proportions, suggesting that individual claims are direct, not derivative. The trial court, however, found that the claims against PwC were derivative

204. *Id.* at 274, 933 N.E.2d at 744, 907 N.Y.S.2d at 145.

205. *Compare Cont'l Cas. Co.*, 15 N.Y.3d at 272, 933 N.E.2d at 743, 907 N.Y.S.2d at 144 (majority opinion), *with id.* at 274, 933 N.E.2d at 744, 907 N.Y.S.2d at 145 (Read, J., dissenting).

206. *Id.*

207. *See id.* at 274, 933 N.E.2d at 744, 907 N.Y.S.2d at 145 (Read, J., dissenting).

208. *See id.* at 271-72, 933 N.E.2d at 742-43, 907 N.Y.S.2d at 143-44 (majority opinion).

209. *See Cont'l Cas. Co.*, 15 N.Y.3d at 271-72, 933 N.E.2d at 742-43, 907 N.Y.S.2d at 143-44.

210. *Id.* at 272, 933 N.E.2d at 743, 907 N.Y.S.2d at 144.

only—not direct—because PwC's sole duty was to the Fund, and not to the individual investors, a finding that precluded a claim for direct damages against PwC by the plaintiffs.[211]

C. Insider Trading and Breach of Fiduciary Duty

Tsutsui v. Barasch is a shareholder's derivative action, inter alia, to recover damages for insider trading and breach of fiduciary duty, and reaffirms the principle embodied in the BCL that the requisite demand on the board of directors may be excused if the futility of making such a demand is alleged with particularity by the plaintiff, and a showing made that a majority of the board of directors is interested.[212]

1. Futility of Demand

Citing *Marx v. Akers*, the court stated that "'[d]irector interest may either be self-interest in the transaction at issue . . . or a loss of independence because a director with no direct interest in a transaction is 'controlled' by a self-interested director.'"[213] In overturning the lower court's decision, the Second Department held that the plaintiff had met the statutory burden in alleging that a majority of the directors of the nominal defendant, Universal American Financial Corporation ("Universal"), was interested in the challenged transaction.[214]

In reaching its decision, the court took particular note of the allegations made by the plaintiff regarding Universal's board of directors, including that the chairman of the board and its chief executive officer received "a direct financial benefit by personally engaging in insider trading"; that three other directors "were interested by virtue of their ownership or close affiliation [with an affiliated] business entity [of Universal], which was alleged to have profited through the sale of Universal stock on the basis of inside information"; and that another director, who was not alleged to have engaged in insider trading, but who nevertheless "lacked independence" and was interested by reason of the substantial fees paid to his small three-attorney law firm.[215] The firm earned nearly one million dollars over

211. Cont'l Cas. Co. v. PricewaterhouseCoopers LLP, No. 0120016/2003, 2007 N.Y. Slip Op. 33619(U), at 6 (Sup. Ct. N.Y. Cnty. 2007).

212. 67 A.D.3d 896, 897, 892 N.Y.S.2d 400, 402 (2d Dep't 2009) (citing Marx v. Akers, 88 N.Y.2d 189, 200, 666 N.E.2d 1034, 1041, 644 N.Y.S.2d 121, 128 (1996)); *see also* N.Y. BUS. CORP. LAW § 626(c) (McKinney 2003).

213. *Tsutsui*, 67 A.D.3d at 897-98, 892 N.Y.S.2d at 402 (citing 88 N.Y.2d 189, 200, 666 N.E.2d 1034, 1041, 644 N.Y.S.2d 121, 128 (1996)).

214. *Id.* at 898, 892 N.Y.S.2d at 402.

215. *Id.*

the two year period prior to plaintiff's filing of the complaint.[216]

2. Sufficiency of Allegations

The court noted that in reviewing allegations of insider trading under New York Civil Practice Law and Rules (CPLR) 3211(a)(7),[217] the court will "'give the pleading a liberal construction, accept all of the facts alleged in the pleading to be true, and accord the plaintiff the benefit of every possible favorable inference in determining whether the allegations fit under any cognizable legal theory.'"[218] Nonetheless because the complaint also involved allegations of breach of fiduciary duty, such allegations are subject to "the more stringent pleading requirements mandated by CPLR 3016(b)."[219]

With regard to insider trading, the court observed that "[a] corporate officer breaches his or her fiduciary duty when he or she profits by trading on the basis of material inside information."[220] The court stated that "'a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his [or her] own personal benefit but must account to his [or her] principal for any profits derived therefrom.'"[221]

Furthermore, in keeping with the decision in *Diamond* and the Restatement of Agency:

> Although trading on inside information does not always cause a direct harm to the corporation, it is the corporation that has the higher claim to profits resulting from the use of inside information which has been entrusted to a fiduciary. Where a misappropriation of corporate inside information is established, equity requires the imposition of a constructive trust over any profits gained from the use of such information in order to prevent an unjust enrichment.[222]

In the instant case, the court concluded that the "complaint alleges with the requisite particularity that the stock sales in question were made on

216. *Id.*

217. N.Y. C.P.L.R. 3211(a)(7) (McKinney 2005).

218. *Tsutsui*, 67 A.D.3d at 898, 892 N.Y.S.2d at 402 (quoting Zane v. Minion, 63 A.D.3d 1151, 1152, 882 N.Y.S.2d 255, 256 (2d Dep't 2009)).

219. *Id.* (citing DeRaffele v. 210-220-230 Owners Corp., 33 A.D.3d 752, 752-53, 823 N.Y.S.2d 202, 203 (2d Dep't 2006)).

220. *Id.*

221. *Id.* (quoting Diamond v. Oreamuno, 24 N.Y.2d 494, 497, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 80 (1969)).

222. *Id.* at 898-99, 892 N.Y.S.2d at 403 (citing *Diamond*, 24 N.Y.2d at 497-98, 248 N.E.2d at 910, 301 N.Y.S.2d at 78; RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958)).

the basis of inside information that Universal's quarterly earnings would steadily decline and fail to meet expectations."[223]

> The allegations are supported, inter alia, by the timing, volume, and frequency of these transactions, the positions of the transacting corporate officers within the company, the scrutiny and timeliness with which management monitored the company's financial situation, and the fact that these transactions occurred during the relevant period in which the company failed to meet its earnings projections.[224]

In conclusion, the court allowed the lower court's dismissal of the first cause of action concerning inaccurate and misleading statements as conclusory, but remitted the case to the lower court to "determine that branch of the defendants' motion which sought, in the alternative, the imposition of a security bond pursuant to [BCL section] 627 . . . ."[225]

3. Conclusion

Pleading with sufficient particularity is essential in order to avoid dismissal for failing to make a demand on interested board members, as required by BCL section 626(c).[226] Moreover, when insider trading allegations are coupled with claims of breach of fiduciary obligations, as is usually the case, particularity should be supported by careful attention to and descriptions of the corporate positions held by and the duties of the malefactors, as well as the timing and volume of the trades in light of other factors such as management's internal monitoring of the company's earnings projections and so on.[227]

D. Votta v. Garcy

In *Votta v. Garcy*, the court handily provided the New York bar with crib notes on a number of issues, including, most notably, the particularity of pleading requisite to survive a motion to dismiss for lack of jurisdiction,[228] failure to make demand on the board in a derivative action,[229] claims of defendants' breach of contract,[230] fraud (including fraud predicated on contractual obligations),[231] violation of section five

223. *Tsutsui*, 67 A.D.3d at 899, 892 N.Y.S.2d at 403.

224. *Id*.

225. *Id.*

226. *See id.* at 897, 892 N.Y.S.2d at 402.

227. *See generally id.* at 897-99, 892 N.Y.S.2d at 401-03.

228. No. 100548/09, 2010 N.Y. Slip Op. 30486(U), at 6-8 (Sup. Ct. Richmond Cnty. 2009).

229. *Id.* at 7-8.

230. *Id.* at 9-10.

231. *Id.* at 10-14.

of the Securities Act of 1933, as well as federal statutes of limitation,[232] and, as they say, so much more.

1. The Facts

E-Z Media, Inc. ("E-Z"), a foreign corporation, was authorized to do business in New York, but its authority to do business in New York had lapsed for failure to pay applicable franchise taxes in the state of its incorporation, Nevada.[233] E-Z had been formed by one of the defendants, George Garcy "as a way to market and sell food and drink carriers whose patents had been created and assigned" by another defendant to E-Z.[234] The defendants developed a business plan for utilizing the patents, which it then used to solicit funds from prospective investors.[235] Although each plaintiff had invested a "significant" sum of money in E-Z, several investors never received physical delivery of any stock certificates indicating their ownership in the corporation; instead, they received only "subscription agreements signed by Garcy in his capacity as president of [E-Z] . . . ."[236] In addition to their purchase of stock, some plaintiffs also loaned money to the company, as evidenced by promissory notes.[237] When E-Z defaulted on payment of these notes, the creditor-plaintiffs were purportedly issued additional ownership percentages in the company.[238] Despite several years of operation, E-Z never generated any revenue and the patents constituted its only asset.[239] E-Z never held a formal meeting of its board of directors, nor any annual meeting of shareholders, and no minutes of such meetings existed.[240] Although the company was only authorized to issue 75,000 shares of stock, E-Z apparently issued shares in excess of that number, although no accurate list of shareholders, or percentages of stock owned, was kept.[241] Over the course of several years, as much as one million dollars of company funds were transferred to defendant, Judith Guido (Guido), listed as secretary of the corporation and Garcy's sister, but at no time had she performed any services for the company.[242]

232. *Id.* at 14-17.
233. *See Votta*, 2010 N.Y. Slip Op. 30486(U), at 2.
234. *Id.* at 3.
235. *Id.*
236. *Id.*
237. *Id.*
238. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 3.
239. *Id.*
240. *Id.*
241. *Id.*
242. *Id.*

2. Procedural Background

The action was commenced by plaintiffs' filing a motion for a temporary restraining order and injunctive relief to, inter alia, remove individual defendants from all corporate positions at E-Z, and replace them with persons chosen by vote of a majority of the plaintiff shareholders.[243] On March 6, 2009, the plaintiff-shareholders filed a verified complaint, amended on April 22, 2009, which raised forty-six causes of action against defendants individually and the corporation derivatively.[244] Defendants countered with a motion to dismiss.[245] On April 9, 2009, plaintiffs paid all of the corporation's unpaid franchise taxes owing in Nevada.[246] On June 12, 2009, following a hearing on the matter, the court denied defendants' motion to dismiss, and recognized plaintiffs' ouster of defendants from E-Z's board of directors and from positions held as officers and representatives of the corporation.[247] In its decision of June 15, 2009, the court not only affirmed the plaintiffs' election of a new board and officers for E-Z, but held the individual defendants in contempt of court for failure to comply with the court's "Disclosure, Discovery and Accounting Orders."[248]

Plaintiffs' subsequently moved by order to show cause for a preliminary injunction to enjoin the defendants from taking any further action with respect to the patents held by E-Z.[249] The court's subsequent decision—and the subject of this analysis—addresses the merits underlying this action.

3. Jurisdiction

The court first addressed E-Z's failure to pay its franchise taxes in Nevada which necessarily rendered the corporation unauthorized to do business in New York.[250] The court held that the "[f]ailure of a foreign corporation doing business in New York to pay applicable state taxes and fees affects that corporation's legal capacity to maintain an action, but does not affect jurisdiction,"[251] but that such a violation "could be

243. Votta v. Garcy, No. 100548/09, 2009 N.Y. Slip Op. 31374(U), at 2 (Sup. Ct. Richmond Cnty. 2009).

244. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 2.

245. *Id.*

246. *Id.* at 5.

247. *Id.* at 2.

248. *Votta*, 2009 N.Y. Slip Op. 31374(U), at 1, 2.

249. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 2.

250. *Id.* at 4; *see also* N.Y. BUS. CORP. LAW § 1305 (McKinney 2003).

251. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 4 (citing N.Y. BUS. CORP. LAW § 1312(b) (McKinney 2003)).

cured nunc pro tunc."[252] Upon the plaintiffs' payment of taxes due, the corporation's license to do business in New York was restored and in good standing.[253]

4. Defendants' Motion to Dismiss

Turning to defendants' motion, the court acknowledged that in considering a motion to dismiss, it must accept the "facts as alleged in the complaint as true and determine only whether the facts as alleged fit within any cognizable legal theory."[254]

5. BCL Section 626(c)

Addressing the defendants' claims that the plaintiffs had failed to comply with the requirements of BCL section 626(c) to make requisite demand on the board of directors in order to initiate a derivative action, the court observed that the plaintiffs had adequately established the futility of such a demand, citing *Tsutsui v. Barasch*[255] and *Marx v. Akers.*[256] The court noted that plaintiffs had alleged with particularity "the self-dealing nature of the transactions," including allegations of the defendants "looting of the Company by continuously soliciting new investors while using the invested funds for personal use," using "shell corporations to transfer Company funds to these corporations without any benefit flowing in return," and transferring "as much as $1 million in company funds to Guido for what appears to be little or no work . . . ."[257] Commenting on the details of defendants alleged misdeeds and omissions, the court stated, "[w]here a complaint attacks the directors' acts in causing the corporation to enter into a transaction for their own financial benefit, demand is excused . . . ."[258]

6. General Business Law Section 130

As to the defendants' efforts to dismiss a corporate plaintiffs' claims for relief for reasons of lack of standing "as an unlicensed

252. *Id.* at 5 (citing Willoughby Rehab. & Health Care Ctr., LLC v. Webster, No. 12431-04, 2006 N.Y. Slip Op. 52067(U), at 3 (Sup. Ct. N.Y. Cnty. 2006)).

253. *Id.* at 5.

254. *Id.* at 6 (citing N.Y. C.P.L.R. 3211 (McKinney 2005 & Supp. 2007); Morone v. Morone, 50 N.Y.2d 481, 484, 413 N.E.2d 1154, 1155, 429 N.Y.S.2d 592, 594 (1980)).

255. *Id.* at 7 n.8, 8 (citing Tsutsui v. Barasch, 67 A.D.3d 896, 897, 892 N.Y.S.2d 400, 402 (2d Dep't 2009)). *See* discussion *supra* Part IV.D.

256. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 7 n.9, 8 (citing Marx v. Akers, 88 N.Y.2d 189, 193, 666 N.E.2d 1034, 1036-37, 644 N.Y.S.2d 121, 123-24 (1996)).

257. *Id.* at 7.

258. *Id.*

corporation operating in New York," the court took judicial notice of the corporate plaintiffs' presentation of documentary evidence gleaned from a search of the New York Department of State's website, and denied defendants' motion to dismiss. [259]

7. Breach of Contract

As to this claim, the court stated that the "complaint must adequately allege existence of a contract, Plaintiffs' performance under the contract, Defendant's beach of the contract, and resulting damages."[260] In this instance, the court observed that the "existence of a valid contract between Plaintiffs and Defendants is undisputed."[261] While the defendants did not allege that plaintiffs failed to perform under the contract, they asserted that they themselves were not in breach.[262] Indeed, the court found that the agreements in question clearly required the transfer of money in exchange for a specific percentage of ownership.[263] Nonetheless, the defendants who breached the contract "by having failed to transfer the requisite percentage of ownership that each Plaintiff was entitled to" and "somewhat randomly assigned percentages as they saw fit, with no regard to any prior subscription agreements entered into or previously assigned percentages of ownership."[264] In sum, "[s]ince the terms of the contract are clear and unambiguous, the documentary evidence fails to 'flatly contradict' Plaintiffs' factual claims, and the facts sufficiently support a claim for breach of contract," the defendants' motion to dismiss as to the breach of contract claim was denied.[265]

8. Fraud

The court then addressed defendants' claim that plaintiffs had failed to state a cause of action pursuant to CPLR 3211(a)(7) for failure to plead fraud with particularity under CPLR 3016(b).[266] Defendants also claimed that "Plaintiffs cannot maintain simultaneous fraud and breach of contract claims since the allegedly fraudulent behavior stems

259. *Id.* at 8-9 (citing N.Y. GEN. BUS. LAW § 130 (McKinney 2004)).

260. *Id.* at 9 (citing JP Morgan Chase v. J.H. Elec. of N.Y., Inc., 69 A.D.3d 802, 803, 893 N.Y.S.2d 237, 239 (2d Dep't 2010); Furia v. Furia, 116 A.D.2d 694, 695, 498 N.Y.S.2d 12, 13 (2d Dep't 1986)).

261. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 9.

262. *Id.*

263. *Id.* at 10.

264. *Id.*

265. *Id.*

266. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 10.

from a breach of a contractual provision."[267]

As the court pointed out, CPLR 3016(b) requires that pleading a cause of action for fraud requires particularity, and to recover damages, the plaintiff must prove:

> (1) a misrepresentation or a material omission of fact, (2) which was false or known to be false by defendant, (3) made for the purpose of inducing the other party to rely upon it, (4) justifiable reliance of the other party on the misrepresentation or material omission, and (5) injury.[268]

Observing that the "question of a fraudulent intent is generally one of fact" and "[b]are allegations . . . are not sufficient to sustain a cause of action,"[269] the court stated:

> Although, as a rule, scienter is a necessary element of fraud, the term includes a pretense of exact knowledge, the assertion of a false material fact susceptible of accurate knowledge but stated to be true to the personal knowledge of the representor, and a reckless indifference to error. A conclusive test for whether misrepresentations were the inducement to a contract is whether the representee would have refused his or her consent to it if the representations had not been made or if he or she had known the truth concerning them.[270]

Using this test, the court reviewed the alleged facts. Defendants apparently knew that the percentages of ownership assigned to each investor were inaccurate, and that they issued stock in excess of the amount permitted under E-Z's articles of incorporation.[271] Plaintiffs also identified other false statements made by the defendants, namely, that the corporation's patents were free of any liens or encumbrances, when in fact, the patents had been pledged to certain of the investors as collateral, as well as assertions that investment funds were to be used solely for business purposes.[272] Indeed, plaintiffs demonstrated that, contrary to such assertions, the defendants had converted the funds to

267. *Id.*

268. *Id*. at 10-11; N.Y. C.P.L.R. 3016(b) (McKinney 2010); *see also* Channel Master Corp. v. Aluminum Ltd. Sales, Inc., 4 N.Y.2d 403, 406-07, 151 N.E.2d 833, 835, 176 N.Y.S.2d 259, 262 (1958).

269. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 11 (citing Gray v. Richmond Bicycle Co., 167 N.Y. 348, 358-59, 60 N.E. 663, 666 (1901); Kline v. Taukpoint Realty Corp., 302 A.D.2d 433, 433, 754 N.Y.S. 2d 899, 899 (2d Dep't 2003)).

270. *Id.* (citing Skrine v. Staiman, 30 A.D.2d 707, 707, 292 N.Y.S.2d 275, 276 (2d Dep't 1968), *aff'd*, 23 N.Y.2d 946, 948, 246 N.E.2d 529, 529, 298 N.Y.S. 727, 728 (1969); Jones v. Title Guarantee & Trust Co., 277 N.Y. 415, 419, 14 N.E.2d 459, 460 (1938)).

271. *Id*. at 11.

272. *Id*. at 11-12.

their own personal use.[273] Having thus adequately alleged that the statements made by defendants "were misrepresentations known to have been false at the time they were made," that court held that plaintiffs had adequately pleaded scienter.[274]

As for justifiable reliance, the court tartly observed that if the plaintiffs had known that the "Company's sole assets were potentially in jeopardy or that their investments would be used for the personal expenses of the Company's directors, it is doubtful that any Plaintiff would have invested in the Company."[275] With that, the court held that the plaintiffs had "pleaded fraud with sufficient particularity to survive a motion to dismiss."[276]

9. Fraud Predicated on Contractual Obligations

The court then turned to the claim of fraud predicated on a contractual obligation, which requires that in order "[t]o survive an attack that a tort claim is but a breach of contract in other clothing, there must be a legal duty independent of the contract that has been violated."[277] In such instance, a plaintiff must either:

> (i) demonstrate a legal duty separate from the duty to perform under the contract; or (ii) demonstrate a fraudulent misrepresentation collateral or extraneous to the contract; or (iii) seek special damages that are caused by the misrepresentation and unrecoverable as contract damages. This legal duty must spring from circumstances extraneous to, and not constituting elements of the contract, although it may be connected with and dependant upon the contract. It is fundamental that fiduciary "liability is not dependent solely upon an agreement or contractual relation between the fiduciary and the beneficiary but results from the relation."[278]

With that, the court decided that the defendants, "[h]ad fiduciary duties separate and distinct from their duty to perform under the contract. Such an independent legal duty, even though connected to and dependent upon the contract is nevertheless extraneous to the contract and is not dependent solely upon the contractual relation between the Plaintiffs and Defendants."[279]

273. *Id*. at 12.

274. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 12.

275. *Id.*

276. *Id.*

277. *Id.* at 13.

278. *Id.* (citing EBC I, Inc. v. Goldman Sachs & Co., 5 N.Y.3d 11, 19, 832 N.E.2d 26, 31, 799 N.Y.S.2d 170, 175 (2005); RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979)).

279. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 13.

10. Violation of the Securities Act of 1933

Finally the court addressed the plaintiffs' claim that the defendants had violated section 5 of the Securities Act of 1933 for failing to register their securities. The court noted that such an allegation is "subject to a one-year statute of limitations."[280] Under the federal tolling doctrine, however, "the statute of limitations does not begin to run 'until plaintiffs discovered, or by reasonable diligence could have discovered, the basis of the lawsuit.'"[281] Defendants countered that the "sale of securities [was] conducted pursuant to Securities Act § 4(2) and Rule 504 of Regulation D promulgated thereunder, which is not subject to the registration requirement of Section 5," and that, in fact, plaintiffs had held themselves out as accredited investors, and not subject to registration requirements.[282]

The court reviewed the arguments and held that "the federal tolling doctrine should be applied in the instant case due to Defendants' concealment of its obligations to register the securities."[283] Nonetheless, the court held:

> Applying the federal tolling doctrine to the present case, the only actions that are timely are those based upon contracts for the purchase of stock within one year after Plaintiffs discovered, or with reasonable diligence could have discovered, Defendants' public solicitation of investors. Additionally, Plaintiffs' cause of action is limited by the absolute three-year statute of limitations under Section 13. Since Plaintiffs commenced this action on March 3, 2009, in no event shall any cause of action under Section 5 concerning a purchase of stock prior to March 3, 2006 be considered timely.[284]

With that, the court also denied defendants' motion to dismiss as it related to similar claims of the plaintiffs, which, in the court's words, "virtually mirror" those discussed in the opinion.[285]

11. Conclusion

This wide-ranging and comprehensive opinion offers useful guidance to the corporate practitioner, with its careful analysis of facts and underlying documentary evidence, and its thoughtful application of pertinent law to the claims presented.

280. *Id.* at 14.
281. *Id.* (citing Fitzgerald v. Seamans, 553 F.2d 220, 228 (D.C. Cir. 1977)).
282. *Id.* at 14.
283. *Id.* at 15 (citing Dyer v. E. Trust, 336 F. Supp. 890, 902 (D. Me. 1971)).
284. *Votta*, 2010 N.Y. Slip Op. 30486(U), at 15-16.
285. *Id.* at 16.

E. Dissolution

In last year's *Survey*, we discussed the trial court opinion in *Lance International, Inc. v. First National City Bank*, which considered the question: how long after dissolution can a lawsuit be brought on behalf of the dissolved corporation?[286] The trial court's answer was that thirty-three years is definitely too long.[287]

The First Department reversed this aspect of the decision[288] on the grounds that (1) the defendant knew about the dissolution of Lance International, Incorporated ("Lance") as early as June 1988, but failed to raise the defense until January 2009, and (2) the lawsuit was commenced prior to Lance's dissolution.[289]

The trial court's opinion had described a long history of occasional action on a lawsuit that was originally commenced around the year 1966.[290] Plaintiff Lance had filed for bankruptcy about 1965.[291] Lance was dissolved by proclamation of the New York Secretary of State in 1975 pursuant to the Tax Law.[292] Thereafter, nothing happened except the deposition of the president of Lance in May 1989.[293] Disclosure issues were litigated sometime around the mid-1990s.[294] Nothing further occurred until Lance filed a Notice of Trial in 2007.[295] In 2009, the trial court dismissed the action on the grounds that Lance had been dissolved in 1975, and there was no justification for taking thirty-three years to wind up affairs.[296] The trial court concluded that a dissolved corporation cannot "just be waiting for a pot of gold at the end of the rainbow," and by allowing too much time to dissolve, "a dissolved corporate plaintiff becomes a mere puppet, whose strings are pulled by lawyers looking for fees and/or by former principals, who stand to gain but not to lose."[297]

The First Department disagreed because the defendant had known

286. 24 Misc. 3d 1109, 1116, 878 N.Y.S.2d 572, 577 (N.Y.C. Civ. Ct. N.Y. Cnty. 2009); Sandra S. O'Loughlin & Christopher J. Bonner, *Business Associations, 2008-09 Survey of New York Law*, 60 SYRACUSE L. REV. 689, 710-13 (2010).

287. *Lance Int'l, Inc.*, 24 Misc. 3d at 1117, 878 N.Y.S.2d at 578.

288. Lance Int'l Inc. v. First Nat'l City Bank, 27 Misc. 3d 13, 14, 898 N.Y.S.2d 752, 753 (1st Dep't 2010).

289. *Id.*

290. *Lance Int'l, Inc.*, 24 Misc. 3d at 1110-11, 878 N.Y.S.2d at 573-74.

291. *Id.* at 1111, 878 N.Y.S.2d at 574.

292. *Id.*

293. *Id.*

294. *Id.* at 1110-11, 878 N.Y.S.2d at 574.

295. *Lance Int'l, Inc.*, 24 Misc. 3d at 1111, 878 N.Y.S.2d at 574.

296. *Id.* at 1116-17, 878 N.Y.S.2d at 577-78.

297. *Id.* at 1116, 878 N.Y.S.2d at 577-78.

since 1988 that Lance had been dissolved, but had failed to assert lack of capacity to sue as a defense until roughly twenty years later, in 2009, and concluded that the defense had been waived.[298] Furthermore, even if the defense had not been waived, it would still have been without merit, because the plaintiff had begun the litigation before it was dissolved.[299] An additional relevant fact, according to the First Department, was that the bankruptcy court had authorized the litigation[300] (in the year 1967).[301] "Accordingly," said the court, "while we are not unmindful of the age of the case and the parties' failure to diligently litigate the matter, we are constrained to reinstate the complaint."[302]

The decision in *Lance* signals to one dealing with a dissolved corporation that, while one may hope that a dissolved corporation will be wound up diligently, there is presently no limit to how long the winding up process might take, nor any assurance that an old lawsuit will not be revived, short of dismissal.

The First Department decided differently in *McCagg v. Schulte Roth & Zabel LLP*, where a Delaware corporation was dissolved in 2003, and the plaintiff sought to add the dissolved corporation as a party plaintiff in 2008, in order to assert derivative claims against the defendants.[303] In *McCagg*, however, the applicable Delaware statute provided that actions were required to be brought by a dissolved corporation within three years after the date of its dissolution.[304] Because the dissolved corporation could not commence a new litigation more than three years after dissolution, the court disallowed joinder of the dissolved corporation as a plaintiff.[305]

In re Dissolution of Eklund Farm Machinery, Inc. discussed an important limit on the commissions to which a receiver is entitled in a corporate dissolution proceeding.[306] Section 1217 of the BCL provides that "[a] receiver shall be entitled, in addition to his necessary expenses, to such commissions upon the sums received and disbursed as may be allowed by the court," but on amounts in excess of $100,000, the

298. *Lance Int'l, Inc.*, 27 Misc. 3d at 14, 898 N.Y.S.2d at 753.

299. *Id.*

300. *Id.* at 14-15, 898 N.Y.S.2d at 753.

301. *Lance Int'l, Inc.*, 24 Misc. 3d at 1111, 878 N.Y.S.2d at 574.

302. *Lance Int'l, Inc.*, 27 Misc. 3d at 15, 898 N.Y.S.2d at 753.

303. 74 A.D.3d 620, 623-24, 904 N.Y.S.2d 31, 34 (1st Dep't 2010).

304. *Id.* at 624, 626, 904 N.Y.S.2d at 34, 36 (citing DEL. CODE ANN. tit. 8, § 278 (2001)).

305. *Id.* at 626-27, 904 N.Y.S.2d at 37-38.

306. (*EFM*), 73 A.D.3d 1319, 903 N.Y.S.2d 157 (3d Dep't 2010).

commissions shall not exceed one percent.[307] In this case, the dissolution proceeding was ended by settlement, with the result that the assets of the corporation were not sold.[308] The receiver asked for the one percent commission to be calculated upon the amounts received (which would be the total assets of the corporation) and then to be calculated again upon amounts disbursed.[309] The appellate division held that BCL section 1217 limits the commissions to amounts both received and disbursed, that is, to a percentage of "'the total amount which passes through the receiver's hands.'"[310] The consequence of the statutory language is that, because the dissolution proceeding was settled, the receiver was not entitled to a commission upon the assets of the corporation remaining unsold at the time of settlement.

V. FOREIGN BUSINESS ENTITIES

The LLC Law contains a door-closing provision, section 808(a), which prohibits a foreign LLC from maintaining any action or special proceeding in New York State courts, if the foreign LLC is "doing business" in the State of New York without a certificate of authority.[311] This provision of the LLC Law tracks the door-closing provision in the BCL at section1312(a).[312] In *Mobilevision Medical Imaging Services, LLC v. Sinai Diagnostic & Interventional Radiology, P.C.*, the Second Department reasoned that, like BCL section 1312(a), a foreign LLC whose petition might be dismissed, would nevertheless be granted "a reasonable opportunity to cure its noncompliance with the statute."[313]

VI. PIERCING THE ENTITY VEIL

There were several attempts to pierce the corporate or LLC veil during this *Survey* period. The complaint was inadequate to pierce the veil in *East Hampton Union Free School District v. Sandpebble Builders, Inc.* (school district action against construction contractor and its president claiming bad faith and unfair negotiating tactics);[314] *South Shore Neurologic Associates, P.C. v. Mobile Health Management*

307. N.Y. BUS. CORP. LAW § 1217(a)(3) (McKinney 2003).

308. *EFM*, 73 A.D.3d at 1319, 903 N.Y.S.2d at 158.

309. *Id.* at 1320, 903 N.Y.S.2d at 158.

310. *Id.* (quoting Jakubowicz v. A.C. Green Elec. Contractors, Inc., 25 A.D.3d 146, 150, 803 N.Y.S.2d 71, 74 (1st Dep't 2005), *appeal denied*, 6 N.Y.3d 706, 845 N.E.2d 467, 812 N.Y.S.2d 35 (2006)).

311. N.Y. LTD. LIAB. CO. LAW § 808(a) (McKinney 2007).

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

313. 66 A.D.3d 685, 686, 885 N.Y.S.2d 631, 631 (2d Dep't 2009).

314. 66 A.D.3d 122, 124, 884 N.Y.S.2d 94, 97 (2d Dep't 2009).

Services, P.C. (claim against corporation for breach of fiduciary duty;[315] shareholders, directors and officers acting in their capacities as such cannot be personally liable);[316] *Superior Transcribing Service, LLC v. Paul* (breach of contract suit against a professional corporation seeking to hold its sole shareholder personally liable);[317] and *Tycoons Worldwide Group (Thailand) Public Co., Ltd. v. JBL Supply Inc.* (breach of sales contract).[318]

The result was the same in *Capricorn Investors III, L.P. v. Coolbrands International, Inc.* but is noteworthy because it involved two LLCs and an attempt to hold their common owner liable for the obligations of the LLCs.[319] Among the factors alleged by the plaintiffs in favor of piercing the veil was the absence of legal formalities:

> The LLCs did not observe corporate formalities as they: (1) had no officers, directors or employees; (2) never held a board of directors or executive committee meeting; and (3) had no letterhead or email address, and did not send or receive emails, with all communications to [t]he LLCs sent to their sole member . . . .[320]

The court's answer to this argument was that an LLC, unlike a corporation, is not presumed to have a board of directors and officers and to hold board meetings:

> [O]ne of the purposes of a limited liability company (LLC) is to provide members the opportunity to participate in management without risk of personal liability for the entity's obligations. LLCs generally have operating agreements, which may include meeting requirements, or other such formalities. Plaintiff's assertion that [t]he LLCs have no officers or directors, and did not hold board or executive committee meetings are not persuasive veil piercing factors for an LLC, where Plaintiff does not argue that management was required to be centralized in a board.[321]

CONCLUSION

This *Survey* period contained much decisional law regarding partnerships, LLCs, and corporations. From decisions of immediate

315. No. 32347-2008, 2010 N.Y. Slip Op. 30615(U), at 4 (Sup. Ct. Suffolk Cnty. 2010).

316. *Id.* at 10.

317. 72 A.D.3d 675, 676, 898 N.Y.S.2d 234, 235 (2d Dep't 2010).

318. 721 F. Supp. 2d 194, 197 (S.D.N.Y. 2010).

319. No. 603795/06, 2009 N.Y. Slip Op. 51608(U), at 3 (Sup. Ct. N.Y. Cnty. 2009), *aff'd on other grounds*, 66 A.D.3d 409, 886 N.Y.S.2d 158 (1st Dep't 2009).

320. *Id.* at 4.

321. *Id.* at 6.

practical utility, such as the guidebook for fraud claims provided in *Votta v. Garcy*,[322] to the more esoteric issue of the de facto LLC doctrine discussed in *In re Estate of Hausman*,[323] the New York courts continued providing an abundance of interpretation of the law of business associations.

322. *See generally* No. 100548/09, 2010 N.Y. Slip Op. 30486(U), at 10-13 (Sup. Ct. Richmond Cnty. 2009).

323. *See generally* 13 N.Y.3d 408, 921 N.E.2d 191, 893 N.Y.S.2d 499 (2009).