

Sieger v Zak

2009 NY Slip Op 31308(U)

June 10, 2009

Supreme Court, Nassau County

Docket Number: 19978-05

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 3
NASSAU COUNTY

STUART M. SIEGER and
DAVID R. SPENCER,

Plaintiffs,

INDEX No. 19978/05

MOTION DATE: May 1, 2009
Motion Sequence #006, 007

-against-

LOUIS ZAK and POWER SYSTEMS
INTERNATIONAL, INC.,

Defendants.

The following papers read on this motion:

Notice of Motion.....	XX
Affirmation/Affidavit in Opposition.....	XX
Supplemental Affirmation.....	XX
Reply Affidavit	X
Supplemental Reply Affirmation.....	X
Memorandum of Law.....	XXXX
Reply Memorandum of Law.....	XX
Rule 19-A Statement.....	XX
Rule 19-A Counter Statement.....	X

This motion, by defendants, for summary judgment dismissing the complaint and for partial summary judgment on defendants' counterclaim for indemnity is **denied**; and plaintiff's motion for partial summary judgment on their first and fifth causes of action is **denied**; and plaintiffs' motion for summary judgment dismissing defendants' counterclaims is **granted** as to the third counterclaim and otherwise **denied**.

This action for fraud and breach of fiduciary duty arises from the buyout by the majority shareholder of the interests of the minority shareholders in a close corporation. Plaintiffs Stuart Sieger and David Spencer and defendant Louis Zak were the sole shareholders of defendant PowerSystems International, Inc. The corporation was engaged in the business of supplying generators and other equipment to the defense department. 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. In the stock purchase agreement, the sellers represented that by reason of their "business expertise," they had the "necessary expertise and capacity to evaluate the merits and risks of the purchase price contemplated by this agreement" and "the capacity to protect [their] own interests in connection with the transactions...." The sellers further represented that they had access to the financial statements of the company and "an opportunity to evaluate the company's business, management, financial affairs and prospects." The agreement further provides that it was negotiated "at arm's length."

In the agreement, the sellers acknowledged that the value of the company may be "substantially greater than \$10.2 million," the "implied value" on which the purchase price had been based. Additionally, the sellers represented that they had not relied upon any representation of the company or the purchaser, except as set forth in the agreement.

The company and the purchaser represented that there was "no pending agreement ... or offer relating to a sale of substantially all, or a substantial portion, of the assets or stock of the company." The company and the purchaser further represented that in the past year there had been no "substantive discussions related to a possible sale transaction," except for i) discussions with Bea Maurer, Inc., a principal customer of PowerSystems, with whom plaintiffs were familiar, and ii) discussions with investment bankers concerning attempts to raise capital to fund the purchase of plaintiffs' stock.

The representations of the company and the purchaser incorporated a letter to plaintiffs dated June 7, 2004 from John Magee, a consultant who had been retained by PowerSystems. In his letter, Magee summarized the negotiations with Bea Maurer and also his discussions with "three investment bankers that specialize in middle market M&A transactions." More specifically, Magee stated that an investment banker, McColl Partners, had estimated the value of the company based on 2003 earnings to be \$8-10

million. Magee stated that McColl thought the valuation range could be “substantially higher,” but only if PowerSystems were able to “replicate the first quarter results for the rest of the year and address the other issues/questions that make it very difficult to value and sell” the company. Magee stated that “McColl advised that even if they could find a buyer now, the company would not, in their opinion, sell for more than \$10 million.” Magee also stated that another investment banker, Jeffries Quarterdeck, had expressed an interest in “beginning a process to market the sale of the entire company.”

The parties agreed to indemnify each other for any loss arising from their failure to “perform or observe” any provision of the agreement or breach of any representation or warranty. Finally, the parties released each other from any and all claims whatsoever, “excepting only the terms of this stock purchase agreement.”

After acquiring plaintiffs’ interests in PowerSystems, Zak subsequently sold the entire company to Hunter Defense Technologies for approximately \$40 million. Plaintiffs claim that Zak’s false representations and withholding of information led them to sell their interests at a grossly inadequate price. Among the information allegedly withheld was a May 2004 report from Jeffries Quarterdeck, valuing the company at \$35-40 million. While plaintiffs were informed of merger discussions with Bea Maurer, they were not told about the proposed “merger formula,” which allegedly valued their stock on a favorable basis. Nor were plaintiffs told that Maurer claimed to have rejected an offer to purchase her company for \$25 million or that she was demanding a \$75 million price.

In their amended complaint, plaintiffs assert claims against Zak for breach of fiduciary duty, fraud, constructive fraud, mismanagement/self-dealing, and breach of the stock purchase agreement. Plaintiffs also assert claims for fraud and constructive fraud against PowerSystems. Plaintiffs seek damages in an amount equal to the profit which Zak earned on their shares. Plaintiffs also seek punitive damages in the amount of \$30 million, except with respect to their breach of contract claim.

Defendants are counterclaiming for breach of contract on the theory that by bringing the present action seeking additional compensation, plaintiffs breached the release provision in the stock purchase agreement. Defendants argue that, by alleging that they relied upon misleading information provided by Zak, plaintiffs breached their representation that they had not relied upon any representation of the purchaser. Defendants argue that, by alleging that Zak was acting as a fiduciary, plaintiffs breached the provision that the agreement was negotiated at arm’s length. Defendants also

counterclaim for contractual indemnity under the indemnity provision in the stock purchase agreement. Finally, defendants counterclaim for breach of fiduciary duty on the theory that plaintiffs failed to disclose to Zak "information in their possession regarding the potential future value" of PowerSystems.

Defendants are moving for summary judgment dismissing the complaint and for partial summary judgment on their counterclaim for contractual indemnity. Defendants argue that pursuant to the terms of the stock purchase agreement, the parties "renounced" their respective fiduciary duties. Defendants stress that plaintiffs expressly disclaimed reliance upon Zak's representations pursuant to the terms of the contract. Defendants argue that plaintiffs' claims are barred by the release provision in the agreement. Alternatively, defendants argue that even if Zak was a fiduciary, plaintiffs' claims for fraud and breach of fiduciary duty are insufficient because, as sophisticated investors, plaintiffs' reliance was not reasonable. Similarly, defendants argue that plaintiffs cannot establish that their damages were caused by defendants' breach of the stock purchase agreement because plaintiffs failed to conduct their own investigation.

Defendants argue that Zak's representations did not constitute fraud because they related to "future events," the value of PowerSystems based on projected future earnings, rather than present facts. Defendants further argue that the reports from the investment bankers were simply "opinions," too speculative to give rise to a fraud claim. Alternatively, defendants argue that, even if Zak committed fraud, PowerSystems cannot be liable for Zak's misconduct because plaintiffs knew that Zak was not acting on behalf of the corporation. Finally, defendants argue that plaintiffs' claim for punitive damages fails as a matter of law because their conduct was not sufficiently egregious and the claim arises from a private business transaction.

In opposition, plaintiffs argue that defendants cannot rely upon a release or disclaimer in the stock purchase agreement because such provisions were themselves "procured through a breach of fiduciary duty." Plaintiffs assert that they reasonably relied upon Zak's providing them with the information needed to evaluate the company. Plaintiffs further argue that Zak not only concealed information but made specific factual misrepresentations as to information obtained from investment bankers. Plaintiffs argue that PowerSystems can be liable for the fraud of both Zak and Magee because both agents were acting within the scope of their authority. Plaintiffs argue that their breach of warranty claim is legally sufficient because reasonable reliance is not an element of that cause of action. Plaintiffs move for partial summary judgment on their first and fifth

causes of action and for summary judgment dismissing defendants' counterclaims.

The minority shareholders in a close corporation are owed a fiduciary duty by the majority shareholder (*O'Neill v Warburg, Pincus & Co.*, 39 AD3d 281, 1st Dept., 2007). When a fiduciary, in furtherance of his individual interests, deals with the beneficiary of the duty in a matter relating to the fiduciary relationship, the fiduciary is strictly obligated to make full disclosure of all material facts (*Blue Chip Emerald v Allied Partners Inc.*, 299 AD2d 278, 1st Dept., 2002). In negotiating such a transaction, the fiduciary is obligated to disclose any information that could reasonably bear on the beneficiary's consideration of the fiduciary's offer (Id). In negotiating with plaintiffs concerning the purchase of their interests in PowerSystems, Zak was under a fiduciary duty to disclose to plaintiffs any information that could reasonably bear on their valuation of the company.

A specific disclaimer clause cannot defeat a claim of fraud if the defendant owes the plaintiff a fiduciary duty and breaches that duty by failing to disclose information that could reasonably bear on the plaintiff's consideration of the transaction (*Dube-Forman v D'Agostino*, 61 AD3d 1255, 877 NYS2d 740, 3d Dept., 2009). The fiduciary cannot relieve himself of the duty of full disclosure by withholding the very information the beneficiary needs in order to make a reasoned judgment whether to agree to the proposed contract (Id). Similar to disclaimer provisions, plaintiffs' representations as to "no reliance" and the agreement being negotiated at "arms' length" are unavailing to relieve defendants from liability for fraud and breach of fiduciary duty claims.

To establish a **prima facie** case for fraud, plaintiff must prove that defendant made a representation as to a material fact, such representation was false, and defendant intended to deceive plaintiff (*Ross v. Louise Wise Services*, 8 NY3d 478, 488, 2007). Additionally, plaintiff must prove that he believed and justifiably relied upon defendant's statement and was induced by it to engage in a certain course of conduct and that, as a result of such reliance, plaintiff sustained pecuniary loss (Id). The elements of constructive fraud are the same as those for actual fraud, except that the element of scienter is replaced by a fiduciary or confidential relationship between the parties (*Klembczyk v DiNardo*, 265 AD2d 934, 4th Dept., 1999).

The issue of justifiable reliance is generally one of fact (*Braddock v Braddock*, 60 AD3d 84, 88, 1st Dept., 2009). However, a sophisticated investor who acquires a business is under an affirmative duty to protect himself from misrepresentations by the seller by investigating the business he is acquiring and the details of the transaction

(*Global Minerals & Metals Corp. v Holme*, 35 AD3d 93, 100, 1st Dept., 2006). Where the purchaser fails to carry out his obligation of “due diligence,” the court may rule as a matter of law that the purchaser’s reliance was not justifiable (Id).

However, where the purchaser owes a fiduciary duty to the seller, the seller is not under a similar duty of due diligence, unless the seller has sufficient information to be on notice that additional inquiry is necessary (*Litman v McGee*, 54 AD3d 14, 18, 1st Dept., 2008). Moreover, the court may consider the purchaser’s position of trust in determining whether the seller’s reliance was justifiable.

To prove a breach of fiduciary duty, the plaintiff must establish that the misrepresentation or other misconduct by the fiduciary was the direct and proximate cause of the losses claimed (*Northbay Construction Co. v Bauco Construction Corp.*, 38 AD3d 737, 738, 2nd Dept., 2007). Thus, the issue of causation takes the place of reliance in a breach of fiduciary duty cause of action. In an action for breach of contract, defendant’s breach must similarly be a proximate cause of the damages sustained by plaintiff (*Lyon v Belosky Construction*, 247 AD2d 730, 3d Dept., 1998). As is the issue of reliance, the issue of proximate cause is ordinarily a question of fact (*Schlanger v Doe*, 53 AD3d 827, 3d Dept., 2008).

On a motion for summary judgment, it is the proponent’s burden to make a prima facie showing of entitlement to judgment as a matter of law, tendering sufficient evidence to demonstrate the absence of any material issues of fact (*JMD Holding Corp. v. Congress Financial Corp.*, 4 NY3d 373, 384, 2005). Failure to make such a prima facie showing requires denial of the motion, regardless of the sufficiency of the opposing papers (Id). However, if this showing is made, the burden shifts to the party opposing the summary judgment motion to produce evidentiary proof in admissible form sufficient to establish the existence of material issues of fact which require a trial (*Alvarez v. Prospect Hospital*, 68 NY2d 320, 324, 1986).

Defendants’ representation that there had been no “substantive discussions” concerning a sale transaction, even as qualified by Magee’s letter, was clearly false because the substance of the Jeffries Quarterdeck report was not disclosed. Since the Jeffries Quarterdeck report valued PowerSystems at almost four times the value “implied” by the stock purchase agreement, defendants’ misrepresentation was clearly material. Moreover, because the Jeffries Quarterdeck report constituted a present valuation of the company, it was a present statement of fact and not a false representation as to a future

event. Thus, plaintiffs have alleged a legally sufficient fraud claim.

On defendants' motion for summary judgment dismissing plaintiffs' claim for breach of fiduciary duty, it is defendants' burden to establish **prima facie** that their misrepresentations as to "no substantive discussions" were not a substantial factor contributing to plaintiffs' entering into the stock purchase agreement. With respect to plaintiffs' fraud claim, it is defendants' burden to establish **prima facie** that plaintiffs' reliance was not justifiable. Similarly, with respect to plaintiff's claim for breach of contract, it is defendants' burden to establish that their breaches of the warranties concerning no "substantive discussions" were not a proximate cause of plaintiffs' losses in the form of diminished compensation for their stock. The court concludes that defendants have not met their various burdens.

In view of Zak's position of trust and the parties' longstanding relationship, the court cannot conclude that it was unreasonable for plaintiffs to rely upon Zak's (i.e. Magee's) representations as to the investment bankers' valuation of the company. Nor can the court conclude that defendants' misrepresentations were not a substantial factor in plaintiffs' entry into the agreement. Defendants' motion for summary judgment dismissing the complaint is **denied** as to plaintiffs' claims against Zak for breach of fiduciary duty, fraud, constructive fraud, mismanagement/self dealing, and breach of contract. Because these various claims are viable, defendants' motion for partial summary judgment on its counterclaim for contractual indemnity is similarly **denied**.

Although PowerSystems joined in Zak's representations, the corporation could act, and entertain an intent to deceive, only through its officers. Thus, the court must consider whether PowerSystems may be vicariously liable for Zak's fraud. "The doctrine of respondeat superior renders an employer vicariously liable for torts committed by an employee acting within the scope of the employment. Pursuant to this doctrine, the employer may be liable when the employee acts negligently or intentionally, so long as the tortious conduct is generally foreseeable and a natural incident of the employment. If, however, an employee for purposes of his own departs from the line of his duty so that for the time being his acts constitute an abandonment of his service, the master is not liable" (*RJC Realty v Republic Ins. Co.*, 2 NY3d 158, 164, 2004). Whether a particular act was within the scope of employment is ordinarily a factual question (*Riviello v Waldron*, 47 NY2d 297, 303, 1979).

Since defendants are moving for summary judgment dismissing plaintiffs' fraud

claim against PowerSystems, the burden of establishing **prima facie** that Zak was not acting within the scope of his employment is on defendants. Defendants argue that Zak was not acting within the scope of his employment in purchasing plaintiffs' interest because he purchased the stock "for his own account." However, the court notes that the Jeffries Quarterdeck report valued PowerSystems on the assumption that the minority interest would be acquired before attempting to market the company. Thus, Zak's negotiating with plaintiffs for their stock was generally foreseeable. Moreover, since transactions with respect to the shares of a corporation are acts "commonly done" by the principal manager, Zak's negotiation with plaintiffs may be seen as a natural incident of his employment (*Riviello v Waldron*, 47 NY2d at 303). Since Zak owed plaintiffs a fiduciary duty, PowerSystems had the right to expect that Zak would comply with his duty of full disclosure. However, in view of business ethics generally, the court cannot conclude that misleading plaintiffs as to the value of their stock was such a "departure from normal methods of performance" that PowerSystems cannot be vicariously liable (Id). Thus, defendants have not carried their burden of establishing that Zak was not acting within the scope of his employment. Defendants' motion for summary judgment dismissing plaintiffs' fraud and constructive fraud claims against PowerSystems is **denied**.

Punitive damages are not recoverable for an ordinary breach of contract as their purpose is not to remedy private wrongs but to vindicate public rights (*Rocanova v Equitable Life Assurance*, 83 NY2d 603, 613, 1994). In tort actions, punitive damages may be awarded where defendant's wrongdoing has been intentional and deliberate, and has the character of outrage frequently associated with crime (*Prozeralik v Capital Cities Communications*, 82 NY2d 466, 479, 1993). There must be circumstances of aggravation, such as spite or malice, or a fraudulent or evil motive on defendant's part, or such a conscious and deliberate disregard of the interests of others that the conduct may be called wilful or wanton (Id). Since breach of fiduciary duty is a tort, punitive damages may be recovered on a breach of fiduciary duty claim, if plaintiff makes the required showing (*Don Buchwald & Assoc. v Rich*, 281 AD2d 329, 1st Dept., 2001). Where the underlying cause of action is based upon fraud, punitive damages are available only if defendant acted in a malicious, vindictive, or reckless manner (*Spano v Central School District*, 877 NYS2d 163, 168, 2nd Dept., 2009).

On this motion for summary judgment, the burden is on defendants to establish, **prima facie**, that their conduct was not so outrageous as to justify a punitive damages award. When the June 7, 2004 letter from Magee is read in the light of the valuation

report from Jeffries Quarterdeck, it appears that the letter was deliberately crafted to mislead the plaintiffs as to the value of their stock. Although the letter states that Jeffries Quarterdeck had expressed interest in "beginning a process," the investment banker had actually evaluated the company at nearly four times the price upon which the stock purchase agreement was based. In view of the fraudulent nature of Magee's letter, defendants have not carried their burden of establishing that their conduct was not sufficiently outrageous to support a punitive damages award. Defendants' motion for summary judgment is **denied** as to plaintiffs' punitive damages claim.

With respect to plaintiffs' motion for partial summary judgment as to their first and fifth causes of action, it is plaintiffs' burden to establish their **prima facie** entitlement to judgment on their breach of fiduciary duty and breach of contract claims. As to plaintiffs' claim for breach of fiduciary duty, plaintiffs must establish not only that Zak breached his fiduciary duty but also that Zak's misconduct was the direct and proximate cause of plaintiffs' receiving inadequate compensation for their shares. As to plaintiffs' claim for breach of contract, plaintiffs must establish not only that Zak breached his warranty as to "no substantive discussions," but also that his breach was a proximate cause of the losses plaintiffs sustained.

A reasonable minority shareholder, with knowledge that the company had been evaluated by an investment banker, might have demanded to see the investment banker's report rather than relying upon excerpts paraphrased by the consultant. Thus, plaintiffs arguably had sufficient information to put them on notice that additional inquiry was necessary. Moreover, in view of the information provided by Zak, a reasonable minority shareholder might have retained his own investment banker to evaluate the company. Thus, the court cannot conclude as a matter of law that plaintiffs' reliance upon Zak's representations was justifiable or that plaintiffs' damages were caused by Zak's breach of the warranty provision of the stock purchase agreement. Plaintiffs' motion for partial summary judgment as to liability on their breach of fiduciary duty and breach of contract claims is **denied**.

With respect to plaintiffs' motion for summary judgment dismissing defendants' counterclaims, it is plaintiffs' burden to establish, **prima facie**, that the counterclaims are without merit. Plaintiffs have failed to establish their **prima facie** entitlement to judgment on their claims for breach of fiduciary duty and breach of contract. Thus, plaintiffs have failed to establish, **prima facie**, that defendants' counterclaims for breach of the stock purchase agreement and contractual indemnity are without merit.

SIEGER, et al v ZAK, et al

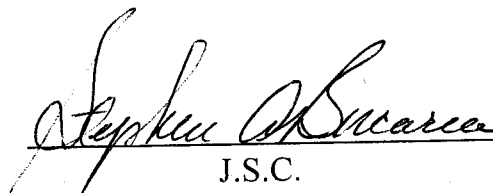
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The Court reaches a contrary conclusion with respect to defendants' counterclaim for breach of fiduciary duty. "The relationship between shareholders in a close corporation...is akin to that between partners and imposes a high degree of fidelity and good faith" (*Brunetti v Musallam*, 11 AD3d 280, 1st Dept., 2004). Thus, plaintiffs arguably owed a duty to Zak to disclose to him information in their possession regarding the value of the company. However, plaintiffs have established, **prima facie**, that they had no information bearing on the value of PowerSystems which they did not disclose. Accordingly, the burden shifts to defendants to show a triable issue as whether plaintiffs breached a fiduciary duty. Since defendants have not carried their burden, plaintiffs' motion for summary judgment dismissing defendants' third counterclaim, alleging breach of fiduciary duty, is **granted**.

This shall constitute the decision and order of the court.

Counsel for all parties shall appear for a Pre-Trial conference on August 11, 2009 at 9:30 a.m. in Chambers of the undersigned.

Dated JUN 10 2009


J.S.C.

ENTERED

JUN 11 2009

**NASSAU COUNTY
COUNTY CLERK'S OFFICE**