

Klein v Auerbach

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February 11, 2009

Supreme Court, Suffolk County

Docket Number: 27366-98

Judge: Elizabeth H. Emerson

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**SUPREME COURT - STATE OF NEW YORK
COMMERCIAL DIVISION
TRIAL TERM, PART 44 SUFFOLK COUNTY**

PRESENT: Honorable Elizabeth H. Emerson

_____x
SAMUEL J. KLEIN, Suing as a Director of
CELLULAR DESIGN CORP.,

Plaintiff,

-against-

STEPHEN B. AUERBACH, CENTRAL RADIO
COMMUNICATIONS CORP. and CELLULAR
DESIGN CORP.,

Defendants.

_____x

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DECISION AFTER TRIAL

The plaintiff, Samuel Klein, and the defendant Stephen Auerbach were each 50% shareholders of the defendant Cellular Design Corp. (hereinafter "CDC"), and they were its only officers and directors. CDC was engaged in the business of providing two-way radio (repeater) services to customers like taxicab companies and other businesses with vehicles in the field that needed to communicate with each other and with their home base. CDC did not sell radios, telephones, or other equipment. Rather, it obtained licenses from the Federal Communications Commission (hereinafter "FCC") for the operation of communication stations on 800 MHZ and 900 MHZ frequencies and then constructed and maintained those stations.

The defendant Central Radio Communications Corp. (hereinafter "CRCC"), of which the defendant Stephen Auerbach was the sole shareholder, was in the business of selling, installing, and servicing two-way radio systems, security video systems, pagers, mobile telephones, office telephone systems, and cellular telephones. CRCC did not provide its customers with repeater services, but referred them to third-party providers such as AT&T, Cellular One, and NorComm. After the formation of CDC, Auerbach referred his CRCC

customers to CDC for repeater services.

On April 1, 1990, Klein and Auerbach entered into a stockholders agreement, which provides, in pertinent part, as follows:

No Stockholder shall devote any time or attention to or have any financial involvement in any remunerative or non-remunerative activity, except those in which he is currently involved (and only to the extent that he is currently involved), and except for passive investments and/or non-remunerative activities the management of which is not likely to interfere with or to divert such Stockholder's attention or energies from his performance hereunder (whether as Stockholder, Director, Officer or otherwise); unless, in each case, the circumstances are made known to the Board of Directors and each other member of the Board votes (or executes a Written Consent to Action) to permit such Stockholder to engage in same. Klein agrees that Auerbach may continue to be a shareholder, director and officer of Central Radio Communications Corp. and devote such time as Auerbach may determine to the business and operation of Central Radio Communications Corp. without limiting or diminishing Auerbach's rights and profits hereunder. The business of Central Radio Communications Corp. shall not be deemed or considered a diversion away from the Corporation of any corporate opportunity by Auerbach.

Auerbach was primarily responsible for obtaining users for CDC's repeater system through his sales and service activities at CRCC. Klein, on the other hand, was primarily responsible for obtaining FCC licenses and for constructing and maintaining CDC's licensed repeater facilities. This arrangement continued until the mid-1990's. Although CDC had approximately 70 FCC licenses at nine separate sites and hundreds of customers, by 1996, the relationship between Auerbach and Klein had begun to deteriorate. In 1996, Auerbach (through CRCC) was designated as an authorized Nextel representative. Because Auerbach was paid for placing and keeping customers on Nextel's radio communications network, Klein claimed that Auerbach promoted the sale of Nextel's services rather than those of CDC, thereby competing with CDC. The parties discussed a buy-out, but could not agree to mutually satisfactory terms. They sold most of CDC's assets, which primarily consisted of FCC radio licenses, to Nextel in 1996 and 1998, respectively. In 1999, CDC's remaining licenses and customers were transferred to Nextel. By an order of this court (Klein, J.) dated July 9, 2001, CDC was judicially dissolved.

In 1998, Klein commenced this derivative action pursuant to Business Corporation Law § 720 alleging, inter alia, breach of fiduciary duty, unjust enrichment, tortious interference with contract, and tortious interference with prospective economic advantage. In

their answer, the defendants asserted counterclaims sounding in breach of fiduciary duty, conversion, and unjust enrichment, among other things. By an order of this court dated February 5, 2008, a motion by the defendants for summary judgment dismissing the complaint was granted to the extent of dismissing the third cause of action and partially dismissing the fourth cause of action. Klein withdrew the remainder of the fourth cause of action at trial. By another order of this court dated February 5, 2008, the plaintiff's motion for summary judgment dismissing the defendants' counterclaims was granted to the extent of dismissing the second through fifteenth counterclaims.

The amended complaint contains eight causes of action. The first cause of action alleges that Auerbach breached his fiduciary duty to CDC by becoming an authorized Nextel representative and engaging in direct competition with CDC in violation of the shareholders agreement. The second cause of action alleges that Auerbach breached his fiduciary duty to CDC by conditioning his consent to the sale of CDC's FCC licenses to Nextel on becoming an authorized Nextel representative. The third and fourth causes of action have been dismissed and/or withdrawn. The fifth, sixth and seventh causes of action have also been withdrawn. The eighth cause of action is for Klein's legal fees, costs, and expenses.

In their answer, the defendants asserted 18 counterclaims. The first counterclaim alleges that Klein breached his fiduciary and contractual duties as a director and shareholder of CDC by failing to devote sufficient time and effort to advancing CDC's business interests, by failing to properly service CDC's customers, by failing to promote CDC's business, by failing to bring business opportunities to the attention of CDC's Board of Directors, by diverting business opportunities to CDC's competitors, by disclosing CDC's confidential business information to third parties, and by secretly forming a separate corporation with CDC's funds. The second through fifteenth counterclaims have been dismissed. The subject matter of the sixteenth counterclaim is the same \$10,000 claim that was dismissed in the fourth cause of action. The record reveals that this \$10,000 claim was included in the parties' March 21, 1997, settlement agreement, which partially resolved the fourth cause of action and also resolved the second through fifteenth counterclaims. The seventeenth counterclaim has been withdrawn. The eighteenth counterclaim is for Auerbach's legal fees, costs, and expenses.

The trial of this action commenced on March 10, 2008. It continued on March 11, 2008; March 12, 2008; March 13, 2008; March 17, 2008; March 18, 2008; March 19, 2008; March 20, 2008; and concluded on March 25, 2008. The court directed that the submission of evidence in support of the parties' respective claims for legal fees, costs, and expenses await its determination of the substantive issues. Accordingly, the parties presented evidence in support of their respective claims for breach of fiduciary duty only. Klein testified on his own behalf and called the defendant Stephen Auerbach as a witness. Auerbach, Patricia Houghton, and David Glodstein testified as witnesses for the defendants. Eight exhibits were introduced into evidence for the plaintiff and 131 for the defendants.

The law provides that officers and directors of a corporation stand in a fiduciary relationship to the corporation and owe their undivided and unqualified loyalty to the corporation (**Howard v Carr**, 222 AD2d 843, 845). They are prohibited from profiting personally at the expense of the corporation and from promoting personal interests that are incompatible with the superior interests of the corporation (**Adirondack Capital Mgt., Inc. v Ruberti Girvin and Ferlazzo, P.C.**, 43 AD3d 1211, 1215). Likewise, they may not divert and exploit an opportunity that should be deemed an asset of the corporation (**Id.** at 1215). Although participation in a business similar to that of the corporation is not precluded by an officer or director, conduct that cripples or injures the corporation is impermissible (**Howard v Carr**, *supra* at 845). Of course, a director or officer is not liable if the corporation consents to him competing with the company (18B Am. Jur. 2d, Corporations § 1841). Whether a breach of duty occurs is measured by the circumstances (**Howard v Carr**, *supra* at 845).

Preliminarily, the court notes that the parties' stockholders agreement allowed Auerbach to continue to be a shareholder, director, and officer of CRCC and to devote such time as he might determine to its business and operation. The parties' stockholders agreement also provided that the business of CRCC would not be deemed or considered a diversion away from CDC of any corporate opportunity by Auerbach. Accordingly, the court finds that the stockholders agreement allowed Auerbach to compete with CDC.

There is evidence in the record that, when Auerbach became a Nextel dealer in 1996, CDC's business was becoming obsolete, and CDC was eventually taken over by Nextel. CDC sold most of its assets, which primarily consisted of FCC radio licenses, to Nextel in 1996 and 1998, respectively. Between 1996 and May 1999, when Nextel exercised its right to purchase the remaining CDC licenses, only 25 out of approximately 600 CDC customers had left CDC and purchased Nextel equipment through CRCC. In November 1999, substantially all of CDC's remaining customers were transferred to Nextel. Under these circumstances, the court is not persuaded that Auerbach's becoming a Nextel dealer crippled or injured CDC.

The doctrine of corporate opportunity provides that corporate fiduciaries and employees cannot, without consent, divert and exploit for their own benefit any opportunity that should be deemed an asset of the corporation (**Alexander v Fritzen**, 147 AD2d 241, 246). Various tests have been used to determine whether a venture should be considered a corporate opportunity. One is whether the corporation has an interest or tangible expectancy in the opportunity. The second is whether an opportunity is the same as, necessary for, or essential to the line of business of the corporation. The third examines whether, at the beginning of the employment or fiduciary relationship, the parties understood or it is reasonable to conclude that the parties understood that the employee, officer, or director would simultaneously pursue other interests, even ones related to or in direct competition with the business of the corporation (**Id.** at 247-248).

As previously discussed, the parties' shareholders agreement specifically provided

that Auerbach would continue to be a shareholder, director, and officer of CRCC and that the business of CRCC would not be deemed or considered a diversion away from CDC of any corporate opportunity by Auerbach. Additionally, the record reveals that the two companies were engaged in different aspects of the same business. CDC's business was limited to providing two-way radio or repeater services to business and industrial users. CDC did not sell equipment, and it only sold repeater services to businesses that could be licensed by the FCC. CRCC's business, on the other hand, was much broader and included the sale and installation of radios, telephones, and other equipment. In addition to two-way radios, CRCC sold security video systems, pagers, mobile telephones, office telephone systems, and cellular telephones. The Nextel dealership was a retail equipment dealership that sold Nextel telephones to the general public for individual and commercial use. Klein repeatedly testified at trial that a Nextel dealership was of no benefit or value to CDC. Under these circumstances, the court is unpersuaded that Auerbach usurped an opportunity that would have been an asset to CDC.

Finally, the court notes that, although the two businesses complemented one another, Auerbach was under no obligation to place CRCC's repeater customers on CDC's system. Before becoming a Nextel dealer, Auerbach was a NorComm dealer, a Cellular One dealer, a Geotek dealer, an AT&T dealer, and a NYNEX Mobile dealer without any objection by Klein. While there is evidence in the record that some Nextel telephones could be used like two-way radios, thereby competing with CDC, the number of CDC customers who actually purchased Nextel equipment from CRCC was small.

In sum, the court finds that Klein has failed to establish by a preponderance of the evidence that Auerbach breached his fiduciary duty to CDC by becoming a Nextel dealer. Moreover, in view of the conflicting testimony regarding the events leading up to Auerbach's becoming a Nextel dealer, the court finds that Klein has failed to establish by a preponderance of the evidence that Auerbach breached his fiduciary duty to CDC by conditioning his consent to the sale of CDC's FCC licenses on becoming a Nextel dealer. Accordingly, the court finds in favor of the defendants on the first two causes of action, and remaining causes of action are dismissed. The trial motion by the defendants to dismiss the first two causes of action is denied as academic.

Turning to the counterclaim, the court notes preliminarily that Patricia Houghton, who testified for the defendants, was an interested witness. Houghton testified that, after working for CDC from 1991 until 1999, she began working for Auerbach at CRCC in 2000. She was still employed full-time by CRCC at the time of trial, and she has a small ownership interest in Stephen Auerbach Associates, another entity of which Auerbach is the principal. Houghton testified that, since her duties at CRCC were scaled down, she has performed services for CRCC and Auerbach in connection with this litigation. She testified that she attended Klein's deposition as well as the depositions of the non-party witnesses, including those of the out-of-state-witnesses. She further testified that she assisted Auerbach's attorney in the conduct of the depositions and in the production of documents. Additionally, she prepared reports and

schedules that were introduced into evidence at trial. In view of her extensive role in the preparation of this case for trial and her employment by CRCC and Auerbach, and after hearing her testimony and observing her demeanor, the court finds that it was impossible for Patricia Houghton to give unbiased testimony.

At trial, the defendants made several claims in connection with their counterclaim for breach of fiduciary duty that were outside the scope of the pleadings. The defendants claimed that Klein participated in an exchange of frequencies or “frequency swap” that did not result in any benefit to CDC, that Klein misappropriated CDC cash and used CDC funds for personal expenses, that Klein bartered CDC’s repeater services in exchange for residential landscaping services, and that Klein performed professional services for others for which CDC was not compensated. While the court permitted testimony regarding these unpleaded allegations at trial, the court declines to consider the additional allegations raised by the defendants for the first time in their reply papers (*cf.*, **Dannasch v Bifulco**, 184 AD2d 415, 417; **Rift v Lennox Hill Hosp.**, 182 AD2d 560, 562).

Generally, the actions of directors and majority shareholders are protected by the business judgment rule, which bars judicial inquiry into the actions of corporate directors taken in good faith, in the exercise of honest judgment, and in the lawful and legitimate furtherance of corporate purposes (*see*, **Auerbach v Bennett**, 47 NY2d 619, 629). The business judgment rule is necessary to avoid judicial second-guessing of corporate decisions and provides protection to directors when a decision is made in good faith and after reasonable investigation (*see*, **Lippman v Shaffer**, 15 Misc 3d 705, 711; **Shapiro v Rockville Country Club**, 2 Misc 3d 1002[A], *citing Auerbach v Bennett*, *supra*). Absent a showing of breach of fiduciary duty to the corporation, judicial inquiry into the actions of corporate directors is prohibited, even though the results show that what the directors did was unwise or inexpedient (*see*, **Jones v Surrey Coop. Apts.**, 263 AD2d 33, 36).

Inquiry into claims of fraud and self-dealing are permitted only when a factual basis exists to support such claims (**Id.** at 36). It is the plaintiff who bears the burden of making the requisite showing that the directors breached their fiduciary duties (**Id.** at 36-37). A plaintiff may overcome the presumption of the business judgment rule by demonstrating that no person of ordinary sound business judgment would say that the corporation received fair benefit (*see*, **Aronoff v Albanese**, 85 AD2d 3, 5). If ordinary businessmen may differ on the sufficiency of consideration received by the corporation, the court will uphold the transaction (**Id.** at 5-6).

The court finds that Klein’s “frequency swap” was protected by the business judgment rule. The record reveals that, sometime between 1996 and 1998, Klein exchanged three frequencies located in Manhattan and Morristown, New Jersey, for three frequencies that could not be used at those locations, but could be used in Selden, New York. Houghton testified that as a result of the swap, CDC was unable to license the new frequencies for a period of two

years because of regulatory and other problems. The defendants contend that Klein gave away three clean, commercially usable frequencies, capable of generating income for CDC in exchange for three impaired frequencies that could not be licensed for two years and, even then, not at the same locations. Although there is evidence in the record that the swap was related to an earlier frequency swap with Jersey Central Power & Light, the defendants dispute that the two swaps were related and argue instead, “[W]hile the swap may have benefitted someone other than CDC, there was no benefit to CDC. Trading assets with friends without benefit to CDC is a breach of Klein’s fiduciary duty.” The record reveals that the three frequencies in question were ultimately licensed and sold to Nextel. Thus, although the swap may have been unwise or inexpedient, it cannot be said that CDC did not benefit therefrom. In any event, the defendants vague and conclusory allegations of self-dealing are insufficient to overcome the presumption of the business judgment rule.

Prior to March 21, 1997, the parties had a history of charging personal expenses to CDC’s corporate account. On that date, the parties entered into a voluntary, mutual accounting in which they agreed to settle or equalize any previously identified personal expenses paid with CDC funds. They also agreed that any future personal expenditures paid with CDC funds would be identified as such and equalized at a later date. Shortly thereafter, Klein asked Houghton, who was CDC’s bookkeeper, among other things, to pay CDC’s corporate attorneys \$273. He did not have an invoice for the bill, but subsequent investigation by Houghton revealed that the expense was not a corporate expense. Houghton testified that, when Auerbach confronted Klein about the expenditure, Klein said he had forgotten that the expense was personal. The court finds that, under these circumstances, the defendants have failed to establish by a preponderance of the evidence that Klein was not acting in good faith.

On May 26, 1997, Klein wrote a check from CDC’s corporate account in the amount of \$1,735.16. The payee was “Small Business in Telecommunications,” an organization to which Klein belonged. The \$1,735.16 was for the salary of the director of such organization, which was divided among 12 contributing parties. The defendants contend that this expense was personal in nature. However, the record reveals that the invoice was addressed to CDC, not Klein. The court finds that, under these circumstances, the defendants have failed to establish by a preponderance of the evidence that this expense was personal.

Klein subsequently gave Houghton a bill dated July 21, 1997, from CDC’s corporate attorneys in the amount of \$1,623.72 and told her to pay it with CDC funds. Houghton questioned the bill, which was for the preparation and execution of wills for Klein and his wife, and showed it to Auerbach. On Auerbach’s instructions, Houghton voided the check that she had prepared to pay the bill. The court finds that, contrary to the defendants’ contention, there was no misappropriation of CDC funds. Moreover, in view of the parties’ earlier agreement that personal expenses would be identified and equalized at a later date, the court is unpersuaded that Klein was acting in bad faith.

The defendants contend that Klein misappropriated cash in the amount of \$11,534.41, which was paid to CDC by its customers. In support thereof, the defendants rely on the testimony Patricia Houghton and on documents prepared by her from CDC's banking and business records long after the events memorialized therein. In view of her clear bias in favor of Auerbach, the court is unable to credit Houghton's testimony in this regard or the exhibits prepared by her. Additionally, Houghton testified that she regularly received a portion of her salary in cash during the period in question, further eroding her credibility. In any event, the court finds that the defendants have failed to establish by a preponderance of the evidence that Klein was the one who misappropriated the cash or that it was not used for corporate purposes.

The defendants produced evidence that, between 1994 and 1997, Klein bartered repeater services for residential landscaping services from a CDC customer, J. Ratto Landscaping. In deposition testimony that was read into the record at trial, Klein testified that Auerbach had made an arrangement with Ratto to do their lawns in exchange for radio service. At trial, Auerbach admitted that he had bartered a radio for lawn services, but claimed that the radio came from CRCC, not CDC. The record reflects that, although the parties did not always observe corporate formalities, decisions were made by mutual consent. Accordingly, the court finds that the defendants have failed to establish by a preponderance of the evidence that Auerbach did not consent, either implicitly or explicitly, to the exchange of residential landscaping services for repeater services.

The defendants produced a fax dated May 30, 1997, from Andre Cote of Industrial Telecommunications Industry, a frequency coordinator, to Klein. Attached thereto are two letters dated May 28 and 30, 1997, respectively, concerning licenses in which CDC did not have an interest. In deposition testimony that was read into the record at trial, Cote testified that he did not know why the letters were faxed to Klein, unless Klein represented someone who had applied for the licenses referenced therein. The defendants contend, based on this testimony, that Klein was providing services to others without compensation to CDC. The court finds that Cote's explanation of why the letters may have been faxed to Klein is entirely speculative. Moreover, Houghton testified that the frequencies enumerated in the letters were part of a group of 16 frequencies that had been brought to Klein's attention earlier and on which CDC had been given an opportunity to bid. The court finds that, under these circumstances, the defendants have not established by a preponderance of the evidence that Klein performed services for third parties for which CDC was not compensated.

The defendants produced a series of documents that Klein faxed to a competitor in early 1996, at about the same time that an FCC auction was being held. The defendants contend that Klein had no right to share the documents in question with a competitor. The defendants do not contend, however, that the documents contained any CDC trade secrets or proprietary information. Moreover, Houghton testified that the documents, applications for participation by bidders in a public FCC frequency action, were available to the general public on the FCC's data base. The court finds that, under these circumstances, the defendants have failed to establish by a

