

Sieger v Zak

2008 NY Slip Op 31663(U)

June 10, 2008

Supreme Court, Nassau County

Docket Number: 9978-05/

Judge: Stephen A. Bucaria

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SHORT FORM ORDER

SUPREME COURT - STATE OF NEW YORK

Present:

HON. STEPHEN A. BUCARIA

Justice

TRIAL/IAS, PART 4
NASSAU COUNTY

STUART M. SIEGER and DAVID R. SPENCER,

INDEX No. 19978/05

Plaintiffs,

MOTION DATE: May 5, 2 008
Motion Sequence # 004, 005

-against-

LOUIS ZAK and POWERSYSTEMS
INTERNATIONAL, INC.,

Defendants.

The following papers read on this motion:

Notice of Motion.....	XX
Affirmation in Opposition.....	XX
Reply Affirmation	XX
Memorandum of Law.....	X
Reply Memorandum of Law.....	X

This motion, by plaintiffs, for an order of attachment, is **denied**; and a motion, by plaintiffs, for an order compelling discovery as to damages, is **granted**.

This is an action for fraud and breach of fiduciary duty. Plaintiffs Stuart Sieger and David Spencer and defendant Louis Zak were the sole shareholders of defendant PowerSystems International, Inc., a closely held defense contractor. Sieger and Spencer each held 1/6 of the stock; Zak held a 2/3 of interest and was the principal manager of the company.

In July 2004, Zak entered into a written agreement with plaintiffs to purchase their combined interests for \$3.4 million. Plaintiffs allege that Zak breached his fiduciary duty by concealing material information relevant to the value of PowerSystems. Plaintiffs claim that Zak's withholding of information led to their agreement to sell their interests at a grossly inadequate price. Plaintiffs further allege that Zak made false representations concerning the value of PowerSystems which they relied upon in agreeing to sell their interests. In October 2005, PowerSystems was purchased by Hunter Defense Technologies in a transaction valued at approximately \$40 million. Plaintiffs seek damages in an amount equal to the profit which Zak earned on their shares.

Plaintiffs move for an order of attachment pursuant to CPLR § 6201(1) on the ground that Zak is a nondomiciliary and resides in Florida. Plaintiffs seek to attach all of Zak's "real and personal property," without distinguishing as to situs. Defendants object on the ground that plaintiffs have failed to show probability of success on the merits and an attachment is not necessary for security.

CPLR 6212(a) provides that on a motion for an order of attachment, plaintiff shall show, among other requirements, that there is a cause of action and that it is probable that plaintiff will succeed on the merits. Defendants argue that plaintiffs cannot make the required showing of probability of success as to their claims for fraud and breach of fiduciary duty because they cannot establish reliance and causation.

To establish a **prima facie** case for fraud, plaintiff must prove that 1) defendant made a representation as to a material fact, 2) such representation was false, 3) defendant intended to deceive plaintiff, 4) plaintiff believed and justifiably relied upon the statement and was induced by it to engage in a certain course of conduct, and 5) as a result of such reliance plaintiff sustained pecuniary loss (**Ross v. Louise Wise Services, Inc.**, 8 NY3d 478, 488, 2007). Sophisticated investors do not justifiably rely upon misrepresentations made during business acquisitions if they fail to investigate the business they are acquiring and the details of the transaction (**Global Minerals and Metals Corp. v. Holme**, 35 AD2d 93, 100, 1st Dept., 2006).

In **Global Minerals**, a closely held corporation claimed that it was fraudulently induced to buy out a minority shareholder. Because the corporation had a "hint" that the representations were false and did not conduct "due diligence," it failed to reasonably rely on the shareholder's representations. However, the case does not indicate that a minority shareholder who sells his interest may not rely upon the representations of the majority shareholder without conducting an independent investigation.

To maintain an action for breach of fiduciary duty, plaintiff must establish that defendant violated a fiduciary duty and the violation was the direct and proximate cause of the losses claimed (**Northbay Construction Co. v. Bauco Construction Corp.**, 38 AD3d 737, 2nd Dept., 2007). While reliance is not a specific element of a breach of fiduciary claim, the reasonableness of plaintiff's reliance may be considered on the question of whether defendant's breach of fiduciary duty was the direct and proximate cause of the loss which plaintiff sustained. The shareholders in a closely held corporation owe a fiduciary duty to each other (**Global Minerals and Metals Corp. v. Holme, supra**, 35 AD2d at 98). In negotiating to buy plaintiffs' interests, Zak was obligated to disclose any information that could reasonably bear on their consideration of his offer (**Dubbs v. Stribling & Assoc.**, 96 NY2d 337, 341, 2001). Because Zak's failure to disclose material information appears to have been a substantial factor in causing plaintiffs' damages, plaintiffs have established a probability of success on the merits. Nevertheless, the court concludes that there are not grounds for an attachment order.

Because attachment is a harsh remedy, CPLR § 6201 is strictly construed in favor of the party against whom an order of attachment is sought (**Kornblum v. Kornblum**, 34 AD3d 748, 2nd Dept., 2006). CPLR § 6201(1) provides that an order of attachment may be granted in any action, except a matrimonial, where the plaintiff has demanded and would be entitled to a money judgment, and the defendant is a nondomiciliary residing without the state. The subdivision has two distinct purposes: to provide a basis of quasi in rem jurisdiction or to secure a money judgment (**J.V.W. Investment Ltd v. Kelleher**, 41 AD3d 233, 1st Dept., 2007). Construing CPLR § 6201(1) strictly, an order of attachment should not be issued against a nondomiciliary who is subject to personal jurisdiction, unless it is necessary to secure the judgment (**J.V.W. Investment Ltd v. Kelleher, supra** 41 AD3d at 234). To issue an order of attachment against the nondomiciliary under such circumstances would be to give plaintiff an "unwarranted priority" over other creditors(Id).

Although Zak is a nondomiciliary, he is subject to personal jurisdiction because he has not raised the defense of lack of jurisdiction either by pre-answer motion or in his responsive pleading(CPLR 3211[e]). Plaintiffs argue that an attachment is necessary for security because Zak, having obtained a stay of the order compelling discovery, has additional time to secrete assets. Plaintiffs further argue that they require security because Zak resides in Florida, a state whose laws supposedly aid a debtor to thwart enforcement.

CPLR § 6202 provides that any debt or property against which a money judgment may be enforced is subject to attachment. CPLR § 5201(b) provides that a money judgment may be enforced against any property which could be assigned or transferred, unless it is exempt from application to the satisfaction of the judgment. While § 5201(b) does not expressly provide that the property must be present in the state, it is clear that presence within the state is a constitutional requirement for property to be subject to attachment (**Banco Ambrosiano v. Artoc Bank & Trust**, 62 NY2d 65, 72, 1984). Since plaintiffs may attach only property located in New York, the supposed leniency of Florida's enforcement laws has very little relevance to the present motion.

Moreover, an intent to secrete assets is not to be "lightly inferred," and mere suspicions that defendant will remove assets from the state are an insufficient basis for an order of attachment (**Waltzer v. Tradescape & Co.**, 31 AD3d 302, 305, 1st Dept., 2006). The court concludes that plaintiffs have not established that an attachment is necessary to secure the judgment. Accordingly, plaintiffs' motion for an order of attachment is **denied**.

In a separate motion, plaintiffs move for an order compelling discovery of documents concerning the acquisition of PowerSystems by Hunter Defense Technologies, including the consideration which Zak received for his stock. Plaintiffs have previously moved to compel discovery of documents relating to an arbitration between Zak and Hunter. The arbitration concerned a dispute as to the annual earnings of PowerSystems for years subsequent to the acquisition. In its order dated February 21, 2008, denying discovery of documents pertaining to the arbitration, the court noted that plaintiffs had not explained how the arbitration was relevant to the value of PowerSystems at the time they sold their interests. Nevertheless, the court granted plaintiffs leave to renew upon a showing that a strong public policy required disclosure.

To the extent that the price which Hunter paid for the stock was dependent upon PowerSystems' subsequent earnings, documents concerning the arbitration are encompassed within plaintiffs' request for production of documents. In seeking discovery, plaintiffs assert that the measure of their damages is the profit which Zak earned on their shares and the consideration which Zak received is relevant to the calculation of his profit. Although plaintiffs have now explained the relevance of the requested documents to the issue of damages, they have not made a showing that a strong public policy requires disclosure. Nonetheless, because "liberal discovery encourages fair and effective resolution of disputes on the merits," the court will proceed to consider

plaintiffs' discovery motion (Spectrum Systems Int'l Corp. v. Chemical Bank, 78 NY2d 371, 376, 1991).

The measure of damages in a fraud cause of action is indemnity for the actual pecuniary loss sustained as a direct result of the wrong, or what is known as the "out-of-pocket rule" (Lama Holding Co. v. Smith Barney Inc., 88 NY2d 413, 421, 1996). "Under this rule, the loss is computed by ascertaining the difference between the value of the bargain which plaintiff was induced by fraud to make and the amount or value of the consideration exacted as the price of the bargain"(Id). Damages are to be calculated to compensate plaintiffs for what they lost because of the fraud, not to compensate them for what they might have gained(Id). Under the out-of-pocket rule, there can be no recovery of profits which would have been realized in the absence of fraud. Pursuant to the out-of-pocket rule, the measure of damages for plaintiffs' fraud claim is the value of their PowerSystems stock on the date they sold less the value of the consideration which they received. Allowing for changes in the market between the date plaintiffs sold and the date of Hunter's acquisition, the consideration which Zak received upon his resale of plaintiffs' stock may be relevant to the value of the stock on the date plaintiffs' sold their shares. However, the consideration which Zak received appears to include the value of his employment contract. Since plaintiffs were not involved in the operation of the business, they cannot recover the value of the employment contract even under a lost profits theory. However, a valuation expert may be able to calculate the value of plaintiffs' stock on the date of sale by starting with the total consideration received by Zak, deducting the value of the employment contract, and adjusting for market factors.

Defendants state that, pursuant to the terms of Zak's agreement with Hunter, Zak was entitled to an "earn out," or additional payment for his stock, if PowerSystems' "modified" before-tax earnings for fiscal years ending June 30, 2006 and June 30, 2007 reached certain levels. A dispute between Zak and Hunter as to the amount of the "earn out" was submitted to arbitration and resolved pursuant to a settlement agreement. To the extent that the "earn out" was dependent on PowerSystems' profitability, and not directly related to Zak's management performance, it is properly attributable to the stock rather than Zak's employment contract (see, Truelove v. Northeast Capital & Advisory, a Inc., 95 NY2d 220, 224, 2000). Nevertheless, defendants have disclosed the amount of the settlement and have offered to provide inspection of the settlement agreement. The court concludes that no further discovery concerning the Hunter acquisition is necessary in order to prosecute plaintiffs' fraud claim(CPLR § 3101[a]).

SIEGER, et al v ZAK, et al

Index no. 19978/05

The measure of damages for breach of fiduciary duty depends upon whether the trustee "simply acted imprudently" or whether he "violated an integral condition of the trust" (Matter of Rothko, 43 NY2d 305, 321, 1977). If the trustee acts imprudently by selling trust property for an inadequate price, he is liable for the difference between the amount he should have received and the amount he did receive. The trustee is not liable for any subsequent rise in the value of the property (Id at 320-21). However, if the trustee engages in deliberate self-dealing, the beneficiary may recover the "lost profit," or appreciation in value of the trust property (Matter of Janes, 90 NY2d 41, 55, 1997). Similarly, if an employee breaches his duty of loyalty by converting a corporate opportunity, the remedy is disgorgement of the employee's profit (Gomez v. Bricknell, 302 AD2d 107, 115, 2nd Dept., 2002).

Because Zak was under a fiduciary duty towards the minority shareholders, Zak's profit on the subsequent resale of plaintiffs' stock is an available measure of damages. However, as with the fraud theory, there must be an adjustment for the value of Zak's employment contract. Because plaintiffs are entitled to recover the profits which they lost by selling their stock, they are entitled to broader discovery concerning the Hunter acquisition in order to prosecute their breach of fiduciary duty claim. Accordingly, plaintiffs' motion to compel discovery of documents concerning the acquisition of PowerSystems by Hunter Defense Technologies is **granted**.

This shall constitute the decision and order of the court.

Dated JUN 10 2008

Stephen A. Bucarea
J.S.C.
ENTERED

JUN 12 2008
NASSAU COUNTY
COUNTY CLERK'S OFFICE