SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: KORNREICH, Justice — PART 54

SUNRISE EQUITY PARTNERS L.P.

- v -

BETAWAVE CORP. et-al

INDEX NO. 602955/09

MOTION DATE 10/7/10

MOTION SEQ. NO. 001

MOTION CAL. NO.

The following papers, numbered 1 to 5 were read on this motion to/for dismiss E-Filed

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	4, 9-14,
Answering Affidavits — Exhibits	17-21
Replying Affidavits	5

& papers on Motion Seq. 002

Cross-Motion: ☐ Yes ☒ No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION AND ORDER.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 2/25/11 JUSTICE SHIRLEY WERNER KORNREICH, J.S.C.

Check one: ☒ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

☐ SUBMIT ORDER/JUDG. ☐ SETTLE ORDER /JUDG.

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

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SUNRISE EQUITY PARTNERS, L.P., individually and on behalf of all others similarly situated,

Plaintiff,

-against-

BETAWAVE CORPORATION f/k/a GOFISH CORPORATION, MCGUIREWOODS LLP, and LOUIS W. ZEHIL,

Defendants.

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Index No.: 602955/2009

DECISION and ORDER

KORNREICH, SHIRLEY WERNER, J.:

This action arises from a criminal conspiracy to commit securities fraud. Plaintiff Sunrise Equity Partners, L.P. (Sunrise), suing individually and on behalf of all other purchasers of securities issued by defendant Betawave Corporation, f/k/a, GoFish Corporation (GoFish) (currently an uncertified class), brings claims against: GoFish for breach of a subscription agreement, negligent and fraudulent misrepresentation, and rescission; and defendant law firm McGuireWoods, LLP (McGuireWoods) and its former partner, defendant Louis W. Zehil (Zehil), for tortious interference with contract. GoFish submits a motion to dismiss under CPLR 3211(a)(7) (failure to state a claim). Mot. Seq. 2. McGuireWoods submits a motion to dismiss under both CPLR 3211(a)(7) and (5) (statute of limitations). Mot. Seq. 1. Sunrise opposes both motions, which are consolidated for disposition.

Background

The Amended Complaint (AC) includes the following allegations. In October 2006,

defendant GoFish, now known as Betawave, sought to raise capital for a merger through a $12.25 Million private placement.[1] 8,166,669 units of its securities were placed on the market for $1.50 a unit. Each unit consisted of one share of common stock and a warrant to purchase one-half share of common stock at $1.75 per share over a five year period.

Under the terms of the private placement, all investors were to receive unregistered, restricted securities, to be subsequently registered. The offering was exempt from securities registration and restricted from sale in the public market absent regulatory compliance. In the October 27, 2006 Subscription Agreement with investors, GoFish represented and warranted that ""[i]n order to induce the Investor to enter into this Agreement"... it did not "have any agreement or understanding with any other purchasers of the Units in the Offering with respect to the transactions contemplated by this Agreement on terms that differ substantially from those set forth in this Agreement." AC ¶ 19; Subscrip. Agreement § 4(t). The Agreement further provided that it would maintain internal accounting controls sufficient to provide reasonable assurance that, *inter alia*, "transactions are executed in accordance with management's general or specific authorizations." AC ¶ 28; Subscrip. Agreement § 4(n). McGuireWoods, and specifically then partner Zehil, represented GoFish in the private placement, which closed on or about October 27, 2006.

On February 23, 2007, after the market had closed, GoFish issued a press release announcing its inquiry into "improper sales of [its] common stock in accounts controlled by Louis Zehil, a former partner of McGuireWoods." AC ¶ 21. The press release stated that on

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[1]To avoid confusion, the court will refer to defendant Betawave by its former name of GoFish.

October 31, 2006, Zehil improperly caused 3 million shares of GoFish common stock to be issued to two private financial entities controlled by him, without restrictive legends. It further stated that 1.5 million of those shares had been sold publicly between October 31, 2006 and early February 2007. GoFish asserted that it was not aware of or involved in Zehil's actions. *Id.* The complaint also alleges that GoFish's disclosure of Zehil's illegal conduct triggered a decline in the price of its common stock from $5.35, at the close of trading on February 23, 2007 (the date of the press release), to $4.10 within a week. AC ¶22. The value of the warrants that had been issued in the private placement also declined. *Id.* Following the press release, the 90 day average of the stock was $4.15; on the date the securities were registered, October 25, 2007, GoFish's share price was $0.37. *Id.* Plaintiff Sunrise, one of approximately 78 investors (excluding the Zehil entities), purchased 166,667 units of GoFish securities, which it could not sell until the stock was registered. AC ¶15. On February 28, 2007, the United States Attorney for the Southern District of New York indicted Zehil on charges of securities fraud.[2] That same day, the Securities and Exchange Commission (SEC) sued Zehil and the two entities he controlled for violating: the Securities Act of 1933 [§§ 5(a), 5(c) and 17(a)], the Securities and Exchange Act of 1934 [§10(b)], and SEC Rule 10b-5. Am. Comp. ¶¶23-24.

The Amended Complaint then describes disclosures in SEC filings by GoFish. On April 17, 2007, in its Form 10-KSB, GoFish disclosed as "risk factors" the misconduct of Zehil, the company's press release and report to the SEC about Zehil, and the SEC civil complaint. Moreover, GoFish warned, "It is possible that one or more stockholders could claim that they

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[2]Zehil pled guilty to these charges on March 15, 2010. Motion, Memo at 6.

somehow suffered a loss as a result of Mr. Zehil's conduct and attempt to hold us responsible for their losses." AC ¶25.

On April 30, 2007, in its Form SB-2 registration statement, GoFish disclosed the criminal and civil SEC investigations of Zehil and his entities and the SEC complaint and its allegations. Those allegations included the following: in the subscription agreements, Zehil's entities (Strong and Chestnut) "agreed that the shares they received ... would be issued with restrictive legends and would not be freely tradeable"; Zehil issued an opinion letter to the GoFish transfer agent directing him to issue unrestricted securities to Strong and Chestnut; between November 3, 2006 and February 14, 2007, Strong and Chestnut sold 1,552,500 shares for approximately $6 Million; and Zehil engaged in similar fraudulent conduct involving six other public companies also represented by McGuireWoods. AC ¶26.

The Amended Complaint further alleges that in these securities filings, GoFish admitted and documented its "lack of internal accounting controls." In the 2006 Form 10-KSB, GoFish states, *inter alia,* that, "our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were not effective as of December 31, 2006. This deficiency consisted primarily of inadequate staffing in our accounting department." In its 2007 Form 10-KSB filed March 31, 2008, GoFish identified "material weaknesses in our internal control over financial reporting," including, *inter alia*, a lack of: independence of board members; a financial expert on the board; formally documented financial analysis; formal communication as to delegation of authority; an effective whistle blower program; and sufficient oversight of external audits and accounting principle implementation.

Sunrise asserts that Zehil was an agent of both GoFish and McGuireWoods and that his misconduct caused the issuance of securities differing from those issued to Sunrise and other investors in the private placement. As a result, the representation and warranty in the subscription agreement of "no additional agreements" amounted to negligent and fraudulent misrepresentation, and the issuance of the unrestricted stock was a breach of the warranty. Sunrise further asserts that GoFish breached the subscription agreement representations and warranties which stated that its internal accounting controls were sufficient. Sunrise claims as well that McguireWoods and Zehil tortiously interfered with the agreement between GoFish and its legitimate investors, causing GoFish to breach that contract. Sunrise, on behalf of itself and "other members of the Class [of investors]," seeks rescission and damages. AC ¶¶29-60.

Discussion

On a motion to dismiss pursuant to CPLR 3211, the court must accept the facts as alleged in the complaint as true, accord plaintiff the benefit of every possible favorable inference and determine only whether the facts as alleged fit within any cognizable legal theory. *Morone v Morone,* 50 NY2d 481, 484 (1980); *Rovello v Orofino Realty Co.,* 40 NY2d 633, 634 (1976); *Skillgames, L.L.C. v Brody*, 1 AD3d 247, 250 (1st Dept 2003). "[T]he criterion is whether the proponent of the pleading has a cause of action, not whether he has stated one." *Rovello* at 636. The test is whether the pleadings give adequate notice to the court and the adverse party of the transactions or occurrences intended to be proved. *Two Clinton Sq. Corp. v Friedler*, 91 AD2d 1193, 1194 (4th Dept 1983); *see Ackerman v 305 E. 40th Owners Corp.*, 189 AD2d 665, 666 (1st Dept 1993).

CPLR 3026 mandates that "[p]leadings shall be liberally construed. Defects shall be

ignored if a substantial right of a party is not prejudiced." "However, factual allegations that do not state a viable cause of action, that consist of bare legal conclusions, or that are inherently incredible or clearly contradicted by documentary evidence are not entitled to such consideration." *Skillgames* at 250. In assessing a motion under CPLR 3211, a court may freely consider affidavits submitted by the plaintiff to remedy any defects in the complaint. *Rovello* at 635 - 636.

GoFish's Motion to Dismiss

Breach of Contract

The elements of a cause of action for breach of contract are: (1) formation of a contract between plaintiff and defendant; (2) performance by plaintiff; (3) defendant's failure to perform; and (4) resulting damage. *Noise in Attic Productions, Inc. v London Records*, 10 AD3d 303 (1st Dept 2004). Sunrise's first two causes of action, for breach of the subscription agreement, are pled solely against GoFish. In its motion, GoFish argues that the allegations are insufficient because: 1) they fail to identify a breach by GoFish; 2) the internal accounting controls described as insufficient to the SEC are unrelated to those described in the subscription agreement; and 3) the allegations fail to identify any damages resulting from insufficient accounting controls. The court agrees.

No Additional Agreements

GoFish's statement in the subscription agreement that it did not "have any agreement or understanding with any other purchasers ... on terms that differ substantially from those set forth in the Agreement" [¶ 4(t), Exh. 1, McBride Affirm.], is a warranty of existing fact. Sunrise's

allegations do not establish that GoFish had a differing agreement or understanding when the subscription agreement became effective. In fact, the complaint acknowledges that *in the subscription agreements, Zehil's entities (Strong and Chestnut) "agreed that the shares they received ... would be issued with restrictive legends and would not be freely tradeable."* (Emphasis added). AC ¶26. What Sunrise does allege is that subsequent to closing, on October 31, 2006, Zehil instructed the transfer agent to deliver securities, without the restrictive legend and the stop transfer order, to Strong and Chestnut, and Zehil then caused his entities to sell the securities on the open market.

Thus, GoFish did not breach the representation and warranty that there were no other agreements. At best, Sunrise alleges that Strong and Chestnut violated the no transfer restriction in their subscription agreements with GoFish.

Internal Accounting Controls

In its second cause of action, Sunrise claims that Betawave breached its representation and warranty in the subscription agreement that it had a "system of internal accounting controls sufficient to provide reasonable assurance that: (i) transactions are executed in accordance with management's general or specific authorizations," and that it admitted the deficiency to the SEC. Am. Comp. ¶¶ 3, 22, 28-31. Sunrise also alleges that the insufficient accounting controls caused it injury, including reduction in the value of its stock. *Id.* In support of this cause of action, Sunrise also relies on, and the court will consider, Zehil's plea allocution, in which he attests that he was "invited or asked to participate" in the financing," which he did through the formation of

Strong and Chestnut. Aslam Affid., Exh. 2 at 16:11-15. These entities were substantial investors, investing approximately 40% of the private placement. Am. Comp. ¶¶ 1, 15, 21, 25-26.

Sunrise argues that "sufficient" accounting controls would have caught the fact that Strong and Chestnut received shares without restrictive legends. GoFish argues that: 1) there was no breach because the weaknesses in internal controls disclosed to the SEC are unrelated to the internal controls described by the subscription agreement; and 2) Sunrise fails to identify damages it suffered as a result of this alleged breach by GoFish.

Plaintiff's second cause of action for breach of contract must be dismissed because plaintiff has not plead a breach that was the proximate cause of an injury. "To satisfy the damages element of a cause of action for breach of contract, the pleadings must allege that the breach 'directly and proximately caused' the plaintiff's injury." *Weiss v TD Waterhouse,* 45 AD3d 763, 764 (2d Dept 2007), *lv denied* 10 NY3d 705 (2008). Plaintiff's claim that the GoFish's accounting controls were "insufficient" is conclusory and not factual. Plaintiff offers nothing to connect accounting controls with the missing restrictive legends, which allegedly led to its injury.

Since the court has ruled that plaintiff has not stated a cause of action for breach of contract, it is not necessary to dwell on Sunrise's argument that Zehil's illegal acts should be imputed to GoFish on an agency theory. In addition, the court need not address GoFish's argument that plaintiff failed to allege that the diminution in value of GoFish's stock was caused by Zehil's fraud.[3]

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[3]The stock value *increased* from $1.50 to $5.35 per share, when Strong and Chestnut sold their securities on the open market in violation of the subscription agreement, a benefit that Sunrise

Negligent and Fraudulent Misrepresentation, Rescission

The third cause of action for negligent or fraudulent misrepresentation is based on the allegations that GoFish had an agreement with terms differing from the subscription agreement, when it represented and warranted otherwise. Since the court has determined that no such differing agreement has been sufficiently alleged, there is no basis for claiming that a misrepresentation occurred. The claim is also duplicative of the claims for breach of contract and must be dismissed. *See Sebastian Holdings, Inc. v Deutsche Bank AG,* 2010 NY App Div LEXIS 8098, 2010 NY Slip Op 7997 (1st Dept Nov. 9, 2010)(nor). It is unnecessary to consider GoFish's additional argument that Sunrise failed to allege fraud with particularity. CPLR 3016(b).

The claim for negligent misrepresentation also is deficient because it fails to allege with particularity the requisite elements: "(1) the existence of a special or privity-like relationship imposing a duty on the defendant to impart correct information to the plaintiff; (2) that the information was incorrect; and (3) reasonable reliance on the information." *J.A.O. Acquisition Corp. v Stavitsky,* 8 NY3d 144, 148 (2007).

The claim for rescission is equally doomed, as it is based on the same alleged misrepresentations, which the court has found insufficiently pled: that GoFish did not have any differing agreements and that its internal accounting controls were sufficient. Since "[the rescission claim] is predicated on the viable assertion of at least one of those claims," it too is

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might not have otherwise received. The subsequent drop in value, to $4.10 per share, resulted from Betawave's press release on February 23, 2007, disclosing that two Zehil entities had been issued securities without restrictive legends, and had sold 1.5 million shares on the open market.

"doomed." *Gall v Summit, Rovins & Feldesman,* 222 AD2d 225, 226 (1st Dept 1995), *app dismissed* 88 NY2d 919 (1996). Even if the rescission claim were sufficient, Sunrise arguably waived it by the delay in demanding rescission for nearly two years after discovery of Zehil's actions. *See e.g. Schwartz v National Computer Corp.,* 42 AD2d 123, 125 (1st Dept 1973), citing 10 NY Jur, Contracts § 411. The court need not engage in the academic exercise of discussing GoFish's further arguments.

Tortious Interference with Contract

Sunrise's fourth cause of action against McGuire Woods and Zehil for tortious interference with contract must be dismissed in light of the court's ruling that plaintiff has not stated a claim for breach of contract. The elements of a tortious interference claim include the defendant's procurement of the third-party's breach of contract, and actual breach of the contract. *Lama Holding Co. v Smith Barney, Inc.,* 88 NY2d 413, 424 (1996). Where the defendant does not induce a breach of contract, the tortious inference claim fails. *Fox News Network, LLC v N.S. Bienstock, Inc.,* 304 AD2d 498, 499 (1st Dept 2003) (finding complaint properly dismissed where defendant did not induce actual breach of underlying contract). It is unnecessary to consider McGuireWoods' further arguments, that the claim is time-barred and Zehil's acts were outside the scope of his employment. Because the fourth cause of action is deficient as a matter of law, the court will grant the motion to dismiss it as to both defendants, McGuireWoods and Zehil. Accordingly, it is

ORDERED that the motion by defendant Betawave Corporation f/k/a GoFish Corporation to dismiss the first, second, third and fifth causes of action in the amended complaint is granted, and these causes of action are dismissed with prejudice; and it is further

ORDERED that the motion by defendant McGuireWoods, LLP, to dismiss the fourth cause of action in the amended complaint is granted, and the fourth cause of action is dismissed with prejudice as to both McGuireWoods, LLP and defendant Louis W. Zehil; and it is further

ORDERED that the Clerk shall enter Judgment accordingly.

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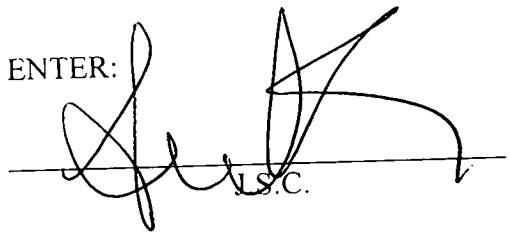

J.S.C.

Dated: February 25, 2011