STATE OF NEW YORK
SUPREME COURT COUNTY OF MONROE

JOSEPH P. MAXON,

Petitioner,

DECISION AND ORDER
Index No. 2004/1489

v.

MIRROR SHOW MANAGEMENT, INC.,

Respondents.

This discovery dispute arises out of a fundamental misconception of BCL §1104-a and §1118, indulged by respondents, that discovery in connection with the valuation of petitioner's shares cannot concern the nondissolution causes of action pleaded in the petition, and that corporate waste and misconduct is entirely foreign to the proper valuation of petitioner's shares. There is also some dispute concerning whether the statutory valuation date may be changed by the court, and whether discovery may be had of post petition filing events.

Under the formulation of Matter of Pace Photographers, Ltd., 71 N.Y.2d 737 (1988), which involved a single claim in the petition for dissolution under §1104-a of the BCL, it was held that "findings on the issue of wrongdoing were superfluous in light of the fact, . . . , that respondent had elected to buy petitioner's shares pursuant to Business Corporation Law §1118." Id. 71 N.Y.2d at 746 (adding that "[f]ixing blame is material

under §1104-a, but not under §1118"). See also, Matter of Seagroatt Foral Company, Inc. v. Ricardi, 78 N.Y.2d 439, 445 (1991)(once the §1118 election was made, "the misconduct charges became irrelevant[,] [and] [t]he issue became one of valuation"). In this case, however, the petition seeking dissolution under §1104-a on the ground of illegal fraudulent or oppressive actions, and on the ground that the property and assets of the corporations are being looted, wasted or diverted for non-corporate purposes (Second Cause of Action), is coupled with a breach of fiduciary duty claim (Fourth Cause of Action), a derivative shareholder action pursuant to BCL §626 and §720 for an accounting of all funds wrongfully diverted (Fifth Cause of Action), a separate claim for appointment of a receiver to prevent further looting, waste or diversion of corporate assets pursuant to Business Corporation Law §1113 (Third Cause of Action), among other claims.

In circumstances such as are presented by the current petition, the cases uniformly hold that even separate proceedings involving allegations of misappropriation of corporate assets should be consolidated into the §1118 valuation proceeding, because "[i]t is clear that the issues in [t]he . . . [misappropriation proceeding] are inextricably intertwined with the determination of 'fair value' of petitioner's shares." Lubena v. Pal, 243 A.D.2d 416 (1st Dept. 1997). See Slade v.

Endervelt, 174 A.D.2d 389, 390-91 (1st Dept. 1991); Imbriale v. Imbraiale, 144 A.D.2d 557, 558 (2d Dept. 1988); Gerzof v. Coons, 168 A.D.2d 619, 620-21 (2d Dept. 1990); Cf., In Re Spielfogel, 237 B.R. 555, 560 (E.D.N.Y. 1999). The foregoing cases stand for the proposition that these types of claims may be prosecuted simultaneously with the §1118 valuation proceeding, and that it is only the §1104-a dissolution proceeding that is stayed pending the valuation. But even more fundamentally, Matter of Pace Photographers, supra, does not preclude discovery of corporate waste or diversion of assets because such "may effect the 'fair value' to be determined under §1118(b)(an issue on which we express no present opinion)." Matter of Cristo Brothers, Inc., 64 N.Y.2d 975, 977 (1985). See Edmonds v. Anmews Corp., 224 A.D.2d 358 (1st Dept. 1996)(derivative action alleging corporate waste or diversion of corporate assets "and the valuation proceeding are inextricably intertwined and should, . . . , proceed in tandem before the same court where a resolution of the non-dissolution claims may effect defendants' rights under §1118(b), including, inter alia, the 'fair value' to be determined").

Accordingly, on two levels, the requested discovery should be permitted: first, because the stay of the §1104-a dissolution action cannot "preclude" pursuit of the derivative corporate waste claims, Slade v. Endervelt, 174 A.D.2d at 391-92, and

second, because the allegations of waste and corporate looting requires discovery to resolve "the question as to whether the alleged misconduct . . . , if proven, adversely impacted upon the 'fair value' of the corporation." Gerzeof v. Coons, 168 A.D.2d at 621. See generally, Peter A. Mahler, Twenty Years of Court Decisions have Clarified Shareholder Rights under BCL §§1104-a and 1118, 71 N.Y. St. Bar J. 28, 33-34 (1999) (describing the case law as permitting the simultaneous prosecution of a derivative action alleging wrongful conduct and a valuation proceeding under §1118, and observing that "[t]he issues in a derivative or other plenary action between shareholder factions are often inextricably intertwined with the determination of 'fair value' of the petitioner's shares after a BCL §1118 election has been made, thereby warranting consolidation"); Glenn Banks, The Unresolved Tension Between the 1979 Amendments to the BCL and Shareholder Agreements in Close Corporations, 67 N.Y. St. Bar J. 16, 25 & n.105 (1995)("since a dissolution action may be joined with derivative claims, . . . , it is logical that the derivative claim be considered an asset of the corporation for purposes of valuation"); Robert B. Thompson, The Shareholder's Cause of Action for Oppression, 48 Bus. Law. 699, 743 (1992)(describing the New York rule which "permit[s] an oppression claim, which had been converted by the defendant's action into a buy out, to include discovery into the possible

wrongdoing by the majority shareholder in control of the corporation" on the ground that "the alleged misconduct, if proven, adversely affected the 'fair value' of the corporation" and observing that the similar Model Business Corporation Act buyout provision, §14.34, also "would include evidence of misconduct for breech of the common law duty" on the valuation issue). See, Model Business Corporation Act §14.34, comment: "If the court finds that the value of the corporation has been diminished by the wrongful conduct of controlling shareholders, it would be appropriate to include as an element of 'fair value' the petitioner's proportional claim for any compensable corporate injury." All of this is fully consistent with the holding of Matter of Cristo Brothers, Inc., 64 N.Y.2d at 977, which was left unaffected by Pace Photographers.

Separately, respondents are also mistaken in their belief that they can cut off discovery on the day that the dissolution petition was filed. Under §1118, the determination of 'fair value' must be made "as of the day prior to the date on which such petition was filed, . . . [together with a discretionary] award [of] interest from the date the petition is filed to the date of payment for the petitioner's share at an equitable rate." BCL §1118(b). Although petitioner has asked the court to move the date of valuation to a date towards the end of 2004, because the proceedings were "effectively stayed" by the litigation and

appeal of the order disqualifying respondents' counsel, the court has determined that it has no discretion to change the date set forth in the statute for valuation. Matter of Vetco, Inc., 260 A.D.2d 642 (2d Dept. 1999). Accordingly, it makes no difference that Justice Stander did not set a valuation date; the date is prescribed in the statute.

Nevertheless, respondents' contention that petitioner can have no discovery of post-valuation date events is misplaced. Particularly in a case such as this, with separate causes of action pled alleging breach of fiduciary duty and corporate diversion or waste, post-valuation date discovery is relevant to the issue of "the ability of the corporation to actually make payment for the value allocated to . . . [petitioner's] shares." Slade v. Endervelt, 174 A.D.2d at 391. The request for discovery of events and documents after the appropriate valuation date may also be relevant to the issue whether the posting of a bond should be ordered under §1118(c)(2). Indeed, post-valuation date events may nevertheless be relevant to the ultimate issues to be decided under §1118, Hall v. King, 177 Misc.2d 126, 130 (Sup. Ct. N.Y. Co. 1998)(Crane, J.), aff'd, 265 A.D.2d 244 (1st Dept. 1999); see also, Dunay v. Ladenburg, Thalmann & Co., Inc., 106 A.D.2d 318, 319 (1st Dept. 1984)(reversing grant of protective order concerning documents created after the dissolution date in a case involving a breach of fiduciary duty claim), particularly

inasmuch as respondents petitioned for a buy out under §1118, and the corporation is not slated for dissolution. Compare Morris v. Crawford, 304 A.D.2d 1018 (3d Dept. 2003); Dunay v. Ladenburg, Thalmann & Co., Inc., 170 A.D.2d 335 (1st Dept. 1991).

"'Where a corporation raises a substantial question of fact concerning a petitioner's good faith and motives in seeking examination of the corporation's books and records, a hearing must be held to determine the petitioner's good faith.'" Matter of Niggli v. Richland Machinery Inc., 257 A.D.2d 623 (2d Dept. 1999)(quoting Matter of Di Palla v. Memory Gardens, 90 A.D.2d 886, 887). But "[t]he corporation bears the burden to show bad faith or an improper purpose." Matter of Dyer v. Indium Corp. of America, 2 A.D.3d 1195, 1996 (3d Dept. 2003). Where a petitioner establishes a proper purpose prima facie, as clearly petitioner does here in connection with its claims of corporate waste and diversion, breach of fiduciary duty, and valuation, respondents have a burden to show that petitioner is acting in bad faith, and cannot do so simply by alleging "that petitioner had no basis for investigating possible mismanagement and that corporate records, financial statements and tax information already in his possession were sufficient to enable valuation of stock." Id. 2 A.D.2d at 1196-97 (holding that these assertions "are insufficient to raise a question of fact regarding petitioner's good faith"). The court has carefully considered respondents'

arguments against disclosure on the ground of putative bad faith, but finds that the itemized treatment of each discreet area of desired discovery contained in Mr. Koegel's reply affirmation dated March 15, 2005, is apt (while not embracing the several ad hominem comments concerning respondents made at the outset of the affirmation). No hearing is required.

CONCLUSION

Accordingly, petitioner's motion to compel is granted. The parties may craft an order providing for discovery of those items not heretofore delivered to petitioner (which are readily identified by the list provided by respondents' counsel concerning the records petitioner has already received), which should extend to employee handbooks, financial statements of all three entities, interim financial statements, cash flow projections, annual budgets, capital expenditure budgets, summary of fixed assets and related depreciation, corporate charge cards and monthly invoices/account statements, business expense reimbursement claims, unusual or non-recurring expense or revenue/sale items, shareholder agreements and employment agreements prepared by Woods Oviatt, and corporate and financial books and records for the year 2004 and 2005. To the extent petitioner requests disclosure to date for the previous 5 years, this is hereby determined to be appropriate and reasonable. Gerzof v. Coons, 168 A.D.2d 619, supra.

Submit order accordingly.

SO ORDERED.

KENNETH R. FISHER
JUSTICE SUPREME COURT

DATED: March 22, 2005
Rochester, New York