

Lawler v KST Holdings Corp.

2008 NY Slip Op 32904(U)

October 23, 2008

Supreme Court, Wayne County

Docket Number: 2008/64725

Judge: Kenneth R. Fisher

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STATE OF NEW YORK
SUPREME COURT COUNTY OF WAYNE

MICHAEL A. LAWLER,

Plaintiff,

DECISION AND ORDER

v.

Index #2008/64725

KST HOLDINGS CORPORATION,
KEVIN S. TAILLIE and
'JOHN DOE' (SAID NAME BEING
FICTITIOUS, IT BEING THE INTENTION
OF PLAINTIFF TO DESIGNATE ANY AND
ALL OCCUPANTS, TENANTS, PERSONS,
OR CORPORATIONS, IF ANY, HAVING OR
CLAIMING AN INTEREST IN OR LIEN
UPON THE PREMISES BEING FORECLOSED
HEREIN,

Defendants.

I agree that there is reasonable excuse for the default by reason of counsel's pneumonia. There was no pattern of willful neglect. Cf., Gironda v. Katzen, 19 A.D.3d 622 (3d Dept. 2003). Accordingly, the question devolves to whether the second mortgagee established a meritorious defense, because the motion to vacate was made within a reasonable amount of time after the default judgment was filed. Lauer v. City of Buffalo, 53 A.D.3d 213 (4th Dept. 2008); Ames Cap. Corp. v. Davidson, 24 A.D.3d 474 (2d Dept. 2005).

The moving party, as second mortgagee, was named by reason of RPAPL §1311(3); see Tornatore v. Bruno, 12 A.D.3d 1115, 1117 (4th Dept. 2004), for the purpose, inter alia, of enabling a

not relate to an actual debt of the corporation; that the note is not a valid obligation of the corporation; and that the mortgage could not impose an enforceable lien on the corporation's real estate.

It appears from the parties' submissions that Taillie, the second mortgagee, successfully bid on the golf course at a foreclosure sale and subsequently arranged with plaintiff's help to have the corporate defendant purchase the Ontario Golf Club, now Brookwoods Country Club, for \$1,575,000. He alleges in a separately filed prior action that he contributed \$278,300 (in this action, plaintiff's counsel said Taillie deposited this money with HSBC), and that plaintiff contributed the rest, but the transaction is otherwise not elaborated in the complaint in that action, which was submitted with the motion to vacate in this proceeding. Taillie does not deny that plaintiff wired the entire purchase price to HSBC on March 7, 2007, i.e., that plaintiff paid HSBC directly, not through the corporate defendant or Taillie himself. Instead, Taillie alleges that, at the first official meeting of the corporation, on April 3, 2007, plaintiff's agent demanded a surrender of Taillie's shares and a relinquishment of his interest in the corporation. Taillie refused, was fired as general manager of the club, and thereafter, at the second meeting of the corporation on April 10, 2007, watched as plaintiff engineered the election of two

See Peacock v. Kalikow, 239 A.D. 188, 190 (1st Dept. 1997) ("must do more than merely make conclusory allegations or 'vague assertion[s]'" (quoting National Recovery Systems v. Weiss, 226 A.D.2d 289, 290 (1st Dept. 1996))). See Loris v. S&W Realty Corp., 16 A.D.3d 729, 731 (3d Dept. 2005) ("a party is only required to demonstrate the existence of issues of fact sufficient to establish a meritorious defense if proven at trial").

Here, questions of fact are presented whether the decision to give plaintiff a first mortgage and Taillie a second, subordinate mortgage, notwithstanding Taillie's contribution of \$278,300 via a deposit at HSBC (according to plaintiff's counsel), satisfies the business judgment rule as claimed by plaintiff in his Memorandum of Law (Lawler did not file an affidavit). Marx v. Akers, 88 N.Y.2d 189, 202 (1996) ("direct financial benefit from transaction which is different from the benefit to shareholders generally").¹ Where a director is thus interested in a transaction, "the burden shifts to the self-interested director to demonstrate the 'entire fairness' and reasonableness of the actions." Lippman v. Shaffer, 15 Misc.3d 705, 711, 715-16 (Sup. Ct. Monroe Co. 2006) (collecting cases).

¹ Plaintiff seeks both in his memorandum of law and in the documentary exhibits attached to his counsel's affidavit to justify the mortgages as authorized by the Board of Directors in resolutions insulated from review by the business judgment rule.

Inasmuch as the minutes of the "Shareholders Annual Meeting" of April 10, 2007 "reflec[t] the votes of Michael A. Lawler, holder of 51% of the outstanding shares of the corporation: 'Yes' on all resolutions, the votes by Kevin S. Taillie, holding 49% of the outstanding shares: 'No' on resolutions 1, 2, 3, 4, 5, 6 [the organizational measures]," abstentions on resolutions 7, 8, and 9 [the mortgage authorizations]," Taillie establishes in support of his motion director self-interest in a transaction which gave plaintiff a first mortgage and Taillie only a subordinate position with respect to the security. Kossoff v. Wald, 241 App. Div. at 484. But that is not the end of the matter.

Plaintiff's reliance on BCL §713 via Memorandum of Law would not be sufficient to defeat at the pleading stage Taillie's presentation of a meritorious defense. Marx v. Akers, 88 N.Y.2d at 204 n.6 (observing that "at the pleading stage we are not concerned with burdens of proof"). The minutes of the April 10th meeting reflect only two persons voting, plaintiff and Taillie, not any of the newly elected directors. Furthermore, the so-called disinterested director Consent to the Mortgages form submitted by plaintiff, in opposition to the motion (Exh. I) was not executed by them until June 15, 2007, over two months later and in apparent response to the filing of Taillie's complaint in the companion action in May of 2007 (Polizzi Affidavit, Exh. C). Because a mortgage is not valid to the extent it exceeds the

underlying valid debt or obligation for which the mortgage is intended as security, Tornatore v. Bruno, 12 A.D.3d at 1117, and it is unexplained why plaintiff should have a superior interest in the security, Taillie presents questions of fact sufficient to raise a meritorious defense to the foreclosure action. Prouty v. Price, 50 Barb. 344 (Sup. Ct. N.Y. Co. 1867); Rezak v. Kings Trading & Holding Co., 154 N.Y.S. 298, 301-02 (Sup. Ct. Kings Co. 1955) ("or that the amount is excessive") (citing Carpentier v. Brenham, 40 Cal. 221 (1820)); 5 Herbert T. Tiffany and Basil Jones, Tiffany Real Property §1466 ("a junior mortgage is entitled to contest the validity of a prior mortgage, or to question the amount of the debt secured thereby"); 2 Mortgages and Mortgage Foreclosure in New York, §35:23 ("junior mortgagee who will be injured by the foreclosure of the prior mortgage may contest it on any ground indicating its invalidity, . . . , or that the amount claimed thereunder is excessive"). See also, id. §17:1, §17.2; Lawrence Ave. Group, USA, Inc. v. Parnes, 134 A.D.2d at 173-74.

There is an even more fundamental problem with the mortgage that the documentary evidence presents which cannot be resolved in the context of this motion other than by ruling that Taillie has presented a colorable defense at this stage. First, as alluded to above, the elected directors did not vote on the mortgage resolutions at the April 10th meeting. Only Lawler and

Taillie voted, and the minutes of the meeting recite that they did so as shareholders. The governance of a corporation, however, is entrusted by statute with the Board of Directors, BCL §701, and although a corporation is authorized to enter into mortgage transactions, BCL §202(a)(7), the statute contemplates that "[t]he board may authorize any mortgage." BCL §911.

This substantially changed prior law, which required 2/3 shareholders approval of a mortgage, in the absence of which the mortgage was "held void for all purposes." Security Discount Assoc., Inc. v. Lynmar Homes Corp., 13 A.D.2d 389, 393 (2d Dept. 1961). See Leffert v. Jackman, 227 N.Y. 310 (1919). But under the applicable BCL provisions cited above 2/3 shareholder approval is no longer required and the board of directors may enter into mortgage transactions creating a security interest in "all or any part of the corporate property" if the certificate of incorporation does not insist on shareholder approval. BCL §911.

It has been held that "[t]he permissive language of . . . [the statute] does not pose an absolute bar to the creation of security interests without board approval." Saleh v. Saleh, 239 A.D.2d 165, 167 (1st Dept. 1997). But summary judgment was denied in that case because of "grave reservations about the conflicts possibly arising from . . . [the shareholder]'s dual role as officer of the corporations and his mother's financial agent, [and because] the propriety or impropriety of the security

agreements simply cannot be determined on the record currently before us." Id. 239 A.D.2d at 167. What the record did reveal, however, is that the plaintiff in that action, suing the corporations for enforcement of her security interest, had arranged for her son (the corporate president, director and shareholder) to assume control over her financial and business affairs. Id. 239 A.D.2d at 166. As part of a complex transaction, the son set up three corporations and "executed written security agreements on behalf of the corporations, purportedly in his capacity as president, evidencing a debt to plaintiff [his mother] in the amount of \$3 million and granting plaintiff a security interest in each of the corporation's receipts, accounts receivable, good will, and other assets." Id. 239 A.D.2d at 166. When the mother sought enforcement of her security interests the corporations defended and moved for summary judgment on the ground "that their board of directors had never been informed of or approved the execution of the security interest[s]." Id. 239 A.D.2d at 166. The trial court sustained this defense. Relying on Collision Plan Unlimited, Inc. v. Bankers Trust Co., 63 N.Y.2d 827, the Appellate Division reversed, as set forth above, and held that the corporations' BCL §911 defenses must be resolved at trial.

Although approaching the issue from a different angle, this case is similar. The board did not act at the April 10th

meeting, but plaintiff acted alone to authorize at a shareholders meeting a note and mortgage in his favor, executed the same on that day as president of the corporation, granting himself a security interest in the corporate assets, Verified Complaint Exh. B, and simultaneously executed another note and mortgage giving the only other shareholder an inferior subordinate interest. The conflict of interest of concern in Saleh and held to require a trial is therefore also present in this case. Inasmuch as the moving party need not make a showing on a motion to vacate as strong as might be required to resist a summary judgment motion, see authorities cited above, Saleh makes clear that Taillie makes enough of a showing here.

Plaintiff's reliance on the execution by the two other board members two months later of a consent on the ground that they are disinterested directors also must await fact finding. The record does not reveal how or why they were placed on the board on April 10th or whether they are truly independent or disinterested directors. Plaintiff says only, again in a memorandum, that they were not directly interested, but provides no proof of the same. Plaintiff offers no reason why a truly disinterested director would vote to discriminate between two financial backers of an enterprise by giving one a superior, and the other an inferior, security interest in their simultaneous investments in the

corporation without the latter investor's consent.² And because the holder of the superior interest is a shareholder/director, he would for the reasons stated above have the burden of proof on the matter unless the April 10th meeting is viewed as a shareholder ratification, something plaintiff has urged on the court in its memorandum (p.7) only in the alternative. Either way, Taillie is entitled to discovery, because even if the April 10th meeting can amount to shareholder ratification, Taillie may still have an opportunity to prove unfairness. See generally, Cohen v. Avers, 596 F.2d 733, 741 (7th Cir.1979) (applying New York law) ("most commentators have construed § 713 as providing only a first line of defense"), cited with approval in, Aronoff v. Albanese, 85 A.D.2d 3, 5-6 (2d Dept. 1982) ("On the other hand, compliance with section 713 of the Business Corporation Law does not automatically validate any transaction"); Blake v. Blake, 225 A.D.2d 337 (1st Dept. 1996).

Accordingly, Taillie may defend the action, obtain discovery, and each side may have an opportunity to weigh in with

² There is some protection in the law available to junior mortgagees, Aubrey Equities, Inc. v. SMZH 73rd Associates, 212 A.D.2d 397 (1st Dept. 1995); see also, Dorff v. Bornstein, 277 N.Y. 236 (1938); Lawrence Ave. Group v. Parnes, 134 A.D.2d 172 (1st Dept. 1987); Holland v. Fulbert, Inc., 49 A.D.2d 86 (3rd Dept. 1975), but the disadvantages of a junior position, particularly in a declining market, can be quite severe. See generally, 1 Bergman on New York Foreclosures § 2.16. As in Aubrey Equities, discovery is warranted. 1 Bergman on New York Foreclosures § 2.16, at pp. 2-69 to 2-70.

