

Zyskind v Industrial Enters. of Am., Inc.

2007 NY Slip Op 34090(U)

December 10, 2007

Supreme Court, New York County

Docket Number: 0602523/2006

Judge: Marylin G. Diamond

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**SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY
PRESENT: HON. MARYLIN G. DIAMOND PART 48**

Justice

BERYL ZYSKIND,

Plaintiff,

-against-

INDEX NO. 602523/06

INDUSTRIAL ENTERPRISES OF AMERICA, INC.
f/k/a ADVANCED BIO/CHEM, INC.,

Defendant.

FILED
DEC 17 2007
NEW YORK
COUNTY CLERKS OFFICE

MOTION SEQ. NO. 004

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that: Motion sequence numbers 004 and 005 are consolidated herein for decision. In this action, the plaintiff seeks to enforce four convertible promissory notes and five warrants which were issued to him in 2004 in return for a loan of \$100,000, made in four installments, which he made to the defendant Industrial Enterprises of America, Inc. ("IEA") when its corporate name was Advanced Bio/Chem, Inc. ("ABC"). The promissory notes and warrants were issued pursuant to an underlying agreement between plaintiff and ABC, dated April 26, 2004 ("Financing Agreement"). The promissory notes provided that plaintiff had the option of converting, in any amount, the outstanding principal, along with the interest which had accrued, into IEA common stock upon written notice during the 30 days prior to the maturity date. Two of the notes provided for a conversion price of \$0.10 per share and the two others provided for a conversion price of \$0.05 per share. All four notes provided for an adjustment in the conversion price under a specified formula in the event that there are subsequently more than 25 million outstanding shares of IEA common stock. The five warrants provide for the purchase of up to 500,000 shares of IEA common stock at a price of \$0.50 per share. The first warrant was exercisable after February 24, 2004 and the other four were exercisable after October 26, 2005. All five warrants included a provision which allows plaintiff to pay for his warrant shares in stock rather than cash by electing to receive fewer shares than would be available on a cash-paid basis and using the cash value of the untaken shares to fund the cash price for the shares he receives.

The complaint alleges that plaintiff timely and properly sent the defendant notice of his intention to convert all of the notes into shares and to purchase shares pursuant to the warrants but that the defendant failed to honor these notices and has never delivered any shares of common stock to him. The complaint asserts three causes of action. The first is for breach of contract with respect to the promissory notes, the second is for breach of contract with respect to the warrants and the third is for attorney's fees.

In its answer, the defendant contends, *inter alia*, that the notes and warrants were issued pursuant to a fraudulent scheme undertaken by the two ABC officers and directors who then controlled the company to transfer ABC's assets without just consideration to another company which they were soon going to control, Power³ Medical Products, Inc. ("Power"). According to IEA, the two officers, Stephen B. Rash and Ira Goldknopf, obtained the requisite approval of ABC's Board of Directors and shareholders for the sale of ABC's assets to Power by issuing ABC stock to a third-party without consideration in return for its agreement to approve the transaction and by having one of the directors, Helen Park, sign a consent form without knowing what she was signing. The defendant claims that the plaintiff was aware of this scheme and participated in it by providing the capital, by way of the four \$25,000 "loans," which allowed Rash and Goldknopf to pay ABA's debts and expenses while, at the same time, transferring all of its assets to Power. The defendant claims that the value of the notes and warrants far exceeds the amount of the loan and that plaintiff must have known or realized that the transaction was not legitimate.

The defendant's answer includes four counterclaims. The first two allege, respectively, that the

[* 2] plaintiff aided and abetted Rash and Goldknopf both in their fraudulent scheme and in breaching their fiduciary duty to the defendant. The third alleges that plaintiff filed a schedule with the Securities and Exchange Commission which falsely claimed that he owned 96% of IEA's stock and that he did so for the sole purpose of injuring the company. The fourth counterclaim seeks the reformation of the first warrant insofar as it may contain a formula for calculating the number of shares available at any given time on a cashless basis which entitles plaintiff to receive approximately 15,000 times as many shares as he would be entitled to if he paid for those shares in cash.

By decision and order dated March 12, 2007, the court, upon plaintiff's motion, dismissed the first two counterclaims, noted that the third counterclaim had been withdrawn and declined to dismiss the fourth. Thereafter, IEA brought a third-party action against Power and Rash seeking indemnification for any liability to plaintiff which may be found herein. The third-party complaint asserts five causes of action. The first three are against Rash for fraud, breach of a fiduciary duty and aiding and abetting a breach of fiduciary duty. The fourth is against Power and Rash for breach of contract and the fifth is against Power for aiding and abetting both the commission of fraud and the breach of a fiduciary duty.

On motion sequence number 004, the plaintiff has moved for summary judgment on all three of his causes of action. In motion sequence number 005, Power and Rash have moved to dismiss the third-party complaint.

Discussion

A. Plaintiff's Motion for Summary Judgment

1. Plaintiff's Alleged Participation in and/or Knowledge of the Fraudulent Scheme

In opposing plaintiff's motion, IEA argues that the notes and warrants are unenforceable because they were issued without proper authority as part of a scheme by Rash, Goldknopf and Power to defraud ABC and that plaintiff knowledgeably participated in this scheme. In support of this argument, IEA cites case law and legal treatises for the proposition that an agent such as Rash cannot bind his principal such as ABC to an agreement with a third party where the agent is known by the third party to be acting contrary to the principal's best interests and in violation of his fiduciary duty to the principal. *See, e.g., Manhattan Life Ins. Co. v. Forty-Second St. & Grand St. Ferry RR. Co.*, 139 NY 146 (1893); *Bertran Packing v. Transworld Fabricators*, 50 AD2d 542 (1st Dept 1975); *Restatement (Third) of Agency*, §§ 8.02, 8.03.

The problem with the defendant's argument is that there is no evidence that plaintiff was aware that Rash and Goldknopf were violating their fiduciary duty to ABC when the parties entered into the Financing Agreement on April 26, 2004. Although the defendant has asserted that plaintiff was an active, knowledgeable participant in the scheme to transfer ABC's assets to Power without adequate consideration, it has no evidence to support this assertion other than the fact that the Financing Agreement between plaintiff and ABC was signed the same day that Rash, acting on ABC's behalf, signed a Letter of Intent to transfer ABC's assets to Power ("Asset Purchase Agreement"). That the two agreements were signed the same day certainly supports the defendant's argument that Rash and Goldknopf sought to obtain Financing in order to pay ABC's debts and expenses while, at the same time, transferring all of its assets to Power. It does not, however, support its contention that plaintiff was a knowledgeable participant.

Indeed, the defendant has not even suggested, much less provided any evidence, that plaintiff and either Rash or Goldknopf had any prior financial or personal relationship which one might expect from parties entering into a conspiracy to defraud. Moreover, as plaintiff points out, on the same day that plaintiff and Rash entered into a Financing Agreement, Rash entered into a practically identical agreement with another company, Trinity Finance Investment Corp. ("TFIC"), for another \$100,000 loan payable in four \$25,000 installments for which four promissory notes were issued allowing the holder to convert them into shares of ABC common stock. *See Bui v. Industrial Enterprises of America, Inc.*, 2007 WL 1974967 (Sup Ct NY Co). It is not clear from the record before the court whether IEA has claimed that TFIC was also an active, knowledgeable participant in Rash's scheme.

In any event, given the fact that the scheme allegedly involved the wholesale "looting" of ABC's

[*3] assets, it hardly makes sense that plaintiff or TFIC would, in return for a \$100,000 loan, seek an option to use their promissory notes and warrants to obtain the stock of such a company. Indeed, as the defendant itself has acknowledged, the notes and warrants which plaintiff received became "virtually worthless" once ABC was stripped of its assets. It was for this reason that plaintiff, a number of months after signing the Financing Agreement and after having made two \$25,000 payments, complained to Rash about the Asset Purchase Agreement. Such a complaint belies the defendant's assertion that plaintiff was a knowledgeable participant in the scheme to defraud.

Alternatively, the defendant argues that even if plaintiff was not aware that Rash and Goldknopf were engaged in a self-dealing scheme to defraud ABC of its assets when he signed the Financing Agreement, he was certainly aware of this fact by the time he complained to them about the Asset Purchase Agreement, entered into an agreement with ABC and Power resolving this complaint and thereafter made his final two \$25,000 loan payments for which he received two promissory notes and two warrants. However, under the April 26, 2004 Financing Agreement, plaintiff was already contractually obligated to make the final two payments. The defendant has not cited any authority for its suggestion that a third party may not enjoy the benefit of a bargain which it innocently entered into with an agent once it thereafter discovers that the agent, in doing so, may have breached his fiduciary duty to his principal.

Moreover, the fact that plaintiff later became aware that Rash and Goldknopf were transferring ABC's assets to Power without adequate consideration does not mean that he had any reason to believe that his \$100,000 to ABC was against that company's interests. On the contrary, as IEA has conceded, the \$100,000 was intended to be used to pay ABC's expenses and debts and was thus arguably in ABC's best interests.

Although the defendant also suggests that the plaintiff's option to convert the notes and warrants into ABC shares was excessively generous, it has not made any attempt to provide the court with an estimate of the value of those shares at the time of the April 26, 2004 Financing Agreement. In any event, at the time plaintiff made the last two \$25,000 payments, the stock was, as noted earlier, virtually worthless. The fact that ABC, under a new name and new management, has since become a solid company having valuable shares of common stock does not transform the option to convert into an unfair bargain when there is nothing in the record to indicate that, at the time it was offered, it was particularly lucrative. Under the circumstances, the court is persuaded that even though the financing transaction between plaintiff and ABC may have been part of a scheme to defraud the defendant, the agreement is nevertheless enforceable by the plaintiff.

2. Satisfaction and Release of Defendant's Obligations - - As already noted, after making his second \$25,000 payment, plaintiff complained about the transfer of ABC's assets to Power pursuant to the Asset Purchase Agreement, presumably because it depreciated the value of the shares of stock on which he held an option to convert. In response to this complaint, Rash and Goldknopf issued plaintiff 2,250,000 shares of Power stock. In addition, the parties executed a mutual release in which they discharged each other from any liability for causes of action or obligations arising out of the acts encompassed within the plaintiff's complaint about the Asset Purchase Agreement. In opposing plaintiff's summary judgment motion, the defendant also argues that (1) plaintiff's right to use his notes and warrants to obtain ABC stock was satisfied by his receipt of the Power shares and (2) defendant's obligation to issue plaintiff shares of its stock pursuant to the Financing Agreement was discharged under the parties' mutual release.

As to the satisfaction of defendant's contractual obligations, there is no evidence that the issuance to plaintiff of Power shares was made by Rash in lieu of, rather than as supplemental to, plaintiff's right to receive ABC shares. Indeed, the Financing Agreement specified that its terms could only be modified by written agreement between the parties. In this respect, neither the mutual release nor any other document in the record before the court indicates that plaintiff's right to ABC shares under that agreement had been expressly extinguished by his receipt of the Power shares. Most importantly, after the release was executed and the Power shares issued to plaintiff, he made two \$25,000 payments pursuant to the Financing

Agreement, in return for which he received from ABC two promissory notes and two warrants entitling him to obtain ABC stock. Clearly, his prior receipt of Power stock was not considered to have satisfied ABC's obligations under the Financing Agreement to issue him an appropriate number of shares of its stock upon a timely and proper demand.

As to the release, it was executed in response to the plaintiff's claim that the transfer of ABC's assets to Power pursuant to the Asset Purchase Agreement had reduced, or threatened to reduce, the value of ABC stock to his detriment in view of his rights under the Financing Agreement. In light of the court's conclusion that the plaintiff's receipt of Power shares was not intended to extinguish his contractual right to obtain common shares of the defendant's stock, it makes little sense that plaintiff would somehow agree to release the defendant from liability in the event that, upon his demand, it refused to issue him any such shares. Although the release employs broad language in describing its coverage, the absence of any specific reference to the plaintiff's contractual right to obtain ABC stock, coupled with the fact that ABC thereafter issued him notes and warrants which reaffirmed this right to obtain ABC stock, clearly indicates that the release was not intended to cover his rights under the April 26, 2004 Financing Agreement.

The plaintiff is therefore entitled to summary judgment on the three causes of action in the complaint. The court notes that the plaintiff, on his motion, has not sought summary judgment on the first warrant which was issued to him since this warrant is the subject of the defendant's fourth counterclaim. Once that counterclaim is resolved, the court will refer the issue of the number of shares of IEA stock that plaintiff is entitled to obtain under notes and warrants, along with the reasonable attorney's fees he has incurred in prosecuting this action, to a special referee to hear and report.

B. Power and Rash's Motion to Dismiss - - In motion sequence number 005, third-party defendants Power and Rash have moved to dismiss the four causes of action in the third-party complaint which assert claims for fraud, breach of fiduciary duty and aiding and abetting a breach of fiduciary duty on the ground that these claims either lack the requisite particularity or fail to state a cause of action. The motion is denied. The court is persuaded that each of these causes of action adequately apprises Power and Rash of the claims against them and properly sets forth the requisite elements.

In addition, Rash has moved to dismiss the complaint as against him, pursuant to CPLR 3211(a)(8), on the ground that this court lacks personal jurisdiction over him. He claims that he is a Texas resident who has had insufficient contact with New York to justify the court's exercise of personal jurisdiction under New York's long arm statute, CPLR 302(a)(1). There is, however, some evidence indicating that Rash met with plaintiff in New York on a number of occasions at which he may have negotiated the terms of the Financing Agreement and the settlement of plaintiff's claim against the Asset Purchase Agreement. Under the circumstances, the court is unable to resolve the issue at this time and is persuaded that, pursuant to CPLR 3211(d), IEA is entitled to obtain additional discovery on this matter. The motion is therefore denied without prejudice to renew upon the completion of discovery.

Accordingly, in motion sequence number 004, the plaintiff's motion for summary judgment is hereby granted with respect to the claims he has asserted on all of the notes and warrants he was issued other than the first warrant. In motion sequence number 005, the third-party defendants' motion to dismiss the third-party complaint is denied.

The parties shall appear before the court in Room 412, 60 Centre Street, New York, New York on January 15, 1008 at 10:00 a.m. for a status conference.

FILED
ENTER ORDER

MGD

Dated: 12-10-07 DEC 17 2007

MARYLIN G. DIAMOND, J.S.C.

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[X] **NON-FINAL DISPOSITION**