

Beldock v Basin Gas Corp.

2007 NY Slip Op 33246(U)

October 4, 2007

Supreme Court, New York County

Docket Number: 0604316/2005

Judge: Barbara Kapnick

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

BARBARA R. KAPNICK

PRESENT: _____

PART 12

Justice

Index Number : 604316/2005

BELDOCK, DONALD

vs

BASIN GAS CORP.

Sequence Number : 002

DISMISS

INDEX NO.

60 4316/05

MOTION DATE

MOTION SEQ. NO.

002

MOTION CAL. NO.

motion to/for _____

PAPERS NUMBERED

Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...

Answering Affidavits — Exhibits _____

Replying Affidavits _____

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that this motion

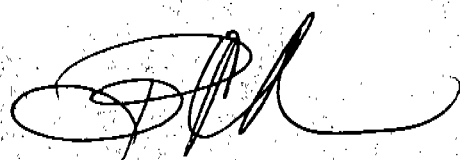
FILED

OCT 10 2007

NEW YORK
COUNTY CLERK'S OFFICE

**MOTION IS DECIDED IN ACCORDANCE WITH
ACCOMPANYING MEMORANDUM DECISION**

Dated: 10/4/07



BARBARA R. KAPNICK /s.c.

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DO NOT POST REFERENCE

THIS CASE IS REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

THIS CASE IS REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 12

-----X
DONALD BELDOCK,

Plaintiff,

-against-

BASIN GAS CORPORATION, DEVONIAN PROGRAM,
a/k/a AMERICA/INTERNATIONAL 1999 VENTURE,
CARL C. VALERI, BENTLEY BLUM, COTTONWOOD
GAS RESOURCES, INC., and SPRINGFIELD OIL
SERVICES, INC.,

Defendants.

-----X
BARBARA R. KAPNICK, J.:

DECISION/ORDER
Index No. 604316/05
Motion Seq. No. 001

FILED
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NEW YORK
COUNTY CLERK'S OFFICE

In or about April 1999, defendants Carl C. Valeri, Bentley Blum, Basin Gas Corporation ("Basin Gas"), Cottonwood Gas Resources, Inc. ("Cottonwood"), Springfield Oil Services, Inc. ("SOSI"), originally sued herein as John Doe 2, and Springfield Oil Drilling Corporation ("SODC"), originally sued herein as John Doe 3, established defendant Devonian Program, a/k/a America/International 1999 Venture ("Devonian Program" or "1999 Venture") as an unincorporated association to participate in the drilling of oil and gas wells in the United States.

Defendant Basin Gas is the manager of Devonian. Defendant Valeri is the President of Basin Gas. Defendant Blum is the President of Cottonwood, as well as the Chief Executive Officer of both SOSI and SODC.

Plaintiff Donald Beldock alleges that the 1999 Venture, through Basin Gas, contracted with Cottonwood to drill for oil or gas, and to provide management and supervision of the drilling of

wells for the Devonian Program. In order to attract investors to the 1999 Venture, defendants prepared a Confidential Private Placement Memorandum ("PPM"), which describes the activities in which the 1999 Venture would engage and the tax benefits that would inure to investors. Defendants also prepared a document entitled Springfield Oil Group Summary America/International 1999 Venture ("Summary"), which purported to summarize the PPM and to also explain the tax benefits.

The PPM and the Summary represented that the 1999 Venture had acquired or was about to acquire leases in oil and gas wells, and described certain tax benefits that would inure to the benefit of each investor, derived primarily as a result of the deductibility of intangible drilling costs in the first year of the Program's operations.

The PPM represented that "each Investor will, in effect, be entering into a Turnkey Contract with Cottonwood ... [and that] Cottonwood will be obligated to arrange for the drilling of the Well(s) and, prior to December 31, 1999, cause operations for the drilling of the Well(s) to be commenced." The PPM further explained that, pursuant to IRS regulations:

[a]n expense is deductible by an accrual method taxpayer, such as the Program, only when "economic performance" occurs with respect to such expense ... [and that] economic performance will occur as follows: (i) if the liability of the taxpayer requires a payment to another person for the providing of property or services to the taxpayer by another person, economic performance will occur when such other person provides the property or services; However, economic performance with

respect to drilling an oil or gas well will be deemed to occur within a taxable year if the drilling of the well is commenced within ninety (90) days after the end of the taxable year.

Accordingly, the PPM provided that "the Investors should be entitled to deduct all Intangible Drilling and Development Costs for which liability for payment is incurred in 1999 provided economic performance, as described above, has occurred in 1999 or by March 31, 2000."

The PPM also represented that Basin Gas would use its best efforts to purchase a "Debt Instrument" to secure 80% of the principal of each investor's Subscription Note. The PPM further provided that investors would be Working Interest Owners, who would receive a pro rata share of any profits from drilled wells, but would not be partners in the 1999 Venture.

The Summary states that it is "presented for analysis purposes only to Broker Dealers and Investment Advisors [and] is not to be shown to potential investors." However, defendants presented the Summary to plaintiff, together with the PPM. The Summary states that a portion of each investor's payment in 1999 would be used "for the purchase of a municipal, government and/or corporate debt instrument that will mature, depending upon interest rates which may vary materially according to the type of bond and market conditions, at approximately 80% of the original principal amount of the Subscription Note."

In addition, the Summary presents the 1999 Venture as a program offered by Springfield Oil Group, that is, SOSI and SODC, and, while it warns that all wells drilled may prove to be dry, it also states that "the Investor [will] still [be] ahead after taxes in 1999."

At some time prior to December 17, 1999, defendant Blum met with plaintiff and allegedly assured him that he was experienced in oil exploration and development, that the Devonian Program had acquired, or was in the process of acquiring, drilling rights in certain prospects in East Texas/West Louisiana, and that through Cottonwood, SOSI, and SODC, it was actively pursuing a drilling program focused on those promising prospects.

Allegedly in reliance on all these representations, plaintiff, on December 17, 1999, invested in the 1999 Venture by delivering to defendants \$250,000 and executing several documents, including a Subscription Agreement and three Subscription Notes, i.e., one for \$157,800 due on December 31, 2012, one for \$184,784 due on December 31, 2013, and one for \$203,724 due on December 31, 2014. However, plaintiff claims that by March 31, 2000, defendants had not commenced drilling on any oil or gas wells in which the 1999 Venture held an interest, nor had Basin Gas made any attempt to obtain the "Debt Instrument."

On or about November 21, 2005, the United States Internal Revenue Service (IRS) issued a Sixty Day Letter disallowing more

than \$12 million in deductions that the Program had claimed for the 1999 tax year. That Letter was apparently based upon a January 14, 2004 Examination Report,¹ in which the IRS Examiner found, inter alia, that economic performance was not met under Code Section 461(h), that the 1999 Venture did not own a working interest in any wells, and that no drilling of an actual well had commenced during 1999 or within 90 days thereafter. The Examiner noted that the 1999 Venture "didn't even attempt to involve itself in the oil business until the IRS pressed the Program for proof about the drilling activities."

Plaintiff claims in connection with the first cause of action in its Amended Complaint for breach of contract that defendant Basin Gas breached its obligations to plaintiff under the Subscription Agreement by failing to drill oil and/or gas wells as provided in the PPM.

Plaintiff claims in connection with his second cause of action for breach of contract that defendant Cottonwood breached its obligations under the contract entered into by Basin Gas for the provision of drilling and management services in connection with the 1999 Venture, and contends that he is a third-party beneficiary of that contract.

¹ Basin Gas and the 1999 Venture are allegedly appealing the Report but this Court has not been informed of any decision on the Appeal.

Plaintiff claims in connection with his third cause of action for fraud that the information contained in the PPM and Summary was false in that the defendants

a) misrepresented [their] intent to drill actual oil and/or gas wells in connection with the 1999 Venture; b) falsely represented that defendants had commenced drilling oil and/or gas wells in connection with the 1999 Venture; c) falsely represented that defendants intended to immediately commence oil and gas drilling activities that would qualify as "economic performance" so that expenses incurred by the 1999 Venture would be deductible in the 1999 tax year; and d) falsely represented that the Manager of the 1999 Venture would use its "best efforts" to purchase a debt instrument to cover 80% of the principal of the Subscription Notes.

Specifically, plaintiff alleges that at the time of his investment, defendants had no intention of drilling oil and/or gas wells which would meet the "economic performance" test and qualify for tax deductions in 1999, and further had no intention to use their "best efforts" to purchase a debt instrument.

Finally, plaintiff claims in connection with his fourth cause of action for conspiracy to commit fraud that defendants "entered into an agreement to induce plaintiff and other investors to invest in the 1999 Venture based on the false representations detailed above, including false representations concerning their intentions to engage in actual drilling activities prior to March 31, 2000."

Defendants now move for an order dismissing the Amended Complaint with prejudice pursuant to CPLR § 3211 (a)(7),² or, in the alternative, for summary judgment in favor of defendants pursuant to CPLR § 3212.

As to the first cause of action for breach of contract against defendant Basin Gas and the second cause of action for breach of contract against defendant Cottonwood, defendants argue that they must be dismissed because at least three wells were, in fact, drilled for the 1999 Venture.

Plaintiff, however, contends that defendants Basin Gas and Cottonwood failed to commence drilling wells by March 31, 2000, the last possible date on which they could satisfy their obligation to achieve "economic performance" of the drilling program in time to qualify for 1999 tax year benefits. According to plaintiff, the IRS examined the three wells referenced by defendants and reached the conclusion that the drilling program was bogus.

There is no dispute that oil and gas exploration is a risky business and expectations may be frustrated in many ways. The PPM warns of this.³ However, the contract between the 1999

² Defendants argue that plaintiff should be permitted an opportunity to replead any of his claims, since he has already served a Complaint and an Amended Complaint.

³ For instance, the PPM specifically warned of the risk of a tax audit by the IRS and the possible disallowance of deductions:

Venture and Cottonwood provides that "in no event later than March 31, 2000, Cottonwood shall commence or cause to be commenced, the drilling of the Well(s)" The Complaint alleges that Cottonwood failed to commence, or cause to be commenced any drilling prior to March 31, 2000. Inasmuch as the PPM represented that "each investor will, in effect, be entering into a Turnkey Contract with Cottonwood," plaintiff is a third-party beneficiary of the contract between the 1999 Venture and Cottonwood, and the Complaint states a claim for breach of that contract by Cottonwood.

TAX AUDITS

Prior Tax Audits

In 1997 the I.R.S. commenced a tax audit of nine (9) Programs sponsored by affiliates of the Manager for Programs beginning in 1994 through 1996. The tax structure of the Programs under audit is identical to the tax structure described in the Offering Memorandum.

To date, the I.R.S. has not indicated what changes it intends to propose, if any. There is a high degree of risk that the I.R.S. will disallow some or all of the tax deductions in the prior Programs. Given the ongoing audit of the prior years Programs, a higher degree of audit risk of this Program and deduction disallowance exist.

Should the Program be audited by the I.R.S., the Program Manager will undertake the defense of the tax deductions and bear all of the costs associated with such defense.

Each prospective Investor should read this Prospectus carefully and consult with his Tax Advisor with respect to the tax consequences prior to making an investment decision. (emphasis supplied).

Therefore, defendants' motion to dismiss is denied as to the first two causes of action for breach of contract.⁴

Defendants next argue that the third cause of action for fraud must be dismissed on the grounds, inter alia, that a cause of action for fraud arising out of a contractual relationship may be maintained only where plaintiff alleges a breach of duty separate from and additional to the breach of contract. Defendants contend that the third cause of action merely alleges a lack of intent to perform contractual obligations, and thus constitutes an improper attempt to reframe a breach of contract cause of action into a fraud claim.

Defendants also argue that plaintiff has failed to make out the elements of a fraud cause of action. "The elements of fraudulent misrepresentation are (1) the defendant[s] made a material false representation, (2) the defendant[s] intended to defraud the plaintiffs thereby, (3) the plaintiffs reasonably relied upon the representation, and (4) the plaintiffs suffered damage as a result of their reliance ... " J.A.O. Acquisition Corp. v. Stavitsky, 18 A.D.3d 389, 390 (1st Dep't 2005).

Defendants contend that plaintiff cannot demonstrate reasonable reliance on the alleged misrepresentations since the PPM

⁴ The Court also denies plaintiff's "request" in his Memorandum of Law for summary judgment on the first two causes of action against Basin Gas and Cottonwood for breach of contract.

contained an explicit warning that the program was speculative and involved a high degree of risk, specified that no assurances, representations or warranties of any kind were made or intended to be made, and advised each participant to consult with his/her own tax advisor.

In addition, defendants argue that three of the four alleged misrepresentations related to Basin Gas's intention to engage in future activities and did not relate to any of the other defendants, and that the claims against SOSI and SODC which were asserted for the first time in the Amended Complaint 6-1/2 years after plaintiff's investment are time barred.

Finally, defendants contend that the fraud alleged could not have caused the alleged injury.

Plaintiff, however, argues that he had no means of confirming defendants' representation that he would obtain substantial tax benefits from his investment in the 1999 tax year because 'most' of the wells would be drilled by March 31, 2000, and was required to rely on defendants' superior knowledge.

Plaintiff further argues that the boilerplate warnings in the PPM and the Summary do not insulate defendants from liability for their false representations concerning defendants' intentions to

conduct drilling and their ability to achieve "economic performance" before March 31, 2000.

In addition, plaintiff argues that the false representations are actionable because they did not involve solely future activities but also involved present facts, and they could have been one of the causes, if not the "exclusive" cause, of plaintiff's damages (i.e., that his deductions were disallowed).

It is well settled that "a cause of action for fraud does not arise where the only fraud alleged merely relates to a party's alleged intent to breach a contractual obligation" (citation omitted). Berger v Roosevelt Investment Group, Inc., 28 A.D.3d 345 (1st Dep't 2006). "Fraud, to be actionable, must be based on false representations of existing facts" (Irving Trust Co. v. La Pilar Realty, 56 A.D.2d 532 [1st Dep't 1977]), not "predicated upon representations with respect to events to occur in the future." New York State Mortgage Loan Enforcement v. Lehigh Valley Houses, 158 A.D.2d 927, 928 (4th Dep't 1990).

Here, the Amended Complaint alleges that Blum stated to plaintiff that the 1999 Venture had acquired or was in the process of acquiring drilling rights in certain prospects and that, through Cottonwood, SOSI, and SODC, it was actively pursuing a drilling program focused on those promising prospects. Those alleged statements are not promises about future activities but rather

representations as to present facts. If plaintiff can prove that Blum made those statements, that he knew them to be false when he made them, and that plaintiff reasonably relied upon them and was thereby damaged, then plaintiff will have made out a case of fraudulent inducement.

Accordingly, this Court cannot find, as a matter of law, that it would have been unreasonable for plaintiff to have believed the statements that the Complaint alleges Blum to have made. However, since the Amended Complaint fails to allege any specific representations by SOSI or SODC on which plaintiff claims to have relied, the fraud claims against them should be dismissed.

Defendants next argue that the fourth cause of action must be dismissed because conspiracy to commit fraud does not constitute a cognizable independent cause of action under New York law. While a plaintiff "may plead conspiracy in order to connect the actions of the individual defendants with an actionable underlying tort and establish that those acts flow from a common scheme or plan," American Preferred Prescription, Inc. v. Health Management, Inc., 252 A.D.2d 414, 416 (1st Dep't 1988), conspiracy is not recognized as an independent tort in New York. (Shared Communications Services of ESR, Inc. v. Goldman Sachs & Co., 23 A.D.3d 162 [1st Dep't 2005]). Thus, the fourth cause of action must be dismissed.

Finally, defendants argue that the allegations in the Amended Complaint cannot support an award of punitive damages since "a private party seeking to recover punitive damages must not only demonstrate egregious tortious conduct by which he or she was aggrieved, but also that such conduct was part of a pattern of similar conduct directed at the public generally." Rocanova v. Equitable Life Assur. Socy. of the the United States, 83 N.Y.2d 603, 613 (1994). "Punitive damages require a demonstration that the wrong complained of rose to a level of 'such wanton dishonesty as to imply a criminal indifference to civil obligations' (citation omitted)." Sterling National Bank v. Ernst & Young, LLP, 9 Misc.3d 1129(A)*8, (Sup. Ct., N.Y. Co. 2005).

Defendants contend that the fraud alleged by the plaintiff was not aimed at the "public generally" since the 1999 Venture was limited to "sophisticated" or "qualified" investors.

Plaintiff argues that this was not a private transaction between Beldock and the defendants, and whether or not defendants' conduct was so egregious as to warrant punitive damages on plaintiff's fraud claim is a question of fact that cannot be decided on a motion to dismiss. See, Sterling National Bank v. Ernst & Young, LLP, supra.

However, the PMM clearly states that investment in the Program "involves a high degree of risk and is suitable only for persons having substantial financial resources and who understand the long-term commitment, tax consequences, and risk associated with this type of investment." Thus, this Program was clearly not offered to the "general public" and does not rise to the level of "such wanton dishonesty as to imply a criminal indifference to civil obligations." Plaintiff's claim for punitive damages must, therefore, be dismissed.

The court now turns to defendants' motion for summary judgment.

With regard to the first cause of action, defendants have submitted an affidavit from Mary Irwin de Mora, who identifies herself as "the geologist who supervised the drilling program for [the 1999 Venture]." Ms. de Mora states that the 1999 Venture was "allocated" five wells, although she fails to identify the entity that allocated those wells, or the dates of any such allocations.

She also states that, during what she calls "the relevant time period," she received contemporaneous drilling reports, among other documents, that described drilling activities. However, the three sets of documents, that appear as Exhibits A, B, and C to Ms. de Mora's Affidavit are dated, respectively, October 28, 2002, December 15, 2002, and August 23, 2003. Inasmuch as the relevant

time period for this lawsuit is from December 17, 1999, through March 31, 2000, these documents appear to have no relevance to the allegations of the Complaint.

Defendants' argument with regard to the second cause of action is, again, that the three wells referred to in Ms. de Mora's Affidavit were, in fact, drilled. The breach alleged in the second cause of action is that Cottonwood failed to commence drilling, or to cause drilling to be commenced, by March 31, 2000. Neither Ms. de Mora's affidavit, nor the exhibits attached thereto, are to the contrary.

With regard to the third cause of action, defendants further argue that plaintiff could not reasonably have relied upon Blum's statements, because the PPM provides in capital letters that

NO PERSON OTHER THAN THE MANAGER HAS BEEN AUTHORIZED TO GIVE ANY INFORMATION OR TO MAKE ANY REPRESENTATIONS OTHER THAN THOSE CONTAINED IN THIS MEMORANDUM IN CONNECTION WITH THE INTERESTS DESCRIBED HEREIN, AND IF GIVEN OR MADE, SUCH INFORMATION OR REPRESENTATIONS MUST NOT BE RELIED UPON AS HAVING BEEN AUTHORIZED BY THE MANAGER.

However, the PPM further provides that "ANY OFFER TO PARTICIPATE IN THE UNITS DESCRIBED HEREIN SHALL ONLY BE MADE THROUGH PERSONAL NEGOTIATIONS BETWEEN A PROSPECTIVE INVESTOR AND THE MANAGER OR ITS AUTHORIZED REPRESENTATIVE." As it was Blum who contacted plaintiff and came to speak with him about investing in

the Program, it was not unreasonable for plaintiff to believe that Blum was such a representative.

Finally, as to this cause of action, defendants contend that the Report of the IRS Examiner stated that plaintiff and other investors were negligent in investing in the Devonian Program, and that the disallowance of the 1999 Venture's claimed deduction for intangible drilling costs was not based solely on defendants' failure to commence any drilling prior to March 31, 2000.

As to the first of these arguments, the only negligence that is discussed in the Examiner's report is that of the Program in the preparation of its 1999 tax return, which negligence, the Examiner contended, justified the imposition of a 20% penalty. As to the second of the arguments, there were additional factors cited as the basis for disallowing the claimed deductions other than the lack of drilling. However, the Examiner concluded that Devonian Program was a sham, designed to allow the promoters to get their payments, with the investors attempting to make their money on the tax write-off.

As noted above, Valeri is the president of Basin Gas. Defendants contend, citing Prudential-Bache Metal Co. v Binder (121 A.D.2d 923 [1st Dep't 1986]), that because there is no allegation as to any act that Valeri may have performed outside the scope of

his duties as an officer of Basin Gas, the Complaint must be dismissed as to him.

However, Valeri is also a partner in the 1999 Venture. Indeed, he is the Tax Matters partner. As a partner, he may be held liable for any breach of contract or tort committed by Devonian. Partnership Law § 26; see, Sier v Jacobs Persinger & Parker, 236 A.D.2d 309 (1st Dept 1997); Lexington Ave. & 42nd Street Corp. v Pepper, 221 A.D.2d 273 (1st Dep't 1995). Therefore, the fraud claim against him stands.

Accordingly, the defendants are directed to serve Answers to those portions of the Complaint which have not been dismissed (i.e., the first cause of action as to defendant Basin Gas, the second cause of action as to defendant Cottonwood, and the third cause of action as to all the defendants, except Springfield Oil Services, Inc. and Springfield Oil Drilling Corporation), within 30 days.

A preliminary conference to schedule discovery shall be held in IA Part 12, 60 Centre Street, Room 341 on December 12, 2007 at 9:30 a.m.

This constitutes the decision and order of this Court.

Dated: October

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